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A Victory for Taxpayers and the Economy

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This afternoon, President George W. Bush signed the Tax Increase Prevention and Reconciliation Act of 2005 (H.R. 4297), which Congress passed last week. His signing assures that millions of taxpayers and millions more workers and business owners will enjoy low tax rates on capital gains and dividends and a potentially stronger economy through 2010. Had the President not signed this legislation into law, taxes would have increased in 2009, and the cost of capital, a key factor for economic growth, would have risen.

Under current law, individual long-term net capital gains realizations and qualified dividend income are taxed at preferential rates. Taxpayers in the lowest two tax brackets pay a 5-percent tax rate on capital gains and dividend income through 2007 and no taxes on capital gains and dividend income in 2008. Taxpayers in all other brackets pay a 15-percent tax rate on capital gains and dividend income through 2008.

These preferential rates are an important part of The Jobs Growth Tax Relief and Reconciliation Act (JGTRRA) of 2003. Along with JGTRRA's partial expensing provisions, they have played a role in helping spur economic activity by boosting disposable income and business fixed investment. JGTRRA's preferential tax rates on capital gains and dividend income were set to expire at the end of 2008.[1] The bill signed by President Bush today extends JGTRRA's preferential rate structure for capital gains and dividend income through the end of 2010.[2] But this is not a complete victory for taxpayers: taxes on both types of capital income will revert to their pre-JGTRRA levels in 2011.[3]

Economic Effects of H.R. 4297's Capital Gains and Dividend Provisions

Extending JGTRRA's preferential rate structure on capital gains and dividend income will have small—but positive—effects on both gross domestic product (GDP) and employment. Personal consumption and business fixed investment are also likely to post modest gains as a result of H.R.4297. These gains will be modest because H.R. 4297 is only a temporary extension of an expiring provision. Real GDP, consumption, and investment would all respond far more positively to a permanent extension of JGTRRA's preferential tax rates on capital gains and dividend income.

H.R. 4297's capital gains and dividend provisions are likely to influence economic activity through two primary channels. They will increase personal disposable income by lowering federal tax payments. And they will reduce the cost of capital to businesses by raising the value of U.S. equities. Higher personal disposable income is likely to

provide an immediate boost to economic activity. The lower cost of capital is likely to provide economic benefits over the medium term.

Most immediately, H.R. 4297's capital gains and dividend provisions will lower income tax payments. The Joint Committee on Taxation (JCT) estimates that extending JGTRRA's rate structure on capital gains and dividend income will reduce federal tax revenues by a total of some $18 billion in fiscal years 2009 and 2010 and over $50 billion between fiscal years 2008 and 2016.[4]

Increases in personal disposable income will likely exceed JCT's estimates of the revenue effects of extending JGTRRA's preferential rate structure. This is because JCT's conventional revenue estimates ignore the influence of tax policy on macroeconomic behavior and aggregates. However, households are likely to allocate some part of H.R. 4297's tax cuts to higher personal consumption. Higher personal consumption is, in turn, likely to encourage businesses to increase output, investment, and staffing in the short run. Center for Data Analysis (CDA) analysts considered the feedback effects of higher personal disposable income on consumption, employment, and incomes. As a result of those feedbacks, total gains in personal disposable income could exceed JCT's revenue estimates by several billion dollars.[5]

The impact of H.R. 4297's capital gains and dividend provisions on the cost of capital is likely to boost personal consumption and business fixed investment over the medium term. This effect is likely to be largest for the extension of JGTRRA's preferential tax rates on capital gains realizations.

A cut in tax rates on capital gains influences the cost of capital through two channels. First, lower capital gains tax rates reduce the before-tax rate of return businesses must pay investors, making it possible for businesses to expand their operations.[6] Second, lower tax rates on capital gains provide firms with a greater incentive to retain their earnings, thus increasing the firms' market value. An increase in the market value of firms translates into an increase in the value of equity markets. This positive effect of lower capital gains tax rates on equity markets may be offset to some extent by lower tax rates on dividend income.

For firms, lower tax rates on capital gains and dividends can imply a reduction in the cost of financing new investments with equity. In 2003 congressional testimony, R. Glenn Hubbard, then Chairman of the President's Council of Economic Advisors, estimated that the Administration's 2003 Jobs and Growth Initiative could reduce the corporate sector's cost of capital for equity-financed equipment investment by more than 10 percent.[7] Kevin Hassett of the American Enterprise Institute independently estimated that the Administration's proposal would reduce the cost of new equipment investment by 4 percent to 7 percent.[8]

Such reductions in the cost of capital encourage businesses to invest more. CDA analysts assume somewhat smaller reductions in the cost of equity finance.[9] Nevertheless, they project modest gains in both real non-residential investment and the economy's stock of capital from 2009. Concomitant with an increase in the economy's capital stock is an increase in its potential output.

