United States Senate

Republican Policy Committee

Jon Kyl, Chairman

Lawrence Willcox, Staff Director
347 Russell Senate Office Building
Washington, DC 20510
202-224-2946
http://rpc.senate.gov

September 6, 2005

The Dividend and Capital-Gain Rate Cuts: Extending Sound Economic Policy

Executive Summary

- Despite the opponents' charge that the reduction in the reduced tax rates for dividends and capital gains enacted in 2003 would amount to little more than tax cuts for the "rich," this important change in the nation's tax policy has resulted in far-reaching benefits for millions of American households as well as the corporate sector of the economy.
- In the year following enactment of the dividend-tax cut, 113 publicly traded corporations initiated dividend payments for the first time, compared to an average of 22 companies in prior years. Moreover, through July 29, 2005, the 500 U.S. companies making up the Standard & Poor's index alone have increased their dividend payments 626 times, resulting in a 21-percent increase in average quarterly dividends.
- The increase in corporate dividends and stock repurchases translates into benefits to all shareholders, not just upper-income investors owning stock in taxable accounts, as opponents have argued. With an estimated 79 percent of equity investors participating in tax-deferred retirement plans, an increase in dividends means additional contributions to retirement income that can compound tax-free until they are withdrawn.
- The lower tax rates on dividends and capital gains have also produced some critical reforms in corporate America by providing an incentive for managers to reinvest corporate earnings more efficiently and return unneeded earnings to the shareholders. Additionally, it promotes straightforward corporate accounting since regular dividends can only be paid out of actual cash earnings. Moreover, corporate balance sheets benefit from the increased use of common stock, rather than debt, to raise capital.
- The lack of permanence of the lower tax rates on capital investments appears to be constraining this growth-oriented tax policy from realizing its full potential. And, as the expiration date approaches, individual investors at all income levels are certain to react, which is likely to have adverse consequences for the stock markets and the economy overall.
- If the success of the dividend and capital-gain tax cuts is to continue – and reach its full potential – Congress must extend the lower rates by at least two years, and ultimately make them permanent.

Introduction

Two of the most significant provisions of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (the 2003 tax cuts or JGTRRA)[1] were the reductions of the tax rates applicable to dividends and 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).[2] In addition, the 2003 tax cuts reduced the capital-gains tax rate from 20 percent to 15 percent.[3]

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.[4] 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, benefitting *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 is promoting greater economic efficiency and significant reforms in the corporate sector of the economy.

For these benefits to continue, however, Congress must address the looming expiration of the rate reduction as soon as possible. A first step toward making the dividend and capital-gain tax rates permanent would be to extend them by two years in the tax-reconciliation bill that Congress will consider later this year.

---

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

[2] JGTRRA § 302. For taxpayers in the bottom two tax brackets, the tax on dividends will be eliminated beginning in 2008.

[3] JGTRRA § 301. Paralleling the treatment of dividends, for taxpayers in the bottom two tax brackets, the tax on capital gains will be eliminated beginning in 2008.

[4] 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."); Senator Bob Graham, *Congressional Record*, May 22, 2003, p. S6951 ("Since generally only the wealthiest of Americans will benefit by this proposal to make the remainder of dividends which are subject to taxation free of taxes, the practical effect is going to be to have these high-income Americans put the money into some account, not to spend it, and create the demand that our economy needs.").

