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Make the Dividend and Capital Gains Tax Rates Permanent to Keep the Economy Growing

Rea S. Hederman, Jr., and William W. Beach

The House of Representatives and the Senate recently passed, respectively, the Tax Relief Extension Reconciliation Act of 2005 (H.R. 4297) and the Tax Relief Act of 2005 (S. 2020). The two bills represent the tax reconciliation legislation of the two chambers, enacted under the guidelines of their respective budget resolutions.

Despite this common parentage, the two bills differ significantly on how they would interact with the economy, thus raising the tax policy stakes in the conference committee. The Senate bill is filled with targeted tax cuts and tax subsidies designed to change specific economic behaviors. Little if anything in the bill would affect the rate of economic growth. However, the House bill would take a substantial step toward a stronger economy by extending the lower tax rates on capital gains and dividend income for two years.

The lower tax rates are currently set to expire at the end of 2008. These tax rates help to reduce the tax code's bias against income that is saved and invested and have helped to fuel the current robust economic expansion. The conference committee on these two bills should adopt the House approach on capital gains and dividends.

Temporary Tax Cuts on Investment

The Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) of 2003 temporarily reduced the tax rates on capital gains and dividend income.[1] Proponents of the tax rate cuts argued that reducing these rates

Talking Points

- Extending the 2003 tax rates or making them permanent would reinforce a central element of good economic policy: predictable and stable tax law.
- Business investment has grown in every quarter since the 2003 tax cut, in part due to the reduced cost of capital. The current average taxation of dividends is 12 percent but will become 28 percent if the JGTRRA provisions are allowed to expire.
- In the end, it is not Congress's job to manage the economy or to assume a "leading role" in directing economic development. Congress's role is to set tax policy that raises needed revenues for government while interfering as little as possible with private-sector decision making, which really does matter to economic growth.
- Extending the lower tax rates on dividend and capital gains income would go a long way toward fulfilling Congress's basic tax policy responsibilities.

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(202) 546-4400 • heritage.org

would bolster the economy by encouraging investment in promising enterprises and by making dividend payments to stockholders more attractive to companies. Dividend payouts allow companies to reward their shareholders in a way other than focusing just on increasing the stock price.

Recent data show that the tax cut proponents' assessment of JGTRRA was right.[2] Regrettably, Congress has not made these tax cuts permanent and risks reversing these positive developments. Because businesses make investment decisions based in part on the taxes that they will face over many years, it is likely that the prospect of tax increases after 2008 is already discouraging some of the more entrepreneurial and risky undertakings. In the jargon of chief financial officers, the "hurdle rate" (the return on investment required to permit an undertaking to go forward) will rise to levels that make some projects untenable.

Businesses are watching now to see whether Congress will make permanent the first of the major economic growth components of the 2001 and 2003 tax acts, extend them, or allow them to expire.[3] Allowing the low tax rates on investment to expire would signal businesses of all sizes that the other major pro-growth elements of the Bush tax plan will expire, undermining the current economic expansion. Thus, Congress should make the tax reductions permanent, which would:

- Bolster economic growth by reducing the cost of capital,
- Increase the distribution of dividend payments, and
- Make the tax code more stable and predictable—key elements of good tax law.

The 2003 Tax Bill Provisions

With business investment slumping in 2001, 2002, and early 2003, JGTRRA focused on reducing the cost of capital to make investment more attractive.[4] The resulting lower capital costs allowed businesses to invest in slightly riskier projects and retire machines and factories early.