For consumers, lower tax rates on capital gains and dividends imply an increase in the value of equities and wealth. In a frequently cited study by the American Council for Capital Formation, the Standard and Poor's chief economist, David Wyss, attributes about 7.5 percent of the increase in the S&P 500 between 1997 and 1999 to the 1997 Taxpayer Relief Act's (TRA 97) lower tax rates on capital gains.[10] In a reduced-form calculation, James Poterba estimates that JGTRRA's 2003 dividend tax cuts could increase aggregate U.S. equity values by about 6 percent.[11] Economic theory suggests that such increases in equity wealth will encourage higher personal consumption (a "wealth effect").

CDA analysts assume smaller increases in the value of U.S. equities (as measured by the value of the S&P 500 index of common stocks) than do Wyss and Poterba.[12] For Poterba's calculation, this is in large part because there is some dispute in the economics literature regarding the magnitude of the impact of dividends tax cuts on equity values. Under the "new" view of the economic effects of dividends, the value of equities rises permanently.[13] Under the "old" view, that same increase in the value of U.S. equities is phased out over time.

The economics literature does not uniformly support one view over another. For example, Alan Auerbach and Kevin Hassett find that a change in dividend taxes—particularly a permanent change in dividend taxes—could have a significant effect on equity markets.[14] However, a Federal Reserve Board working paper, using a methodology similar to that of Auerbach and Hassett, found little evidence that cuts in capital taxation have boosted U.S. equity prices.[15] CDA analysts took this ambiguity in the literature into account when analyzing the cost-of-capital effects of H.R. 4297's dividend provision.

A Step in the Right Direction

H.R. 4297's capital gains and dividend provisions are a step in the right direction. Extending JGTRRA's preferential rate structure on capital gains and dividend income will help spur economic activity.

Most immediately, higher personal disposable income is likely to boost personal consumption, encouraging businesses to increase investment spending and staffing to meet higher demand in the short term. Farther out, lower costs of capital and higher U.S. equity values could bolster both personal consumption and business fixed investment. Higher business fixed investment will, in turn, raise both the economy's capital stock and its potential output.

However, any gains in real GDP, personal consumption, and business investment spending are likely to be modest. This is because H.R. 4297's capital gains and dividend provisions are only temporary. Real GDP, consumption, investment would all respond more positively to a permanent extension of JGTRRA's preferential tax rates on capital gains and dividend income.