Measuring the Success of the Lower Tax Rates

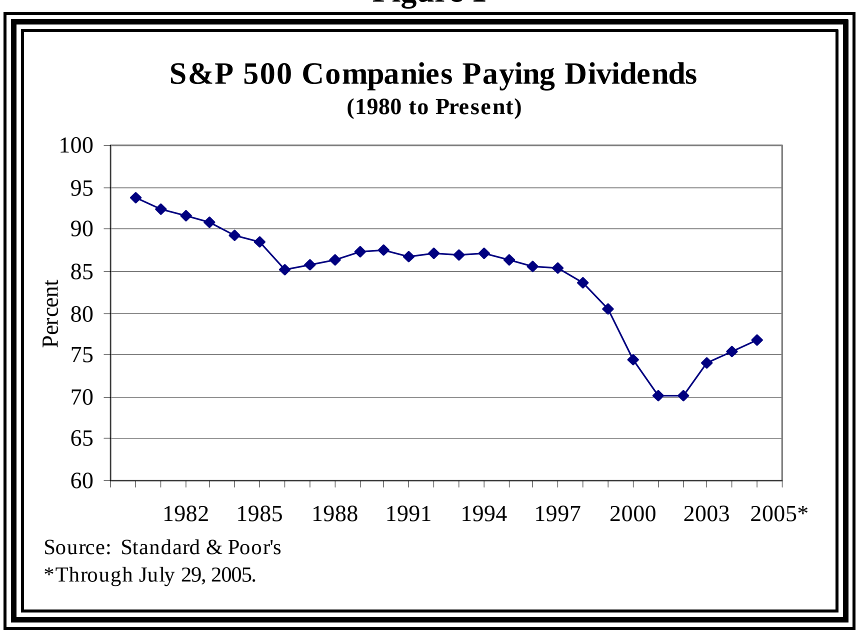
A Substantial Increase in Distributions of Corporate Profits

After just one year, the reduction in the dividend and capital gains tax rates has produced some very impressive results. In terms of the lower tax on dividends, academic research has demonstrated that the rate reduction has induced a significant number of publicly traded companies to raise or initiate regular dividend payments.[5]

For example, since May 28, 2003 when the dividend-tax cut was signed into law, the publicly traded corporations making up the Standard & Poor's index of the 500 leading U.S. companies (S&P 500) alone have increased their dividend payments 626 times through July 29, 2005 – many companies raising their dividend multiple times over the 25-month period.[6] In dollar terms, dividends by S&P 500 companies have averaged nearly $46 billion per quarter since the reduction in the dividend-tax rate was enacted – a 21-percent increase from the quarterly average of the 10 years preceding the rate cut.

The dividend-tax cut has also reversed the long-term negative trend in the percentage of firms paying regular dividends. As Figure 1 below illustrates, the percentage of S&P 500

Figure 1



[5]Raj Chetty and Emmanuel Saez, "Dividend Taxes and Corporate Behavior: Evidence from the 2003 Dividend Tax Cut," NBER Working Paper 10841, October 2004, pp. 2-3 – http://papers.nber.org/papers/w10841.pdf.

[6]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 cut, 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.

companies that pay dividends had fallen from over 90 percent in 1980 to 70 percent in 2002, before rebounding to nearly 77 percent so far in 2005.[7] More broadly, a study of companies listed on the major U.S. stock exchanges (including S&P 500 companies) found a similar rebound in the percentage of companies paying regular dividends.[8]

Even more impressive is the fact that the number of *new* dividend-paying companies increased significantly. Among all publicly traded companies, in just the first three quarters following the enactment of the dividend-tax cut, 113 corporations initiated dividend payments for the first time, compared to 21 companies in 2002.[9] In dollar terms, dividend initiations surged from $13 million per quarter before the 2003 tax cuts to an average of $205 million per quarter after the legislation was enacted.[10]

While the reduced tax rate on dividends has prompted a substantial increase in corporate dividend distributions, companies have also responded to the capital-gains rate cuts by increasing the use of stock repurchases.[11] In general, a stock repurchase enables a company to distribute earnings to stockholders by buying back shares of the company's stock on the market. Through a repurchase, stockholders who sell their stock can recognize their built-in gains at the lower capital-gains rate. And, with a smaller number of shares outstanding after the repurchase, the remaining stockholders generally realize an increase in the value of their stock.[12]

According to the Securities Industry Association, new stock repurchases totaled $311.9 billion in 2004, up sharply from the $153.9 billion total during 2003 and the $164.4 billion total for 2002.[13] And, the level of stock repurchases shows little sign of slowing, with $231.3 billion in repurchases recorded in the first half of 2005.[14] Additionally, at the end of July 2005, non-financial S&P 500 companies reported holding more than $600 billion in cash, significant resources that can be used to continue stock buy-backs.[15]

Real Benefits for American Shareholders

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. First, a survey of equity ownership in this country shows that 49.5 percent of American households – representing 84.3 million individuals – owned equities such as stock or mutual funds in 2002.[16] As reflected in Figure 2, nearly half of these equity owners have household incomes of less than $50,000 and

---

[7] Standard & Poor's Quantitative Services.