Before these changes, the tax code did not differentiate between dividend income and other types of income. Dividend income could be taxed at a rate as high as 38.6 percent, the highest marginal rate in the tax code. The average marginal tax rate for dividends was 28 percent, almost twice the average marginal rate of capital gains of 15 percent. Taxpayers above the 15 percent marginal tax bracket paid a capital gains tax rate of 20 percent. Those below the 15 percent bracket paid a tax rate of 10 percent.[5]

JGTRRA reduced dividend taxation by treating dividend income like capital gains income. Both dividend and capital gains income are investment income, which means that they have already been

1. The 15 percent tax rate on capital gains and dividend income is set to expire at midnight on December 31, 2008. The tax rate on capital gains income will rise to 20 percent, and dividend income will be taxed at ordinary income tax rates, or as high as 35 percent until 2011, when the top rate increases to 39.6 percent. All of the provisions of the 2001 tax act expire on December 31, 2010.
2. A survey of investors by Eaton Vance, a financial management company, found that investors now prefer increased dividends (57 percent) to stock buybacks (23 percent), a reversal of preferences since the 1990s. Furthermore, 46 percent of individual investors had increased investment in dividend-paying companies, with 57 percent of those investors citing the 2003 tax cuts as a factor in the decision. News release, "First-Ever Eaton Vance Dividend Study Surveys Top Finance Executives at Dividend-Paying US Corporations," Eaton Vance Corp., January 18, 2006, at *www.eatonvance.com/alexandria/pressreleases/200601/Dividend%20Survey%20Release.pdf* (February 13, 2006).
3. According to an Eaton Vance survey of finance executives of dividend-paying companies, 44 percent believe that Congress will make the tax cuts permanent and 43 percent believe that failure to do so will have a negative impact on the economy. News release, "First-Ever Eaton Vance Dividend Study."
4. According to one estimate, JGTRRA reduced the economy-wide cost of equity by 50 to 100 basis points. See Richard W. Kopcke, "The Taxation of Equity, Dividends and Stock Prices," Federal Reserve Bank of Boston *Public Discussion Paper* No. 05–1, January 2005, at *www.bos.frb.org/economic/ppdp/2005/ppdp051.pdf* (December 27, 2005).
5. Congressional Budget Office, "Taxing Capital Income: Effective Rates and Approaches to Reform," October 2005, at *cbo.gov/ftpdocs/67xx/doc6792/10-18-Tax.pdf* (December 27, 2005).

taxed once as regular income. JGTRRA sought to reduce the burden of double taxation, which reduces the incentive to invest.

Because of this tax bias against dividends, stockholders preferred compensation in the form of retained earnings (capital gains) rather than distributed earnings (dividends), and companies shifted toward capital gains and stock appreciation and away from dividend payments. The difference in taxation changed the price of capital for companies and made dividend payments more expensive than capital gains.[6] As a result, many companies focused too much on their stock prices, leading to scandals and fraud such as those involving Enron and Arthur Andersen.

Members of Congress wanted to give companies another option to reward shareholders other than increases in stock prices. Taxing capital gains and dividend income at the same rate gives investors a strong incentive to seek reliable companies that would pay out earnings in cash instead of speculative stock gains.

Dividend Payments After JGTRRA

Dividend payments increased after JGTRRA was enacted in the second quarter of 2003. Some companies responded by increasing their dividend payout, and 19 other companies instituted a dividend payment for the first time. Overall, almost 9 percent more companies paid out dividends after the 2003 tax cut than before the tax cut.[7]

Dividends payments to taxpayers increased from an average of $410 in the second quarter of 2003 to $518 in the third quarter of 2005—an increase of 24 percent.[8] The overall payout of dividends in 2005 was over 36.5 percent higher than the payout before the 2003 tax cut.[9] Dividend income increased by a similar margin after the 2003 cut, from $750 to $1,000.[10] This is particularly important for individuals age 62 and over and close to retirement because dividend payments are an important source of their incomes.

A number of studies point to the dramatic increase in dividend payouts following the 2003 act. Jennifer Blouin, Jana Ready, and Douglas Shackelford documented significant increases in dividends following passage of JGTRRA.[11] Others have noted the strong growth in equity values that stemmed from enhancing the income stream from stock ownership.[12] Table 1 in the Appendix shows the distribution of dividend income by state as reported on federal tax returns for 2003.

