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SENATE REPUBLICAN POLICY COMMITTEE

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Marking the 4th Anniversary of the 2003 Tax Relief Law: A Boon to Taxpayers, Tax Receipts, and the Economy

Executive Summary

- May 28, 2007 marks the four-year anniversary of the Jobs and Growth Tax Relief Reconciliation Act of 2003, a landmark law enacted by Republicans that directly and greatly has contributed to today's strong pro-growth economy.
- Two of the most significant provisions of this law were the reductions of the tax rates applicable to dividends and to capital gains received by individual taxpayers.
- Despite opponents' predictions, the lower tax rate on capital investments has been remarkably successful.
  - It has resulted in a dramatic increase in dividend distributions, benefiting *all* Americans owning dividend-paying stocks, a significant number of whom are far from wealthy.
  - It has also encouraged investors to realize capital gains, unlocking critical capital for business growth and increased employment. Moreover, it has promoted greater economic efficiency and significant reforms in the corporate sector of the economy.
  - The lower rates have also led to a surge in tax receipts.
- The lower tax rates on dividends and capital gains have succeeded in producing two very positive results – an expansion of the supply of capital and a reduction in the cost of that capital. This, in turn, allows American businesses, and in particular small enterprises, to increase investment, productivity, and employment.
- Since the tax relief was enacted in 2003, revenues have exceeded official CBO projections by 68 percent. The deficit has been reduced faster than hoped while Congress still funds the war and Hurricane Katrina cleanup.
- While some opponents continue to dispute the efficacy of the 2003 tax relief, even the non-believers must have a difficult time arguing with *facts* that show that the economy is strong and continues to grow.
- Allowing the 2003 tax relief to sunset will have the effect of increasing taxes and so will have devastating consequences for the economy.

Introduction

May 28, 2007 marks the four-year anniversary of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (the 2003 tax cuts or JGTRRA),[1] a landmark law enacted by Republicans that directly and greatly has contributed to today's strong pro-growth economy. Two of the most significant provisions of JGTRRA were the reductions of the tax rates applicable to dividends and to capital gains received by individual taxpayers. Prior to that change, dividends were taxed at a taxpayer's marginal tax rate, which in 2002 could be as high as 38.6 percent. The 2003 tax cuts reduced the dividend-tax rate to 15 percent for most taxpayers (and to 5 percent for taxpayers in the lowest two tax brackets). In addition, the 2003 tax cuts reduced the capital-gains tax rate from 20 percent to 15 percent.

The lower tax rates on dividends and capital gains were designed to reduce the double taxation of corporate profits, equalize the taxation of returns on capital investments, and decrease the tax burden on individuals who invest in corporate equities. In so doing, it was expected to reduce the cost of capital for American businesses. Nevertheless, opponents assailed the rate reduction as a tax cut for only the "elite" and "wealthiest" Americans.[2] In particular, they claimed that stock ownership is concentrated among wealthy individuals and, as a result, these taxpayers would be the only beneficiaries.

Despite the opponents' predictions, the lower tax rate on capital investments has been remarkably successful. It has resulted in a dramatic increase in dividend distributions, benefiting *all* Americans owning dividend-paying stocks, a significant number of whom are far from wealthy. It has also encouraged investors to realize capital gains, unlocking critical capital for business growth and increased employment. Moreover, it has promoted greater economic efficiency and significant reforms in the corporate sector of the economy.

Extending beyond the taxpayer and economic benefits, the lower rates have also led to a surge of tax receipts into the Department of Treasury. Since the capital gains rate was reduced in 2003, revenues have exceeded official CBO projections by 68 percent.[3]

As the fourth anniversary of this landmark tax-relief law approaches, Republicans should take credit for enacting strong, pro-growth economic policy, and should continue their efforts to make the relief permanent.

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[1] Public Law 108-27, May 28, 2003.