[8] Chetty and Saez, "Do Dividend Payments Respond to Taxes?" p. 3.

[9] Chetty and Saez, "Do Dividend Payments Respond to Taxes?" p. 3.

[10] Chetty and Saez, "Dividend Taxes and Corporate Behavior," p. 20.

[11] Chetty and Saez, "Dividend Taxes and Corporate Behavior," pp. 4-5.

[12] Eugene F. Brigham and Michael C. Ehrhardt, *Financial Management Practice and Theory*, 10th Edition, pp. 721-23.

[13] TrimTabs Weekly Liquidity Review, August 8, 2005 (supplied by the Securities Industry Association).

[14] Standard and Poor's, "S&P 500 Buybacks Surge 91 Percent During First Quarter, Says S&P," Press Release, June 6, 2005.

[15] Standard & Poor's Quantitative Services.

[16] "Equity Ownership in America, 2002" Investment Company Institute and Securities Industry Association, Figure 14 – http://www.sia.com/research/pdf/equity_owners02.pdf.

71 percent have household incomes of less than $100,000 – hardly the elite and wealthiest Americans.

Figure 2

Characteristics of Equity Investors by Household Income

	Household Income		
	Less than $50,000	$50,000 to $99,999	$100,000 or More
Percent of All Equity Owners	49%	22%	29%
Median Age	46 Years	44 Years	47 Years
Median Household Income	$34,000	$70,000	$125,000
Median Household Financial Assets	$37,500	$100,000	$421,500

Source: "Equity Ownership in America, 2002" Investment Company Institute and Securities Industry Association, Figures 17 and 79.

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.[17]

Moreover, the opponents suggest that taxpayers who own equities in a tax-deferred account, such as an Individual Retirement Account or a pension plan, do not benefit from the rate cut because any dividends received in such an account are not subject to taxes until they are withdrawn. This argument overlooks two important factors: the dividend-tax cut has stimulated significant increased corporate dividend distributions, and stock repurchases have contributed to rising equity values, as noted above.

For example, as illustrated in Figure 3 (on page 6), an individual owning a hypothetical portfolio of four stocks in an Individual Retirement Account or employer-based 401(k) retirement plan saw the dividend income rise from $94 in 2002 to $300 in 2004, in large measure because the dividend-tax reduction stimulated increased dividend payments. Moreover, with an estimated 79 percent of equity investors participating in or covered by tax-deferred retirement plans,[18] the increase in corporate dividends translates into additional contributions to retirement income – contributions that then can compound tax-free until they are withdrawn.[19]

[17]Mallory Factor and Jack Kemp, "Real Corporate Governance Reform," *Investor's Business Daily*, June 8, 2005.

[18]Equity Ownership in America, 2002, p. 19.

[19]Joint Economic Committee, "Who Benefits from Ending the Double Taxation of Dividends?" February 2003, p. 9 – http://jec.senate.gov/_files/DividendDoubleTax.pdf.

