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Economic Effects of Increasing the Tax Rates on Capital Gains and Dividends

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On December 31, 2010, the low tax rates on capital gains and dividends enacted in 2003 will increase to the higher level that applied prior to that year. Many economists agree that the expiration of these tax cuts will discourage investment and slow economic growth. The United States already has one of the world's highest capital gains tax rates.

This paper examines the economic effects of allowing the tax rates on long-term capital gains and dividend income to increase in 2011. Because the economy would suffer from these tax increases, Congress should act now to make permanent the existing tax rates for capital gains and dividends.

Our analysis indicates that higher tax rates on these forms of income would do serious economic harm.[1] For example:

- The slower economy causes employment to shrink by 270,000 job in 2011 and 413,000 in 2018. Similar job losses continue for the next seven years of our model's forecast horizon of 2008 through 2018.
- Economic output as measured by gross domestic product (GDP) after inflation would fall by $44 billion in 2011 and $50 billion in 2012 from the levels that the economy would attain without this policy change.
- These economic effects would be vividly evident in take-home pay. Personal income after taxes would decline by $113 billion after inflation in 2011 and $133 billion after inflation in 2012 when compared, again, to levels that would likely prevail without tax rates going back up.

Capital Gains and Economic Growth. Capital gains taxes are voluntary, paid only when appreciated capital assets are sold. President Bush reduced capital gains taxes on the sale of taxable assets that have been held for longer than one year (so-called long-term assets). Short-term taxable assets, held for less than a year, are taxed at a rate that usually is higher than the 15 percent long-term capital gains tax rate under the President's tax reduction.

The current long-term rate does not appear to discourage investors significantly from selling assets. However, high capital gains taxes do create what is called a "lock-in effect," where investors avoid onerous taxation by not selling assets. Econometric analysis shows a strong link between higher capital gains tax rates and the lock-in effect.[2] Investors are willing to hold onto investments for a longer period of time in order to pay the lower taxes on long-term capital gains.

If high taxes make investors unwilling to sell taxable assets, the lock-in effect can reduce economic growth by preventing the reallocation of capital in low-performing investments to more profitable ventures. Economic growth slows as new businesses find it difficult to acquire start-up or expansion capital.

This paper, in its entirety, can be found at:
www.heritage.org/Research/Taxes/wm1891.cfm

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Though reducing the tax on capital gains is beneficial to the economy, a better tax policy would reduce the tax rate on all capital investment. A broad reduction in the taxation of capital will lead to more investment and more capital stock. As the Congressional Budget Office notes, "Reductions in capital taxation increase the return on investment and therefore the formation of capital. The resulting increase in the capital stock yields greater output and higher incomes throughout much of the economy."[3]

Lower Taxes on Dividends. The Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) of 2003 set the taxes for qualified dividends at the same rate as taxes for long-term capital gains. This change ensures that income from different investments are treated the same. The appreciation of capital gains is thus no more desirable than dividend income from investment.

Before JGTRRA, the average dividend marginal tax rate was 28 percent, or almost twice that of the current long-term capital gains tax rate of 15 percent.[4] This made retained earnings (capital gains) a more popular investment choice than distributed earnings (dividends). The focus on stock appreciation contributed to accounting scandals at companies like Enron and WorldCom. At the other end of the income spectrum, high taxes on dividends lowered the income of retirees who depend on dividend income.

Companies responded to the change in the dividend tax rates by increasing dividend payments, and some, such as Microsoft, disbursed dividend payments for the first time.[5] Investors now have more choices when making investment decisions between companies that pay dividends or rely on capital appreciation to reward investors.

Lowering taxes on dividends also reduced the double taxation of corporate income, as this dividend income was already taxed at the corporate level. This makes the tax code fairer and also encourages economic growth by reducing the tax on capital. Previous research by the Heritage Center for Data Analysis indicates that even firms that do not distribute dividends could have lower capital costs and increased investment.[6]

Historical Treatment of Capital Gains. Throughout most of the 20th century, capital gains either were taxed at a lower rate than other income or were only partially exposed to taxation. The encouragement of capital formation and investment, the offset of double taxation of corporate income, the offset of inflation's effect on capital gains, and the encouragement of risk-taking all justified this discrepancy.

The Tax Reform Act of 1986 ended the differential treatment of capital. Capital gains realizations spiked 91 percent during 1986, the last year of the lower capital gains tax rate. They then declined 55 percent in 1987 and did not recover to the pre–tax hike level for almost a decade.[7] In 1990, capital gains tax rates, then at 28 percent, were again lower than the top marginal tax rate after the latter increased to 31 percent. This differential grew after the 1997 capital gains tax cut.

