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Obama Tax Hikes: Higher Dividend Taxes Hurt America's Seniors

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Abstract: *There is much talk in Washington and the media about the impending expiration of the 2001 and 2003 tax relief. Those in favor of letting the tax cuts expire argue that to do otherwise would be merely to reward the rich at the expense of the lower-income population. Lost in these misguided accusations is the fact that higher dividend taxes—part of the tax increase currently scheduled for January 1, 2011—will not only hurt American companies, but penalize America's senior citizens. Older people hold the most stock of any demographic group, and often rely heavily on dividends to supplement their Social Security income. Penalizing retirees would be one of the particularly bad outcomes of letting the Bush tax cuts expire. Time is running out and Congress should act now to make the tax relief permanent.*

Unless Congress votes to extend them, the 2001 and 2003 tax relief packages will expire at the end of this year. Congress is currently focusing exclusively on whether to maintain lower income tax rates for all taxpayers or only those earning less than $250,000 a year. Lost in this narrow focus is the fate of other pro-growth tax policies that are vital to maintaining a strong and robust economy.

A lower tax rate on dividends is one of the most important pro-growth policies that will be lost unless Congress takes action. If Congress allows the tax rate on dividends to rise, the value of all stocks will fall sharply. The decline in stock value will harm all shareholders, but seniors will be hit hardest, as a dispropor-

Talking Points

- Under the current budget blueprint that Congress is using, the tax rate on dividends will more than double on January 1, 2011.
- The increased rate will reduce the price of all stock traded in U.S. markets, thereby reducing the wealth of the shareholders who own those securities.
- Seniors who rely on retirement savings accounts will be particularly hard hit. They rely heavily on dividends to supplement their income, and the higher rate will confiscate a larger portion of this much-needed income.
- Businesses will also pay seniors fewer dividends because a much lower capital gains tax rate will induce the businesses to retain their earnings. This will be a double blow to seniors that will shrink their income even further.
- Congress should keep the dividend tax rate at 15 percent, and equal to the capital gains rate, to prevent serious harm to America's senior citizens.

This paper, in its entirety, can be found at: *http://report.heritage.org/bg2461*

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tionate number of retirees rely on stock dividends for a significant portion of their income.

To prevent a reduction on seniors' income, Congress should make the current tax rate on dividends—15 percent—permanent.

Legislative Plan for Dividends

The budget resolution for 2010 calls for the tax rate on dividends to rise from 15 percent to 39.6 percent—a 164 percent increase—on January 1, 2011. That is the same rate as before 2003, when dividends were taxed as regular income.

The budget resolution is a guide that lays out Congress's future fiscal plans. The policies contained in the resolution do not become law when Congress passes the resolution. Usually, Congress must pass legislation for policies contained in a resolution to become law. Under current law, the tax rate on dividends will revert to its pre-2003 level, which means that Congress need simply do nothing for the remainder of 2010 and the tax rate on dividends will increase automatically. This makes it more likely that the rate will rise.

Further increasing the likelihood that the rate on dividends will increase are the lopsided pay-as-you-go (PAYGO) budget rules that are supposed to hold spending down, but in reality make tax hikes more probable.[1] Congress exempted many of the provisions in the 2001 and 2003 tax relief from PAYGO rules before passing the budget resolution. It will not have to "offset" those policies by raising other taxes or reducing spending. However, Congress inexplicably left out dividends from the PAYGO exemptions. Members of Congress did not even make an exception for President Obama's plan to set the dividend tax rate at 20 percent for families making more than $250,000 a year, another sign that this harmful tax hike was intentional.

If Congress chooses to enforce its PAYGO restrictions in this case, Members of Congress that want to keep the dividends rate at its current 15 percent will need to find a way to reduce spending or increase other taxes to make up the revenue that the increased dividend tax rate was estimated to raise. The Treasury Department estimates that the revenue "lost" by keeping the rate at 15 percent instead of allowing it to spike to 39.6 percent is more than $233 billion over 10 years,[2] and $128 billion "lost" over 10 years under President Obama's 20 percent. Of course, as with spending, Congress could choose to simply waive the PAYGO restriction in order to prevent this harmful tax hike.

Impact of Higher Dividend Taxes

The impending dividend tax increase will not be the only hike in the near future. In 2013, the 3.8 percent Medicare tax on investment income, which passed as part of the recent Patient Protection and Affordable Care Act, goes into effect. That will increase the total tax rate even further to 43.4 percent for families making $250,000 or more a year. In 2013, the tax rate on dividends will have almost tripled in the span of two years.

Higher taxes on dividends will reduce the value of all corporate stocks traded in U.S. markets, shrinking the wealth of anyone who owns stocks. Once again, it is particularly seniors who rely on stock holdings in retirement savings plans to supplement their Social Security benefits. These plans include 401(k)s, 403(b)s, IRAs, and self-directed state, local, and federal government employee retirement funds.

Dividend taxes decrease stock prices in two ways: (1) They reduce the after-tax value of the dividends earned by stocks, and (2) they increase the cost of capital for businesses, thereby reducing future business profitability.

Stock Prices Fall

Using a widely accepted methodology to determine the impact of raising the dividends tax rate to 39.6 percent, the value in current dollars of the

1. J. D. Foster, "Obama to CBO Revenue Baseline: Nuts—and He's Right!" Heritage Foundation *WebMemo* No. 2019, August 11, 2008, at *http://www.heritage.org/Research/Reports/2008/08/Obama-to-CBO-Revenue-Baseline-Nuts-and-Hes-Right*.
2. U.S. Department of the Treasury, "General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals," February 2010, p. 153, at *http://www.treas.gov/offices/tax-policy/library/greenbk10.pdf* (September 3, 2010).

