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Extension of the Dividend and Capital-Gains Tax Rates: Why Now?

Executive Summary

- After two and a half years, the lower tax rates on dividends and capital gains enacted in 2003 have produced impressive economic results – dividend distributions have risen substantially, business investment has surged, and the nation's Gross Domestic Product has grown steadily. Moreover, the lower rates benefit the majority of American households.
- Nevertheless, critics contend that, since the lower rates are not scheduled to expire until the end of 2008, Congress does not have to bother with the issue for two years or more – an approach that, at best, can be described as shortsighted.
- American companies are making investment decisions *today* that will be influenced in significant part by the *future* tax rates imposed on individual investors who supply the capital that is essential for those companies to expand and create new jobs.
- The lower tax rates on dividends and capital gains have effectively reduced the cost of capital for businesses to invest in new equipment, facilities, and products by as much as 15.5 percent, according to Treasury Department estimates.
- If Congress assures investors that the lower tax rates will be extended, businesses can factor that stability into their financing cost estimates made *today* for future investments.
- Alternatively, investors are likely to begin demanding higher returns as soon as they believe that Congress will allow the rates to expire – a perception that could take root if Congress fails to extend the dividend and capital-gains rates in the tax-reconciliation bill. And, if investors' return requirements begin to rise, the cost of capital will likely follow suit.
- The tax imposed on investor returns is one of the only factors that Congress can control, among the many that influence the cost of capital and business investment.
- To ensure that the impressive growth in business investment is sustained and the growth in jobs and the economy is realized in the coming years, Congress must provide certainty with respect to the tax code by maintaining the current 15-percent tax rate on dividends and capital gains through 2010, and ultimately making the rates permanent.
- Providing this certainty will encourage investors and businesses to make investment decisions *today* that will add to the nation's economic well being *far beyond tomorrow*.

Introduction

After two and a half years, the lower tax rates on dividends and capital gains enacted in the Jobs and Growth Tax Relief Reconciliation Act of 2003 have produced impressive economic results.[1] Notably:

- ♦ Dividend distributions are up – quarterly dividends paid by the constituent firms comprising Standard & Poor's S&P 500 Index have increased 51 percent from the quarterly average of the 10 years preceding the rate reduction, which has benefitted Americans saving for retirement and the nation's seniors who rely on dividend and capital gains to supplement Social Security benefits.[2]
- ♦ After declining for nine quarters prior to the 2003 tax act, corporate investment in new property, plant, and equipment has surged, motivated significantly by the reduced cost of capital that the lower tax rates have produced.[3]
- ♦ The nation's Gross Domestic Product has grown for 10 consecutive quarters at a rate above 3 percent since the 2003 tax legislation was enacted, fueled in part by capital investment resulting from the lower tax rates.[4]
- ♦ Because of the change in the tax treatment of dividends, corporate executives are now more likely to focus on measurable, consistent value in the form of dividend payments, thereby improving corporate governance.[5]

Moreover, the lower dividend and capital-gains rates have benefitted the majority of American households. According to a recent survey of equity ownership in this country, 50.3 percent of American households – representing 91.1 million individuals – owned equities such as stock or mutual funds in 2005.[6] Among these individuals are a significant number of senior citizens, many of whom rely on dividend and capital gains to supplement Social Security benefits. In fact, 57 percent of individuals age 65 and older reported taxable dividend income and 23 percent reported taxable capital-gains income in 2003, according to the most recent data

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[1] H.R. 2, 108th Congress, 2d Session, Public Law 108-27, May 28, 2003.

[2] Data supplied by Standard & Poor's Quantitative Services; see also Chetty and Saez,"Do Dividend Payments Respond to Taxes? Preliminary Evidence from the 2003 Dividend Tax Cut," NBER Working Paper 10572, June 2004, p. 16-17 – http://papers.nber.org/papers/w10572.pdf (In each of the three quarters following the dividend tax rate reduction, an average of 65 publicly traded companies that were *already paying* dividends raised the size of their dividend payments by 20 percent or more. In contrast, an average of only 32 companies raised their dividends by similar amounts in prior years.); Stephen Moore and Phil Kerpen, "Show Me the Money! Dividend Payouts after the Bush Tax Cuts," Cato Institute, October 11, 2004 – http://www.cato.org/pubs/briefs/bp-088es.html.