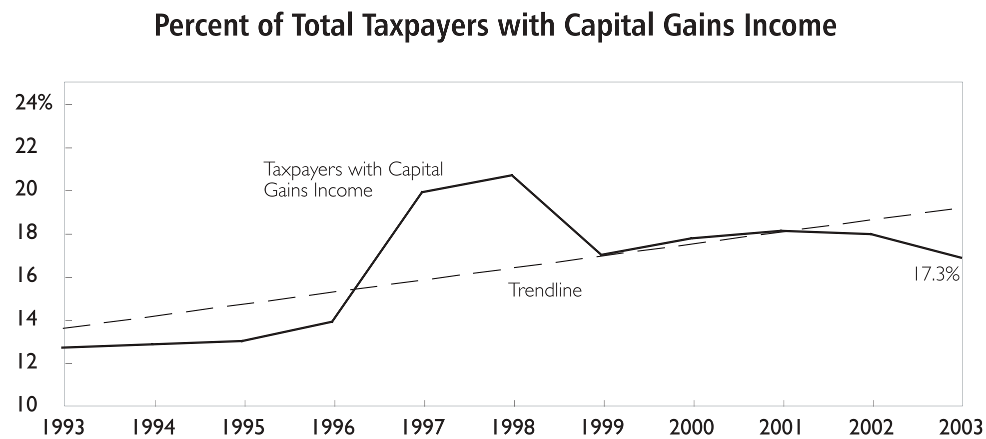
Capital Gains After JGTRRA

Chart 1 shows that the number of Americans reporting capital gains income is clearly increasing. In 1993, 14.5 million Americans claimed capital gains income. By 2003, the number had grown to 21.9 million Americans—a 51 percent increase. More important, the percent of all taxpayers reporting capital gains income increased from 12.6 percent in 1993 to 16.8 percent in 2003.

The 2003 tax cuts probably contributed to a strong stock market in 2003, which helped to increase tax revenues on capital gains. The stock market experi-

6. Kopcke, "The Taxation of Equity, Dividends and Stock Prices."
7. American Shareholders Association, "ASA Dividend Scorecard," October 18, 2005, at *www.americanshareholders.com/news/asa-dividend-10-18-05-_2.pdf* (February 13, 2006).
8. U.S. Department of Commerce, Bureau of Economic Analysis, "Personal Income and Outlays, November 2005," December 5, 2005, Table 2.1, at *www.bea.gov/bea/newsrelarchive/2005/pi1105.xls* (December 5, 2005).
9. American Shareholders Association, "ASA 2005 Dividend Scorecard," January 3, 2006, at *www.atr.org/content/pdf/2006/jan/010306ot-asadividend.pdf* (February 13, 2006).
10. Heritage Foundation tabulations based on data from Bureau of the Census, Current Population Survey, March 2004 and March 2005.
11. 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.
12. Jeffrey Brown, Nellie Liang, and Scott Weisbenner, "Executive Financial Incentives and Payout Policy: Firm Responses to the 2003 Dividend Tax Cut," National Bureau of Economic Research *Working Paper* No. 11002, December 2004.

Chart 1 B 1914



Source: Internal Revenue Service, Statistics of Income Division, *Individual Income Tax Returns*, 1993 to 2003, Table 1.4.

enced the second largest percentage increase in the past decade: The broad-market indexes experienced double-digit annual growth rates after the 1997 capital gains tax cut and the 2003 capital gains tax cut.[13] This increase in equity capital helped to finance new businesses and has led to the increased job growth since the summer of 2003.

In addition to the economic effects, taxpayers claimed an average of $12,283 in capital gains income in 2003. As Table 2 shows, this average varies significantly from state to state. The five states with the highest averages are Nevada ($28,582); Wyoming ($22,639); Connecticut ($18,466); Florida ($17,118); and Massachusetts ($17,024). However, the unmistakable feature of Table 2 is the surprising size of the average in every state. Clearly, gains from taxable capital investments constitute a substantial portion of income for the average taxpayer.