1. These estimates are based on a simulation of these tax increases using the U.S. Macroeconomic Model of Global Insight, Inc. The Global Insight model is used by private-sector and government economists to estimate how changes in the economy and public policy are likely to affect major economic indicators. The methodologies, assumptions, conclusions, and opinions presented here are entirely the work of analysts at The Heritage Foundation's Center for Data Analysis. They have not been endorsed by, and do not necessarily reflect the views of, the owners of the Global Insight model.
2. Janet A. Meade, "The Impact of Differential Capital Gains Tax Regimes on the Lock-In Effect and New Risky Investment Decisions," *The Accounting Review*, Vol. 65, No. 2 (April 1990), pp. 406–431.
3. Congressional Budget Office, "Capital Gains Taxes and Federal Revenues," October 9, 2002.
4. Rea S. Hederman, Jr., and William W. Beach, "Make the Dividend and Capital Gains Tax Rates Permanent to Keep the Economy Growing," Heritage Foundation *Backgrounder* No. 1914, February 16, 2006, at *www.heritage.org/Research/Taxes/bg1914.cfm.*
5. Jennifer Blouin, Jana Ready, and Douglas Shackelford, "Did Dividends Increase Immediately After the 2003 Reduction in Tax Rates?" National Bureau of Economic Research *Working Paper* No. 10301, February 2004.
6. Norbert J. Michel, Ralph A. Rector, and Alfredo Goyburu, "How The President's Dividend Plan Would Increase Corporate Investment," Heritage Foundation *CDA Report* No. CDA03-07, April 30, 2003, at *www.heritage.org/Research/Taxes/CD0307.cfm.*
7. Congressional Budget Office, "Capital Gains Taxes and Federal Revenues," October 9, 2002.

This history clearly demonstrates that the tax rate on capital gains and dividends makes an enormous difference in the way investors and firms handle income from capital.

High tax rates on dividends also have a distorting effect. Firms retain earnings instead of paying them to stockholders. This reduces the influence of stockholders as firms seek funding from resources independent of the marketplace of investors.

In short, high taxes on these two forms of income from capital have the same effect they exercise on other capital incomes: The marketplace for capital operates less efficiently and with less capital, the pace of economic growth slows, and the quality of investments diminishes.

The Economic Costs of Failing to Extend the Low Tax Rates. The scheduled expiration of the President's tax cuts at the end of 2010 will alter future investment decisions, slow economic growth, and reduce personal income. The top capital gains tax rate will increase from 15 percent to 20 percent. This increase will promote lock-in, expand the double taxation of capital income, and drive investment abroad.

The capital gains rate in the United States already is higher than the average long-term tax rate in most industrial countries.[8] Americans don't save enough as it is, and investment and savings would both be discouraged by higher capital gains tax rates.

In addition, the special exclusion for dividend income will end, and dividend income will again be less desirable than capital appreciation. The highest rate for dividends will climb back up to 36.5 percent if marginal rates remain at current levels, which will further distort investment decisions and hamper growth.

Effects of Higher Tax Rates. An analysis of how increasing these tax rates would likely affect the U.S. economy shows a general slowing of economic activity when compared to the economic situation that would prevail without tax increases. For example:

- Increasing capital gains and dividend tax rates would reduce the capital stock by $12 billion (in constant 2000 dollars) by 2012.[9]
- Potential employment would drop by 270,000 in 2011 and 413,000 in 2012.
- Personal incomes would decline by $1,675 (in 2000 dollars) for a family of four in 2012.
- The broadest measure of economic activity, GDP after inflation, would decline steadily over the forecast period of 2011 through 2018.
- In 2011, GDP would be $44 billion below where it would be if the tax cuts were made permanent. That figure would rise to $50 billion in 2012.
- Annual GDP after inflation losses would average $37 billion below baseline over that seven-year period.

Conclusion. Higher taxes on capital will hinder the growth of investment and capital stock. The decrease in capital will reduce economic growth, which will lead to higher unemployment and reduced personal income. Tax rates should not be a determining factor in allocating investment dollars, and lower tax rates mitigate the lock-in effect.

Investment is a forward-looking enterprise, and companies are already making decisions about their future. Making permanent the lower tax rates on capital gains and dividends will make future investment more attractive to businesses and investors. This will ensure more capital stock and economic growth. Congress should therefore make permanent these reductions on the cost of capital.

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8. Joint Economic Committee, Staff Report, *Cutting Capital Gains Tax Rates: The Right Policy for the 21st Century*, August 1999.
9. Readers will be provided with a description of our methodology upon request. By way of summary, the CDA Individual Income Tax Model produced annual estimates of rate and revenue changes for capital gains and dividend taxpayers. These rate and revenue changes were introduced into the GII U.S. Macroeconomic Model. Heritage analysts used the April 2008 short-term, 10-year model bank to create the forecasts reported here. In addition to changes in the model's tax rates and revenues derived from capital income, small changes were made in the labor force participation rates and user costs of capital in the model to reflect the theoretically expected movements in these indicators beyond their fixed levels in the model.