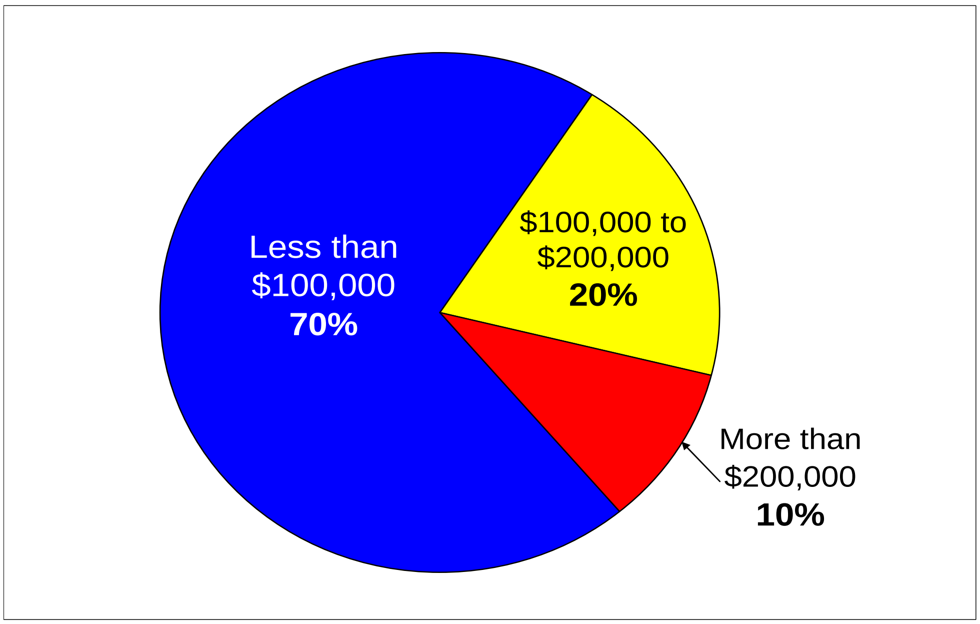
[2] *See* Senator Max Baucus, Congressional Record, May 22, 2003, p. S6950: "This tax cut [with respect to dividends] alone is heavily weighted to the elite. . . . So the overwhelming majority of Americans will get little or no benefit from this provision. But look how much this single provision will benefit the elite who do profit from it."

[3] American Shareholders Association, found at http://www.americanshareholders.com/blog/2007/01/cbos-capital-gains-error-now-stands-at.php.

Dividends and Capital Gains Lower Rates Benefit Not Just the Wealthy

While opponents have argued that the dividend and capital-gains tax cuts would benefit only the wealthy, research has demonstrated that their argument lacks merit. A survey of equity ownership in this country shows that more than half (50.3 percent) of American households – representing 91.1 million individuals – owned equities such as stocks or mutual funds in 2005.[4] In 2005, the most recent tax-year data available, 26 million tax filers reported $112 billion of dividend income that qualified for the lower tax rates.[5] The majority of these tax filers were middle-income taxpayers: 10.5 million tax filers had AGI less than $50,000 and reported an average of $1,200 of dividend income and 18.1 million tax filers had AGI less than $100,000 and reported an average of $1,600 of dividend income.[6]

Figure 1: 70 Percent of Families Who Benefited from the Lower Rates on Dividends in 2005 Had AGI under $100,000



Source: IRS, Individual Income Tax Returns, Preliminary Data, 2005 (SIFMA calculations)

In addition, with the median age in each household-income category being approximately 45 years old, a significant number of equity owners in this country are nearing retirement or are already retired. For individuals in the final years of saving for retirement as well as retirees, the lower tax rates on capital investments are particularly important because these individuals rely heavily on dividends and capital gains for a large part of their retirement income.

Lower Rates Are Vital to the Success of American Businesses

The rate reductions on capital investments have also played an important role in the strong economic growth that has occurred since they were enacted. Since May 28, 2003, when

[4] Equity Ownership in America, 2005, the Investment Company Institute and the Securities Industry Association.
[5] IRS, Statistics of Income, Individual Income Tax Returns, Preliminary Data, 2005.
[6] IRS, Statistics of Income, Individual Income Tax Returns, Preliminary Data, 2005.

the 2003 tax cuts were signed into law, the primary stock-market indexes have shown significant gains. Dividends paid by S&P 500 companies increased by 35 percent since the lower rates took effect from $166 billion in 2002 to $224 billion in 2006, while dividends paid per share also increased from $18.03 in 2002 to $24.88 in 2006.[7] For individual investors, the increases in the stock indexes have resulted in obvious benefits. As a stock's price grows, investors realize a larger capital gain when they choose to sell the equity investment.[8] However, the lower tax rate on capital gains also provides an incentive for shareholders to realize gains they have accumulated on stocks and other capital investments, unlocking investment capital that is critical to the market.[9] Additionally, because investors incur lower tax bills on expected dividends and capital gains, they accept a lower rate of return on new investments that they make. That lower expected rate of return reduces the cost that businesses must incur to raise capital.[10]

Thus, the lower tax rates on dividends and capital gains have succeeded in producing two very positive results – an expansion of the supply of capital and a reduction in the cost of that capital. This, in turn, allows American businesses, and in particular small enterprises, to increase investment, productivity, and employment.