It is not surprising, then, that reductions in capital gains tax rates enjoy widespread support. In state after state, about one-fifth of all tax returns contain taxable capital gains. Even in the states with the lowest percentage of returns showing taxable gains, the percentage is remarkably high: Mississippi ranks 50th with 10 percent of returns containing capital gains; West Virginia (ranked 49th) shows 11 percent of its taxpayers with taxable gains. The five states with the highest percentages are Connecticut (23.4 percent); New Jersey (22.3 percent); Montana (22.0 percent); Colorado (21.4 percent); and South Dakota (21.1 percent). (See Table 2 in the Appendix.)

Conclusion

Reducing dividend and capital gains taxes succeeded in supporting stronger economic growth and making dividend payments more popular to businesses. After the tax cut, many companies such as Microsoft began offering dividend payments or increased their dividend payouts. In addition, extending these tax rates or making them permanent would reinforce a central element of good economic policy: predictable and stable tax law.

Business investment has grown in every quarter since the 2003 tax cut, in part due to the reduced cost of capital. The Congressional Budget Office estimates that the current average taxation of dividends is 12 percent, but it will become 28 percent if the JGTRRA provisions are allowed to expire.[14]

In the end, however, it is not Congress's job to manage the economy or to assume a "leading role," as old-style European socialists call it, in directing economic development. Congress's role is to set tax policy that raises needed revenues for government

13. American Shareholders Association, "ASA Stock Market Scorecard," January 16, 2004, at *www.americanshareholders.com/news/asastockmarket01-16-04.pdf* (February 13, 2006).

14. Congressional Budget Office, "Taxing Capital Income."

while interfering as little as possible with private-sector decision making, which really does matter to economic growth.

Extending the lower tax rates on dividend and capital gains income would go a long way toward fulfilling Congress's basic tax policy responsibilities.

—Rea S. Hederman, Jr., is Manager of Operations and a Senior Policy Analyst in the Center for Data Analysis, and William W. Beach is Director of the Center for Data Analysis, at The Heritage Foundation. *The authors gratefully acknowledge the contributions of J. Scott Moody, who worked on an early version of this paper while serving as a Senior Policy Analyst in the Center for Data Analysis.*

APPENDIX

Table 1a B 1914

Dividends Income for 2003

State	Returns with Dividends	Amount	Amount per Return	Rank	Total Returns	Percent of Returns	Rank
United States	30,372,542	$111,506,336	$3,671	-	131,356,582	23.1%	-
Alabama	307,512	1,104,964	3,593	16	1,883,765	16.3%	48
Alaska	81,286	182,877	2,250	49	343,032	23.7%	27
Arizona	506,710	1,721,051	3,397	24	2,285,323	22.2%	32
Arkansas	196,177	999,398	5,094	3	1,121,518	17.5%	41
California	3,318,927	12,692,407	3,824	12	15,171,832	21.9%	33
Colorado	541,043	2,028,054	3,748	14	2,079,044	26.0%	13
Connecticut	556,719	2,585,760	4,645	5	1,653,789	33.7%	1
Delaware	101,174	464,603	4,592	6	388,288	26.1%	12
Florida	1,780,549	8,750,878	4,915	4	7,849,542	22.7%	31
Georgia	725,173	2,660,558	3,669	15	3,709,312	19.6%	37
Hawaii	143,865	389,578	2,708	43	591,084	24.3%	23
Idaho	119,515	330,572	2,766	40	577,926	20.7%	36
Illinois	1,512,635	5,342,266	3,532	18	5,722,755	26.4%	11
Indiana	595,153	1,648,723	2,770	39	2,816,535	21.1%	34
Iowa	362,453	836,554	2,308	48	1,324,876	27.4%	9
Kansas	301,772	879,122	2,913	37	1,218,580	24.8%	19
Kentucky	312,949	1,031,908	3,297	26	1,740,856	18.0%	39
Louisiana	303,858	925,937	3,047	34	1,879,651	16.2%	49
Maine	143,003	463,171	3,239	27	615,092	23.2%	30
Maryland	646,287	2,261,900	3,500	19	2,601,859	24.8%	18
Massachusetts	889,905	4,063,689	4,566	7	3,051,697	29.2%	3
Michigan	1,116,274	3,461,841	3,101	33	4,546,347	24.6%	21
Minnesota	669,508	1,789,202	2,672	44	2,383,813	28.1%	4
Mississippi	152,545	492,438	3,228	28	1,169,646	13.0%	50
Missouri	609,456	2,344,566	3,847	11	2,563,895	23.8%	26
Montana	111,223	313,840	2,822	38	433,522	25.7%	14
Nebraska	205,696	520,356	2,530	46	802,709	25.6%	15
Nevada	182,061	1,007,505	5,534	2	1,044,025	17.4%	42