[3] Treasury Secretary John Snow, Statement on Tax Cut Permanency Being "Essential" to Business Investment, Treasury Department Office of Public Affairs, January 10, 2005 – http://www.treas.gov/news/index2.html.

[4] Bureau of Economic Affairs, "Gross Domestic Product: Third Quarter 2005 (Final)," BEA 05-57, December 21, 2005, Table 1 – http://www.bea.gov/bea/newsrelarchive/2005/gdp305f.pdf

[5] For a detailed review of the results that the lower tax rates have produced, see the Republican Policy Committee's "The Dividend and Capital-Gain Tax Rates: Sound Economic Policy Well Worth Extending," January 19, 2006 – http://rpc.senate.gov/_files/Jan1906DividendCapGainsMW.pdf.

[6] "Equity Ownership in America, 2005" Investment Company Institute and Securities Industry Association, Figure 48 – http://www.sia.com/research/pdf/EquityOwnership05.pdf.

available from the IRS.[7] Additionally, lower- and middle-income individuals are substantial beneficiaries of this change in tax policy – research has shown that more than 80 percent of taxpayers who reported dividend income earned less than $100,000 and 76.4 percent of those who reported capital gains earned less than $100,000 in 2004.[8]

Despite the impressive results and broad application among American taxpayers, critics continue to oppose extension of this important growth-oriented tax policy. Economists have repeatedly warned that the failure to extend these tax rates will likely result in adverse consequences for the stock markets and the economy overall.[9] Nevertheless, critics contend that, since the lower rates are not scheduled to expire until the end of 2008, Congress does not have to bother with the issue for two years or more – an approach that, at best, can be described as shortsighted.

Why Extend the Rates Now?

The key to understanding why time is of the essence is the effect that the lower tax rates on dividends and capital gains have on the cost of capital for American businesses. In turn, the cost of capital influences business investment and the economy over the long term. In short, companies are making investment decisions *today* that will be influenced in significant part by the *future* tax rates imposed on individual investors who supply the capital that is essential for those companies to expand and create new jobs.

Tax Rates and the Cost of Capital

At the most basic level, a business' cost of capital is the rate of return it must offer in order to entice individuals to invest in the company.[10] For their part, investors are generally

[7]Data supplied by the IRS Statistics of Income Division, based on tax year 2003 income-tax returns.

[8]Scott A. Hodge, "Majority of Seniors Benefit from Reduced Capital Gains and Dividend Tax Rates," Tax Foundation, *Fiscal Facts*, December 6, 2005 – http://www.taxfoundation.org/publications/show/1236.html.

[9]See Ben Bernanke, Chairman, Council of Economic Advisors, and nominee for Chairman of the Federal Reserve, October 20, 2005 ("I do think uncertainty and delay, all else being equal, would be costly in the sense that investors would not know what to anticipate... There would be an increase in uncertainty and there may be some impact on growth"); John Silvia, Chief Economist, Wachovia Corporation, October 21, 2005 ("Policy makers can enhance employment and growth by providing a stable tax environment for capital by extending the 15-percent tax rate now. Opportunities lost may be difficult to quantify in the short run but the competitive nature of a global marketplace suggests that other nations will attract the capital necessary to improve their competitiveness and long-run employment if we fail to extend the current 15 percent rate"); Frank Fernandez, Chief Economist, Securities Industry Assoc., October 18, 2005 ("The failure to meet those expectations will result in downward pressure on the financial markets, beginning this year and increasing further as the 2008 sunset gets even closer. In fact, if Congress fails to extend these tax policies this year, the U.S. economy could see greater negative ramifications going forward than we saw positive results from their enactment in 2003"); Chuck Gabriel, Prudential Securities, CNBC, November 11, 2005 ("If they don't follow through and enact [an extension of the tax cuts on capital gains and dividends] this year while they can, it's going to be a very negative signal for Wall Street")

[10]Eugene F. Brigham and Michael C. Ehrhardt, *Financial Management Practice and Theory*, 10th Edition, p. 419.

concerned with the return on the investment that remains after taxes.[11] When taxes applicable to that return – dividends and/or capital gains – are high, companies must provide higher rates of return in order to meet investors' requirements.[12] The result is a higher cost that businesses must bear to raise equity capital for new equipment, facilities, products, research and development, and other business investments.