Figure 3

Hypothetical Portfolio of Stock Held in a Taxable vs. Tax-Deferred Account						
.	Taxable Account			Tax-Deferred Account		
	2002	**2003**	**2004**	**2002**	**2003**	**2004**
Annual Dividend Income*	$94	$204	$300	$94	$204	$300
Taxes Due**	(36)	(31)	(45)	(0)	(0)	(0)
Net Dividend Income	$58	$173	$255	$94	$204	$300

*Based on a hypothetical portfolio of 100 shares of each of the following stocks: Citigroup ($0.70 per share dividend in 2002; $1.10 in 2003; $1.60 in 2004); McDonalds ($0.24 per share in 2002; $0.40 in 2003; $0.55 in 2004); Microsoft (no dividend in 2002; $0.24 per share in 2003; $0.32 in 2004; not including the special dividend of $3.00 in November 2004); and Federated Department Stores (no dividend in 2002; $0.38 per share in 2004 $0.53 in 2004).
**Assuming the maximum individual-tax rate in 2002 of 38.6 percent (rounded to the nearest dollar) and the reduced dividend-tax rate in 2003 of 15 percent.

Similarly, for individuals owning stock in taxable accounts – approximately 31.4 million households[20] – the lower tax rate on dividends allows them to keep more of the dividends they receive. Using the hypothetical portfolio in Figure 3, an investor would have seen the after-tax income increase substantially – from $58 to $255 in just over two years – because of the reduced tax on the dividends as well as the fact that the rate cut stimulated larger dividend payments.

In addition, to the extent that rising dividends and stock repurchases result in increased stock prices,[21] shareholders receive an added benefit. As a stock's price increases, investors realize a larger capital gain when they choose to sell the equity investment, again regardless of whether it is held in a taxable or tax-deferred account.[22]

Critics of the reduction of the dividend and capital-gains tax rate also overlook a critical feature of the 2003 tax cuts for lower-income Americans. Starting in 2003, the dividend and capital-gains rates for taxpayers in the 10-percent and 15-percent tax brackets dropped to

[20]Frank A. Fernandez, "Dividend Tax Cuts Deemed Effective," SIA Research Report, Volume V, No. 8, August 2, 2004, p. 6 – http://www.sia.com/research/.

[21]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; and 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. See also, James Poterba, "Taxation and Corporate Payout Policy," NBER, Working Paper 10321, February 2004, pp. 6-7 – http://papers.nber.org/papers/w10321.pdf; Kevin A. Hassett, "Dividend Tax Cut Makes Sense," American Enterprise Institute, December 1, 2003 – http://www.aei.org/news/filter.,newsID.19615/news_detail.asp.

[22]Joint Economic Committee, p. 8.

5 percent. However, beginning in 2008, the rates drop to zero for these taxpayers.[23] At that point, lower-income Americans will be able to invest in stocks or mutual funds on a virtually tax-free basis – an incredible savings incentive that, unfortunately, expires at the end of 2008 – that is, after just one year.

Taken together, the impressive results of the lower tax rates on capital investments translate into real benefits for *all* individuals who invest in corporate equities, benefitting nearly half of all households nationwide.[24]

A Key to Unlocking Capital for 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. Between May 28, 2003, when the 2003 tax cuts were signed into law, and July 29, 2005, the primary stock-market indexes have shown significant gains – a 21-percent increase in the Dow Jones Industrial Average, a 29-percent rise in the S&P 500, and a 40-percent jump in the NASDAQ.[25] Overall, during that same period, the growth in stock prices has boosted shareholder wealth by $3.3 trillion.[26] While a variety of factors may account for this substantial increase, the influence of the dividend and capital-gains rate reductions cannot be overlooked.

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.[27] 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.[28] 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.[29]

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. The results are stronger corporate profits and rising employee wages.[30] Most importantly, the lower tax rates on capital investments have

[23] Jobs and Growth Tax Relief Reconciliation Act § 301.

[24] "Equity Ownership in America, 2002" Figure 14.

[25] See "Historical Prices" for the DJIA Index (^DJI), S&P 500 Index (^GSPC), and NASDAQ Index (^IXIC) at http://finance.yahoo.com/.

[26] See "Historical Prices" for the Dow Jones Wilshire 5000 Composite Index (^DWC) at http://finance.yahoo.com/.

[27] Joint Economic Committee, p. 8.

[28] Entin, p. 3; Malpass, p. 4.

[29] Entin, pp. 3-7.