2003 Tax Law Yields Reforms by Corporate America

The success of the 2003 rate reductions are also evidenced by the resulting reforms and improvement in economic efficiency in the corporate sector. Historically, the tax law created a bias that prompted corporations to reinvest their earnings in new equipment or the development of new products or services, even when such actions might not complement the core competency of the business.[11] To the extent that such reinvestments led to higher stock prices, shareholders would realize capital gains, which were taxed at a 20-percent rate prior to the 2003 tax cuts. In contrast, companies that distributed their earnings as dividends left shareholders with ordinary income, which was taxed at as much as 38.6 percent prior to 2003.

By equalizing the dividend and capital-gain rates, the 2003 tax cuts largely eliminated that bias. Consequently, managers now have an incentive to invest only in the best capital projects available to their company – new equipment and/or development of products or services that are consistent with the business' expertise and that produce superior returns. And, the unneeded earnings can be distributed to the shareholders, who now pay the same 15-percent tax on dividends as they do on capital gains. The result is a more efficient use of reinvested earnings to provide capital for corporate growth and expansion.[12]

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[7] Standard & Poor's Quantitative Services.
[8] Joint Economic Committee, "Who Benefits from Ending the Double Taxation of Dividends?" February 2003, http://jec.senate.gov/_files/DividendDoubleTax.pdf.
[9] David R. Malpass, Chief Economist, Bear Stearns, in testimony before the Senate Finance Subcommittee on Taxation and IRS Oversight, June 30, 2005, p. 4, http://finance.senate.gov/hearings/testimony/2005test/dmtest063005.pdf.
[10] Stephen J. Entin, President and Executive Director, Institute for Research on the Economics of Taxation, in testimony before the Senate Finance Subcommittee on Taxation and Internal Revenue Service (IRS) Oversight, June 30, 2005, p. 8, http://finance.senate.gov/hearings/testimony/2005test/setest063005.pdf.
[11] Mallory Factor and Jack Kemp, "Real Corporate Governance Reform," *Investor's Business Daily*, June 8, 2005.
[12] Frank A. Fernandez, "Dividend Tax Cuts Deemed Effective," SIA Research Report, Volume V, No. 8, August 2, 2004.

Tax Relief Has Promoted a Pro-Growth Economy and Surging Revenues

While some opponents continue to dispute the efficacy of the 2003 tax relief, even the non-believers must have a difficult time arguing with *facts* that show that the economy is strong and continues to grow:

- Since August 2003, 7.8 million jobs have been created − more jobs than all the other major industrialized countries combined.[13]
- The economy has added jobs for 43 straight months through April of this year.[14]
- The unemployment rate is at 4.4 percent − below the average of each of the past four decades.[15]
- In 2006, U.S. exports (12.7 percent) grew faster than imports (10.5 percent) for the first time since 1997.[16]
- At the end of 2002, the stock market was valued at $9.1 trillion. The rate reductions were enacted the following year, and the stock market quickly recovered. By the end of 2006, the stock market was valued at $12.7 trillion – a 40-percent increase in only four years (after adjusting for inflation).[17]
- In 2006, S&P 500 companies paid $224 billion in dividends – 35 percent *more* than what they paid in 2002 before the lower rates took effect (after adjusting for inflation).[18]

In addition to the strong economy, current tax policies are providing the necessary funding for the government. Tax receipts were up almost 12 percent in FY 2006, after rising by 14.6 percent in FY 2005.[19] According to a *Wall Street Journal* article on May 9, 2007, "tax receipts for April were $70 billion above the same month in 2006, and April 24 marked the single biggest day of tax collections in U.S. history, at $48.7 billion. Tax revenues for the first seven months of FY 2007 are up 11.3 percent and at this pace, the deficit this year could shrink to 1 percent of GDP."[20] Indeed, since the capital gains rate was reduced in 2003, revenues have exceeded official CBO projections by 68 percent.[21]

With regard to capital gains receipts, Figure 2 below depicts CBO's estimates of tax receipts compared to the actual receipts following the 2003 rate reductions. Specifically, CBO estimated that the lower capital gains and dividend rates would cost the federal government $5.4 billion in the first four years of the law's enactment, which in turn, would result in only $192 billion of capital gains tax collections from FY2003-2006. However, capital gains tax receipts were actually $298 billion – $106 billion higher than government forecasts. In other words,