Table 1b B 1914

Dividends Income for 2003 (cont.)

State	Returns with Dividends	Amount	Amount per Return	Rank	Total Returns	Percent of Returns	Rank
New Hampshire	174,112	608,950	3,497	20	634,654	27.4%	8
New Jersey	1,281,103	4,336,675	3,385	25	4,082,108	31.4%	2
New Mexico	144,979	467,638	3,226	29	813,731	17.8%	40
New York	2,296,558	10,120,477	4,407	8	8,589,932	26.7%	10
North Carolina	773,243	2,697,492	3,489	21	3,680,813	21.0%	35
North Dakota	72,465	144,147	1,989	50	302,426	24.0%	25
Ohio	1,286,641	3,995,410	3,105	32	5,444,137	23.6%	28
Oklahoma	251,102	683,757	2,723	42	1,460,943	17.2%	45
Oregon	383,455	1,136,074	2,963	36	1,571,871	24.4%	22
Pennsylvania	1,619,706	5,206,190	3,214	30	5,771,764	28.1%	5
Rhode Island	122,606	391,716	3,195	31	498,063	24.6%	20
South Carolina	332,127	1,142,759	3,441	23	1,804,803	18.4%	38
South Dakota	83,310	200,538	2,407	47	357,449	23.3%	29
Tennessee	428,154	1,476,404	3,448	22	2,565,045	16.7%	47
Texas	1,613,167	6,349,409	3,936	10	9,298,799	17.3%	43
Utah	167,096	496,347	2,970	35	969,812	17.2%	44
Vermont	84,710	321,921	3,800	13	302,209	28.0%	6
Virginia	869,231	3,470,430	3,993	9	3,431,766	25.3%	17
Washington	716,877	2,558,477	3,569	17	2,808,556	25.5%	16
West Virginia	126,968	350,431	2,760	41	744,440	17.1%	46
Wisconsin	716,010	1,853,367	2,588	45	2,589,845	27.6%	7
Wyoming	57,929	414,430	7,154	1	240,998	24.0%	24
District of Columbia	61,437	436,792	7,110	-	275,645	22.3%	-

Source: Internal Revenue Service, Statistics of Income Division, "Tax Year 2003: Historical Table 2 (SOI Bulletin)," at *www.irs.gov/pub/irs-soi/03in54cm.xls* (December 28, 2005).