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yearly revenue raised by the tax increase is discounted by the latest available price-to-earning ratio of the Standard & Poor's 500 to calculate the aggregate decline in stock prices.[3]

According to this calculation, the tax hike on dividends would cause stock prices to drop by more than $211 billion. The reduction in share values would happen almost immediately at the beginning of 2011, or whenever Congress makes clear it will allow the rate to rise. Unlike a decline in stock prices due to market forces, which can turn around at any time, this government-induced reduction in wealth would be permanent unless Congress voted to reverse the tax hike in the future.

The $211 billion in lost wealth hits various sectors of shareholders differently. The tax increase would reduce the share values of households the most, by more than $77 billion. Mutual funds are the next hardest-hit; their worth would decline by more than $43 billion. Table 1 shows the rest of the decline in share value by sector.[4]

Higher Tax Rate on Dividends Would Reduce Stock Values

If the dividends tax rate is increased from 15 percent to 39.6 percent, the value of stocks in the sectors shown below would be reduced by more than $211 billion.

Sector	Reduction in Stock Values (in millions)
Households, nonprofit organizations, and corporations	$77,489
Mutual funds	$43,388
Foreigners	$26,133
Private pension funds	$19,072
State and local government employee retirement funds	$16,517
Life insurance companies	$13,264
Exchange-traded funds	$6,833
Property-casualty insurance companies	$2,314
Federal government retirement funds	$1,271
State and local governments (excluding employee retirement funds)	$1,165
Security brokers and dealers	$1,088
Closed-end funds	$941
Federal government	$669
Commercial banks	$345
Monetary authority	$253
Funding corporations	$253
Savings institutions	$217
TOTAL	**$211,210**

Source: Heritage Foundation calculations based on Federal Reserve Flow of Funds Report, Table L.218 Home Mortgages (1), at *http://www.federalreserve.gov/releases/z1/Current/z1r-4.pdf* (September 7, 2010).

Table 1 • B 2461 heritage.org

Seniors Hit Hard by Tax Increase

The percentage of all stocks held in retirement savings plans is approximately 24 percent.[5] As such, one-fourth of the decline in stock prices would fall on stocks owned through these plans and the retirees that rely on them. This works out to $50 billion of unnecessarily lost value for current and future retirees because of the higher tax rate on dividends.

Seniors sell shares held in these funds after they retire to pay for their living expenses, including basics, such as housing, food, and medical care. When the stocks they sell decline in value, seniors have less money to pay their bills, and their budgets are squeezed tighter. Seniors also use dividend income to supplement their retirement income.

3. James Poterba, "Taxation and Corporate Payout Policy," *The American Economic Review*, Vol. 94, No. 2 (May 2004), pp. 171–175, at *http://jstor.org/stable/3592877* (September 3, 2010), and U.S. Department of the Treasury, "Report of the Department of the Treasury on the Economic Effects of Cutting Dividend and Capital Gains Taxes in 2003," March 14, 2006, p. 9, at *http://www.ustreas.gov/press/releases/reports/report%20on%20econ%20of%20cap%20gains%20%20dividends%203.14.06.pdf* (September 3, 2010).
4. Calculations based on Federal Reserve Board, "Flow of Funds Accounts of the United States," June 10, 2010, p. 92, at *http://www.federalreserve.gov/releases/z1/Current/z1.pdf* (September 3, 2010).
5. *Ibid.*, p. 92.

Higher taxes on dividends means the amount of after-tax income they are accustomed to receiving from dividends to pay their bills will decline. Higher dividend taxes, in effect, penalize seniors, as stock prices are still struggling to recover from the financial contagion—a particularly misguided step.

Lower Dividend Payouts, Riskier Investments

An even larger problem for seniors will arise when businesses that traditionally pay dividends stop paying them and choose to return value to their shareholders in other ways. If the rate on dividends rises to 39.6 percent, it will be almost 20 percentage points higher than the tax rate on capital gains. The capital gains tax is currently 15 percent, but will increase to 20 percent with the expiration of the 2001 and 2003 tax relief.

As a recent Heritage Foundation paper explained,[6] businesses will have an incentive to return value to their shareholders by increasing the value of their shares rather than by paying out dividends. The incentive to increase share value will be greater than the incentive to pay dividends because shareholders will retain a larger portion of the capital gains from increased share prices than from the dividend they would have earned under the 15 percent rate. Businesses can increase share prices by investing retained earnings in the business to increase profitability. While seniors will benefit from increased share value in the long run (assuming the internal investment undertaken by the businesses is successful), in the near term seniors will simply lose a source of income upon which they previously relied.

There is no guarantee that the investments that businesses undertake will be successful. In fact, the gap between the tax rate on capital gains and dividends would be an incentive for businesses to invest in riskier ventures that could pay high returns, but that also have a high likelihood of failure. Businesses will make high-risk investments they would not have made if the rate on dividends and capital gains were equal. All shareholders, including seniors, will suffer lower share values when the fail rate of business investment inevitably increases and the returns that businesses tried to offer through internal investment instead of dividends never materialize.

Don't Punish Seniors

Seniors rely heavily on dividends from corporate stocks and the sales of those stocks to supplement their retirement income, allowing them to maintain a higher standard of living. Rather than inflicting unnecessary harm on seniors, Congress should make the current 15 percent dividend tax permanent, and should waive its PAYGO oversight. In addition to helping seniors, this will keep the dividends tax rate equal to the capital gains tax rate and eliminate incentives for unnecessary risky ventures.

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6. Rea S. Hederman, Jr., and Patrick Tyrrell, "How a Dividend Tax Increase Hurts American Companies and the Economy," Heritage Foundation *Backgrounder* No. 2460, September 10, 2010, at *http://report.heritage.org/bg2460*.

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