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[1] H.R. 4297 includes section-179 expensing provisions. However, this paper only considers the economic effects of H.R. 4297's capital gains and dividend provisions.
[2] All estimates of the revenue effects of the tax reconciliation bill are taken from Joint Committee on Taxation, "Estimated Revenue Effects of the Conference Agreement for the 'Tax Increase Prevention and Reconciliation Act of 2005,'" JCX-18-06, May 9, 2006, at http://www.house.gov/jct/x-18-06.pdf.
[3] With no further extension of JGTRRA's preferential rates, dividend income would be taxed at ordinary income tax rates starting in 2011. Capital gains realizations would be taxed at a pre-JGTRRA maximum rate of 10 percent or 20 percent starting in the same year. The 10-percent rate applies to all taxpayers in the lowest (15-percent) tax bracket. The 20 percent rate applies to taxpayers in all other tax brackets.
[4] See Joint Committee on Taxation, "Estimated Revenue Effects of the Conference Agreement for the "Tax Increase Prevention and Reconciliation Act of 2005," JCX-18-06, May 9, 2006, at http://www.house.gov/jct/x-18-06.pdf. JCT is officially charged with estimating the "static" revenue effects of proposed changes in tax policy. Such static (or conventional) revenue estimates may include the microeconomic effects of changes in tax policy on federal receipts. However, they exclude the macroeconomic effects of changes in tax policy on labor force participation, saving, interest rates, etc. "Dynamic" revenue estimates include these macroeconomic effects. They can differ, sometimes substantially, from static revenue estimates that assume that changes in tax policy have no effect on macroeconomic behavior or aggregates. Rough dynamic revenue estimates show small—but positive—revenue feedbacks from H.R. 4297's capital gains and dividend provisions.
[5] The Global Insight short-term U.S. Macroeconomic Model is used to help gauge the economic-and-budgetary effects of enacting the capital gains and dividend provisions of H.R. 4297. CDA analysts begin with a version of the Global Insight model that has been calibrated to the Congressional Budget Office's January 2006 baseline economic and budgetary projections. The methodologies, assumptions, conclusions, and opinions in this analysis have not been endorsed by and do no reflect the views of the owners of the Global Insight model. Fortune 500 companies and numerous government agencies use Global Insight's short-term U.S. macroeconomic model to forecast how changes in the economy and in public policy are likely to impact major economic indicators.
[6] For a more detailed description of how reducing the effective tax rate on capital gains affects the cost of capital, see Ben Page, "How CBO Analyzed the Macroeconomic Effects of the President's Budget," Congressional Budget Office, July 2003, at http://www.cbo.gov/ftpdocs/44xx/doc4454/07-28-PresidentsBudget.pdf; and Congressional Budget Office, "An Analysis of the President's Budgetary Proposals for Fiscal Year 2006," March 2005, Chapter 2 and Appendix C, at http://www.cbo.gov/61xx/doc6146/03-15-PresAnalysis.pdf.
[7] See R. Glenn Hubbard, "Testimony of R. Glenn Hubbard, Chairman, Council of Economic Advisers, Before the Budget Committee, United States Senate," February 4, 2003, at http://www.senate.gov/~budget/democratic/testimony/2003/hubbard_hrng020403.pdf.
[8] See Kevin A. Hassett, "Evaluation of Proposals for Economic Growth and Job Creation: Incentives for Investment," Testimony before the United States Senate Finance Committee, February 12, 2003, at http://www.aei.org/publications/pubID.15964,filter.all/pub_detail.asp.
[9] CDA analysts estimate that the drop in the cost of equity finance attributable to H.R. 4297's capital gains provision ranges from just over 1 percent to almost 4 percent. They attribute a much smaller potential decline in the cost of equity finance to H.R. 4297's dividend provision.
[10] For example, see Margo Thorning, "Capital Gains Taxation and US Economic Growth," Testimony before the Standing Committee on Banking, Trade and Commerce of the Senate of Canada, December 16, 1999, at http://www.accf.org/publications/testimonies/test-dec16-99.html. Alternatively, Shackelford, et al. examine the effects of personal capital gains taxation on asset prices in the period surrounding the announcement of TRA 97's capital gains tax cuts. Their analysis incorporates both the demand-side capitalization effects and the supply-side lock-in effects of a change in the capital gains tax rate. Shackelford, et al. find evidence of initial price declines (a capitalization effect), followed by price increases after the official announcement of TRA 97's cuts in the tax rate on capital gains (a lock-in effect). Their results are still tentative but seem to suggest that the two effects approximately offset one another. See Shackelford, et al., "Capital Gains Taxes and Asset Prices: Capitalization or Lock-in?," February 16, 2006, at http://www.public.kenan-flagler.unc.edu/taxsym/Dai-DMSZ.pdf.
[11] See James Poterba, "Taxation and Corporate Payout Policy," National Bureau of Economic Research, Working Paper No. 10321, February 2004, at http://www.nber.org/W10321. Poterba obtains this 6 percent estimate by using an S&P 500 price-earnings ratio to capitalize CBO projections of the annual flow of foregone dividend taxes.

[12] CDA analysts derive estimates of changes in the S&P 500 using an equation that links changes in S&P 500 dividends and the maximum capital gains tax rate to changes in the cost of equity. CDA analysts obtain a static estimate of the change in the cost of equity using a separate equation for the after-tax rental price of capital. That equation expresses the after-tax price of—or return to—equity as a weighted average of the after-tax return to dividends and the after-tax return to capital gains. An explicit expression for the after-tax return to equity is obtained by equating that weighted average with the after-tax return to corporate debt.

[13] For a more detailed description of the treatment of the old and new views of the economic effects of dividends in macroeconomic models, see Ben Page, "How CBO Analyzed the Macroeconomic Effects of the President's Budget," Congressional Budget Office, July 2003, at http://www.cbo.gov/ftpdocs/44xx/doc4454/07-28-PresidentsBudget.pdf.

[14] See Alan J. Auerbach and Kevin A. Hassett, "The 2003 Dividend Tax Cuts and the Value of the Firm: An Event Study," National Bureau of Economic Research, Working Paper No. 11449, June 2005, at http://www.nber.org/papers/W11449.

[15] See Gene Amromin, Paul Harrison, Nellie Liang, and Steve Sharpe, "How Did the 2003 Dividend Tax Cut Affect Stock Prices and Corporate Payout Policy," Finance and Economics Discussion Series, Divisions of Research and Statistics and Monetary Affairs, Federal Reserve Board, Working Paper No. 2005-57, September 2005, at http://www.federalreserve.gov/pubs/feds/2005/200557/200557pap.pdf.