Conversely, by lowering the taxes on dividends and capital gains, the 2003 tax act effectively reduced the cost of capital.[13] In fact, the Treasury Department estimates that the act produced a 15.5-percent decrease in corporate financing costs,[14] which corresponds to a reduction of 50 to 100 basis points (0.5 percent to 1 percent) in the actual cost of capital, according to another study.[15] Thus, a pre-2003 cost of capital of 6.5 percent would have declined to 5.5 percent after the 2003 tax act, based on these findings – representing a significant cost savings for corporations seeking to finance multimillion-dollar investments over long periods of time.

Cost of Capital and Business Investment

While influenced by a number of factors including taxes, risk, and other economic conditions, the cost of capital is a fundamental determinant of business investment. Every capital investment considered by corporate management is evaluated on the basis of how much of a return the investment – the new product, equipment, facility – will produce and how much it will cost the business to finance it.[16] What the critics of the lower tax rates fail to understand is the fact that American businesses do not live in a world that plans only for tomorrow or a week down the road. Successful businesses rely on business plans that span five to ten years in most instances when it comes to capital investments. These are commitments that companies make *today* with respect to projects that are vital to the company's long-term profitability.

Consider, for example, a hypothetical company that is evaluating two major projects for its five-year capital-investment plan: (1) a new consumer product that the company expects to begin developing in 2006 and have available for retail sales in 2007; and (2) a new manufacturing facility that the company will start in 2008 and take at least two years to complete. While a host of non-tax factors will influence the company's cost of capital, the effect

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[11]See Eaton Vance, "Seventh Annual Eaton Vance National Investor Survey," December 6, 2005 – http://www.eatonvance.com/alexandria/pressreleases/200512/2005SurveyRelease.PR.pdf (Survey found that 89 percent of investors reported that the impact of taxes on their investment returns is important to them).

[12]Joint Economic Committee (JEC), "Who Benefits from Ending the Double Taxation of Dividends?" February 2003, p. 7 – http://jec.senate.gov/_files/DividendDoubleTax.pdf.

[13]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. 3 – http://finance.senate.gov/hearings/testimony/2005test/setest063005.pdf.; David R. Malpass, Chief Economist, Bear Stearns, in testimony before the Senate Finance Subcommittee on Taxation and IRS Oversight, June 30, 2005, p. 1 – http://finance.senate.gov/hearings/testimony/2005test/ dmtest063005.pdf; and JEC.

[14]Treasury Department, Office of Tax Policy, "Fact Sheet: How Have the President's Tax Cuts Encouraged Investment?" March 2, 2005 – http://www.treasury.gov/press/releases/reports/ factsheettaxcutsandinvestment.update.pdf. http://www.bos.frb.org/economic/ppdp/2005/ppdp051.pdf.

[15]Richard Kopcke, "The Taxation of Equity, Dividends and Stock Prices," Federal Reserve Bank of Boston, Public Discussion Papers, 05-1, January 2005, p. 18 – http://www.bos.frb.org/economic/ppdp/2005/ppdp051.pdf.

[16]Brigham and Ehrhardt.

of investor tax rates deserve particular attention. If Congress assures investors that the tax rates on dividends and capital gains will be extended, the company can factor that stability into its financing cost estimates for both potential projects.[17]

On the other hand, investors are likely to begin increasing their return requirements on equities as soon as they believe that Congress will allow the lower tax rates to expire at the end of 2008 – a perception that could take root if Congress fails to address the rates in the tax-reconciliation bill.[18] And, if investors' return requirements begin to rise, the company's cost of capital will follow suit, which could adversely affect the prospects for proceeding, especially with the new product, which must be financed in the near term.