[30] Entin, pp. 6-8; Malpass, pp. 4-6.

helped to sustain the current economic expansion – 14 quarters of growth in the nation's real Gross Domestic Product since the recession ended in 2001.[31]

A Significant and Effective Reform of 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.[32] 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.[33]

In addition, new and increased dividends lead to greater corporate accountability to shareholders. The corporate scandals in 2002 revealed that some companies have used questionable accounting practices to overstate their profitability or mask losses. The dividend-tax cut, in contrast, promotes straightforward accounting of a company's earnings since regular dividends can only be paid out of actual cash remaining after the company pays its expenses.[34] As a result, for the first time in more than a decade, there is a correlation between the growth in corporate earnings, as reflected on their financial statements, and the growth in actual cash dividend payments.[35]

Similarly, the current trend toward dividend-paying stock can be viewed as strengthening corporate balance sheets. The reduction in the dividend-tax burden has made it easier for many corporations to raise capital through dividend-paying common stock, when they previously might have turned to debt or other forms of financing to raise needed capital for the business.[36] By encouraging companies to utilize more equity financing, the dividend-tax cut takes some of the pressure off corporate borrowing (although debt still retains a tax benefit due to the

---

[31]Bureau of Economic Affairs, "National Income and Product Accounts, Second Quarter 2005 GDP (Advance)," BEA 05-34, July 29, 2005, Table 1 – http://www.bea.gov/bea/newsrelarchive/2005/gdp205a.pdf.

[32]Mallory and Kemp.

[33]Fernandez, p. 10.

[34]Mallory and Kemp; Dan Clifton, "Incentives Matter: A Lesson," *Tech Central Station*, July 23, 2004 – http://www2.techcentralstation.com/1051/defensewrapper.jsp?PID=1051-350&CID=1051-072304F.

[35]Henry H. McVey, "A Brave New World in Growth is Emerging," Morgan Stanley, July 2005.

[36]Joint Economic Committee, p. 7; Trevor S. Harris, R. Glenn Hubbard, and Deen Kemsley, "The Share Price Effects of Dividend Taxes and Tax Imputation Credits," NBER Working Paper 7445, December 1999, p. 33 – http://papers.nber.org/papers/w7445.pdf.

deductibility of interest).[37] Ultimately, by operating with lower debt levels, companies are not as susceptible to interest-rate fluctuations and have more flexibility to respond to changes in the business cycle.

The Record of Success is Limited by Uncertainty

The significant increase in new and existing dividends and stock repurchases is unmistakable evidence that corporations are responding to tax policy affecting their shareholders.[38] Nevertheless, the lower tax rates on dividends and capital gains are set to expire at the end of 2008. As a result, the lack of permanence appears to be constraining this growth-oriented tax policy from realizing its full potential.

A fundamental principle that corporations follow when setting a regular dividend policy – as opposed to declaring an extraordinary, or non-recurring, dividend – is conservatism. Corporations usually limit the level of their regular dividend to one that can be maintained for the foreseeable future.[39] A subsequent reduction in a company's regular dividend generally evokes a severe negative response from the market with respect to the company's stock price. The dividend cut signals that the company is facing economic difficulties and has no other choice but to cut its regular dividend.[40]

Based on this principle, the significant increases in regular dividend payments and new dividend offerings by publicly traded companies over the past year may represent the level of dividends that management believes can be sustained in the worst-case scenario – that is, that the dividend-rate cut expires.[41] In other words, in a more certain environment in which the dividend-tax cut were permanent, the dividend increases may have been, and may be, even higher.

The same can be said for companies that are still considering whether to start paying a dividend for the first time. Since they are generally reluctant to initiate a dividend if it cannot be

[37]Fernandez, p. 3; *Wall Street Journal*, op-ed by Bill Ford, "Accelerate the Recovery," May 13, 2003.