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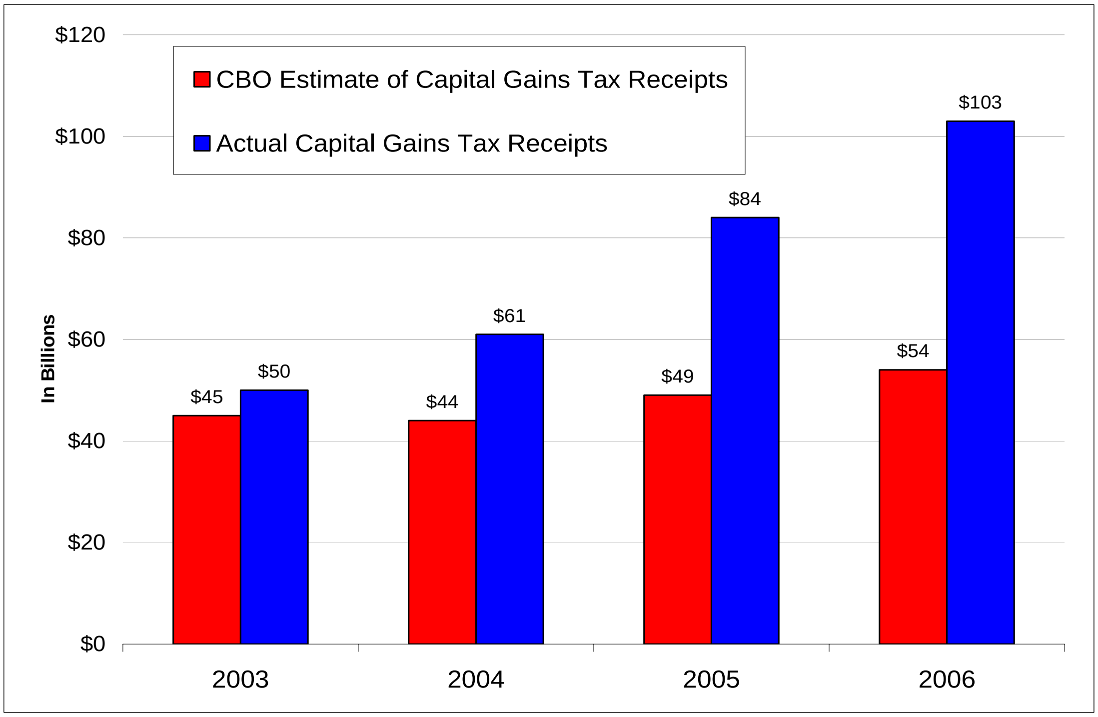
[13] Department of Treasury, Press Release, *Treasury Economic Update,* April 23, 2007.
[14] Department of Treasury, Press Release, *Treasury Economic Update,* April 23, 2007.
[15] Department of Treasury, Press Release, *Treasury Economic Update,* April 23, 2007.
[16] The White House, Office of the Press Secretary, Press Release, "*Job Creation Continues – More Than 7.8 Million Jobs Created Since August 2003*," April 6, 2007.
[17] Standard & Poor's Quantitative Services.
[18] Standard & Poor's Quantitative Services.
[19] Congressional Budget Office, The Budget and Economic Outlook: Fiscal Years 2008 to 2017, January 2007.
[20] *Wall Street Journal*, "April Showers," May 9, 2007.
[21] American Shareholders Association, found at http://www.americanshareholders.com/blog/2007/01/cbos-capital-gains-error-now-stands-at.php.

government estimators predicted that the tax cuts would reduce federal revenue by $5.4 billion in the first four years after enactment, but federal revenue actually increased.

Figure 2: Capital Gains Tax Receipts Increased After the 2003 Rate Reductions



Source: Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2005 – 2014*, January 2004 and *The Budget and Economic Outlook: Fiscal Years 2008 – 2017*, January 2007

Allowing the 2003 tax relief to sunset will have devastating consequences for the economy. Less capital in the private sector will increase financing costs for American businesses, hindering their ability to make capital investments, expand their operations, and provide critical jobs. Moreover, slower economic growth — or worse, a recession — will have adverse effects on tax revenues, resulting in additional budgetary challenges for the federal government.

Conclusion

The lower tax rate on capital investments has been remarkably successful. Republicans should celebrate the anniversary of JGTRRA and recognize the valuable effect that such policy has had on the economy. As the expiration of the 2003 tax relief approaches, it is imperative that the relief be made permanent, a battle that the U.S. economy cannot afford to lose.