The second project under consideration by the hypothetical company, the new manufacturing facility, would present an even more difficult decision since its construction will not begin until 2008 and then take two years to complete. As a result, the company would not have to raise the capital for several years, forcing the company to make a guess *today* as to what the cost of capital will be four to five years in the future.[19] If the lower rates are not extended this year, prudent business management would suggest that (holding the other non-tax influences constant) the company should assume that the cost of capital will rise significantly, at least by 2009 when the dividend-tax rate will increase from 15 percent to as much as 35 percent and the capital-gains rate will return to 20 percent.

At that point, an investor who required an after-tax return of a $1.00 prior to 2009 then would demand a return of $1.10 to $1.25 (depending on whether the return consists of capital gains or dividends) in order to achieve the same $1.00 after-tax return. For the company, the additional 10-to-25 cents per dollar would raise the cost of capital and reduce the profitability of the new manufacturing facility (or, in the worse case, exceed the facility's expected rate of return), making the investment less attractive or even uneconomical. And, if the company were to decline to move forward with the investment, the jobs that the new installation would otherwise have produced would also be lost.

The bottom line is that this hypothetical company must make decisions ***today*** as to whether it will commit to these capital investments, delay them for some period, or forgo them altogether – all of which hinge on the financing costs. At the margins, a stable tax policy with respect to the current tax rates on dividends and capital gains may well be a deciding factor between a company's decision to undertake a long-term, innovative project and a decision to abandon a job-creating investment altogether.

Moreover, this example assumes only two investment proposals, a small fraction of the number likely being considered by a typical U.S. multinational business in its annual long-range investment plans – investments that are essential for it to remain competitive in the global

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[17]Entin, p. 1.

[18]William W. Beach and Rea S. Hederman, Jr., "Making the Bush Tax Cuts Permanent," Heritage Foundation, *WebMemo* #956, January 5, 2006 – http://www.heritage.org/Research/Taxes/wm956.cfm; Malpass, pp. 1 & 7.

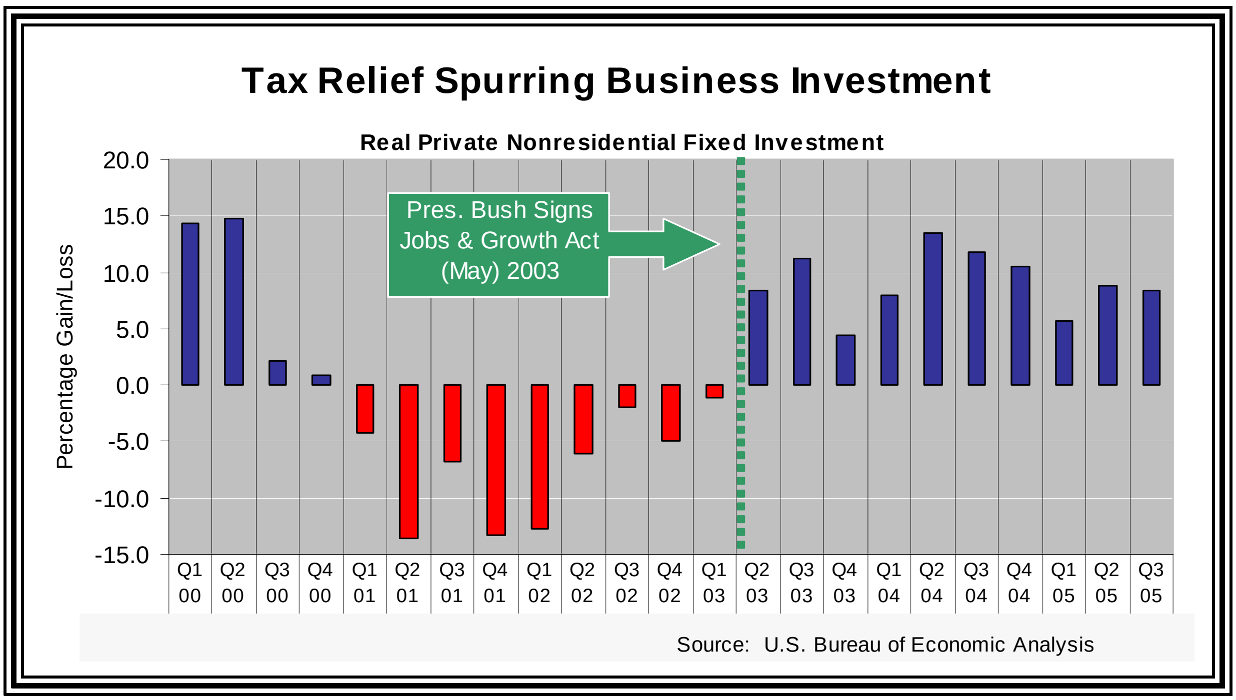
[19]While some may argue that the company should simply raise the capital today when the rate is perceived to be low and more certain, doing so would require the company to pay a return to investors on capital that is sitting idle while the company prepares for the construction of the new facility in three years.