Table 2a B 1914

Capital Gains Income for 2003

State	Returns with Capital Gains	Amount	Amount per Return	Rank	Total Returns	Percent of Returns	Rank
United States	22,733,299	$279,230,564	$12,283	-	131,356,582	17.3%	-
Alabama	221,708	2,260,866	10,197	25	1,883,765	11.8%	48
Alaska	51,305	468,157	9,125	34	343,032	15.0%	36
Arizona	417,598	4,580,410	10,968	19	2,285,323	18.3%	23
Arkansas	156,417	1,564,587	10,003	28	1,121,518	13.9%	43
California	2,791,444	44,299,317	15,870	7	15,171,832	18.4%	20
Colorado	445,872	5,875,072	13,177	8	2,079,044	21.4%	4
Connecticut	387,632	7,157,950	18,466	3	1,653,789	23.4%	1
Delaware	66,158	696,128	10,522	22	388,288	17.0%	30
Florida	1,423,783	24,372,030	17,118	4	7,849,542	18.1%	25
Georgia	522,806	6,860,840	13,123	9	3,709,312	14.1%	40
Hawaii	100,822	1,142,959	11,336	17	591,084	17.1%	29
Idaho	107,169	1,131,202	10,555	21	577,926	18.5%	19
Illinois	1,051,800	13,678,762	13,005	10	5,722,755	18.4%	21
Indiana	415,565	3,544,178	8,529	39	2,816,535	14.8%	38
Iowa	263,297	1,496,951	5,685	50	1,324,876	19.9%	14
Kansas	227,579	1,741,906	7,654	42	1,218,580	18.7%	18
Kentucky	233,707	1,899,325	8,127	40	1,740,856	13.4%	44
Louisiana	221,664	1,632,360	7,364	44	1,879,651	11.8%	47
Maine	103,040	1,080,586	10,487	23	615,092	16.8%	32
Maryland	470,967	5,257,876	11,164	18	2,601,859	18.1%	26
Massachusetts	632,808	10,773,076	17,024	5	3,051,697	20.7%	7
Michigan	786,559	5,499,507	6,992	46	4,546,347	17.3%	28
Minnesota	492,109	4,564,684	9,276	32	2,383,813	20.6%	8
Mississippi	117,433	1,177,810	10,030	27	1,169,646	10.0%	50
Missouri	444,838	3,397,435	7,637	43	2,563,895	17.4%	27
Montana	95,197	901,758	9,473	31	433,522	22.0%	3
Nebraska	165,595	1,183,742	7,148	45	802,709	20.6%	9
Nevada	158,749	4,529,370	28,532	1	1,044,025	15.2%	35

Table 2b B 1914

Capital Gains Income for 2003 (cont.)

State	Returns with Capital Gains	Amount	Amount per Return	Rank	Total Returns	Percent of Returns	Rank
New Hampshire	126,422	1,586,258	12,547	13	634,654	19.9%	13
New Jersey	911,171	9,248,280	10,150	26	4,082,108	22.3%	2
New Mexico	114,544	917,226	8,008	41	813,731	14.1%	41
New York	1,644,345	27,174,946	16,526	6	8,589,932	19.1%	17
North Carolina	563,598	5,357,214	9,505	30	3,680,813	15.3%	34
North Dakota	63,402	395,167	6,233	48	302,426	21.0%	6
Ohio	849,620	5,675,282	6,680	47	5,444,137	15.6%	33
Oklahoma	205,178	1,870,891	9,118	35	1,460,943	14.0%	42
Oregon	318,169	3,315,111	10,419	24	1,571,871	20.2%	11
Pennsylvania	1,052,162	9,143,653	8,690	38	5,771,764	18.2%	24
Rhode Island	83,903	982,202	11,706	15	498,063	16.8%	31
South Carolina	239,904	2,347,981	9,787	29	1,804,803	13.3%	45
South Dakota	75,474	673,095	8,918	36	357,449	21.1%	5
Tennessee	323,468	4,089,505	12,643	12	2,565,045	12.6%	46
Texas	1,323,540	17,154,286	12,961	11	9,298,799	14.2%	39
Utah	144,262	1,685,402	11,683	16	969,812	14.9%	37
Vermont	61,112	561,511	9,188	33	302,209	20.2%	12
Virginia	628,985	6,724,842	10,692	20	3,431,766	18.3%	22
Washington	573,151	6,934,420	12,099	14	2,808,556	20.4%	10
West Virginia	81,815	502,660	6,144	49	744,440	11.0%	49
Wisconsin	503,490	4,406,507	8,752	37	2,589,845	19.4%	16
Wyoming	47,164	1,067,734	22,639	2	240,998	19.6%	15
District of Columbia	45,380	1,029,375	22,683	-	275,645	16.5%	-

Source: Internal Revenue Service, Statistics of Income Division, "Tax Year 2003: Historical Table 2 (SOI Bulletin)," at *www.irs.gov/pub/irs-soi/03in54cm.xls* (December 28, 2005).