economy. Additionally, there are more than 5,000 publicly traded companies headquartered in the United States and countless more privately held businesses that are making the same decisions every day.[20] If too many of these businesses decide *today* to forgo new investments (as well as the essential jobs that go with them), the economy will surely suffer over the long run.

A Measure of Certainty is Needed

In a recent statement, Treasury Secretary John Snow made the following observation, illustrated by the accompanying chart:

> The Jobs and Growth Act of 2003 was especially effective at encouraging investment because it lowered the cost of capital – the lifeblood of a free market economy. Business investment literally turned around overnight when those tax cuts took effect, ending nine quarters of investment dearth and spurring ten quarters – so far – of outstanding business investment, which has then led to growth and job creation."[21]



To put this impressive growth in perspective, several points should be considered. First, the significant decline in business investment was a primary contributor to the 2001 recession, and, unlike the case in most other recessions, consumer spending remained relatively steady during that period.[22] Second, the recovery in business investment, which paralleled the

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[20]See Dow Jones Wilshire 5000 Index – http://www.wilshire.com/Indexes/Broad/Wilshire5000/.

[21]Treasury Secretary John Snow, Statement on Tax Cut Permanency Being "Essential" to Business Investment, Treasury Department Office of Public Affairs, January 10, 2005 – http://www.treas.gov/news/index2.html.

[22]Bureau of Economic Affairs (BEA), National Income and Product Accounts (NIPA), Table 1.1.1, 1947-2005 – http://www.bea.gov/bea/dn/home/gdp.htm. See Martin and Kathleen Feldstein, "Uncertainty could derail recovery," originally published in *The Boston Globe*, January 1, 2002, and republished by the National Bureau of

(continued...)

enactment of the 2003 tax act, has contributed to substantial growth in employment. In fact, between May 2003 and December 2005, more than 4.6 million net new payroll jobs were created.[23] Lastly, real (or inflation-adjusted) private business investment today represents more than 11 percent of the nation's Gross Domestic Product, according to figures from the first three quarters of 2005.[24] Based on these factors, it is clear that changes in business investment can have a pronounced effect on the strength or weakness of the nation's economic health.

One of the only factors that Congress can control, among the many that influence the cost of capital and business investment, is the tax imposed on investor returns – dividends and capital gains. To ensure that the impressive growth in business investment is sustained and the growth in jobs and the economy is realized in the coming years, Congress must provide certainty with respect to the tax code by maintaining the current 15-percent tax rate on dividends and capital gains through 2010, and ultimately making the rates permanent. Doing so will encourage investors and businesses to make investment decisions *today* that will affect the nation's economic well being *far beyond tomorrow*.

Conclusion

Businesses across the nation, large and small, are making decisions every day about capital investments that they will implement over the next one to ten years. And those decisions are based in part on how the cost of capital will respond to changes in tax policy that may occur years in the future. If American businesses collectively start factoring significantly higher costs of capital into their current planning, the result is likely to be a downturn in capital investments and a decline in new job creation over the long term – a decline that could ultimately retard economic growth. To avoid that result, Congress should assure investors and the business community *today* that tax rates on capital investments will remain stable.

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[22](...continued)
Economic Research – http://www.nber.org/feldstein/bg010102.html.

[23]BLS, "Employment Situation: December 2005," USDL 06-07, January 6, 2005 – http://www.bls.gov/news.release/pdf/empsit.pdf.

[24]BEA, "Gross Domestic Product: Third Quarter 2005 (Final)," Table 3.