[38]Chetty and Saez, "Dividend Taxes and Corporate Behavior," p. 3; Jennifer L. Blouin, Jana Smith Raedy, Douglas A. Shackelford, "Did Dividends Increase Immediately After the 2003 Reduction in Tax Rates?" NBER Working Paper 10301, February 2004, p. 25 – http://papers.nber.org/papers/w10301.pdf.

[39]Alan Levinsohn, "Does it make sense to pay dividends?" *Strategic Finance*, May 2003.

[40]Zahid Iqbal and Mohammad Habibur Rahman, "Operational Actions and Reliability of the Signaling Theory of Dividends: An Investigation of Earnings Anomaly Following Dividend Cuts and Omissions," *Quarterly Journal of Business and Economics*, Winter 2003, p. 15; H. Kent Baker, Gary E. Powell, and E. Theodore Veit, "Revisiting Managerial Perspectives on Dividend Policy," *Journal of Economics and Finance*, Fall 2002, p. 278.

[41]*Wall Street Journal*, editorial, "Paying Dividends," July 22, 2004 ("The timing of the Microsoft decision tells us something. . . . the company was clearly concerned with the possibility that John Kerry might be elected President and carry out his promise to return dividends to their former status as ordinary income (thus raising the dividend tax back to the nearly 40 percent Clinton-era top rate from today's 15 percent."); Robert D. Arnott and Clifford S. Asness, "Surprise! Higher dividends = higher earnings growth," *Financial Analysts Journal*, January/February 2003 ("We found that the empirical facts conform to a world in which managers possess private information that causes them to pay out a large share of earnings when they are optimistic that dividend cuts will not be necessary and to pay out a small share when they are pessimistic, perhaps so that they can be confident of maintaining the dividend payouts.").

sustained,[42] the current uncertainty surrounding dividend-tax policy may be inhibiting more companies from paying dividends.

The increase in extraordinary, or non-recurring, dividends since the 2003 dividend-tax cut also suggests that corporations are uncertain about the continuation of the lower dividend rate. Extraordinary dividends allow companies to return earnings to shareholders while avoiding the adverse signaling effects discussed above, because management carefully describes such dividends as non-recurring distributions.[43] For example, while Microsoft announced a significant dividend increase in 2004, only $3.5 billion related to the doubling of the company's regular annual dividend, while the company spent $32 billion on a one-time extraordinary dividend rather than larger regular dividends for the shareholders.[44]

Unlike ordinary dividends, extraordinary dividends do not have the same positive effects over the long term on a company's stock price and cost of capital because they are isolated distributions of corporate earnings.[45] And so, to the extent that these extraordinary dividends are taking the place of increases in a company's regular dividends, they are limiting the beneficial changes that the dividend-tax cut is promoting in the corporate sector, as described above.

When taken together, these factors strongly suggest that shareholders are not realizing the full extent of the dividend increases that might otherwise be possible, due to the uncertain future of the reduced tax rates.[46] As the Congressional Budget Office recently acknowledged: "Many of the gains in efficiency that could result from the effects of the lower rates on the allocation of investment will not be realized unless JGTRRA's provisions are perceived to be permanent."[47]

Economic Consequences of the Rate Cuts' Expiration

If current law remains unchanged with respect to the taxation of dividends and capital gains, taxpayers would see a substantial increase in their taxes beginning in 2009. Depending on their tax bracket, individuals would see every dollar of dividends reduced by 10 to 20 cents – and capital gains by 5 to 10 cents – in the form of additional taxes owed to the government, as illustrated in Figure 4 (on page 11). Furthermore, at the end of 2010, the lower individual income-tax rates enacted in the 2001 tax bill are scheduled to expire, which would increase the tax on dividends for nearly every taxpayer even further– to as much as 39.6 percent for individuals in the top tax bracket.

---

[42] Alon Brav, John R. Graham, Campbell R. Harvey, and Roni Michaely, "Payout Policy in the 21st Century," NBER, Working Paper 9657, April 2003, p. 35 – http://papers.nber.org/papers/w9657.pdf.

[43] Claire E. Crutchley, Carl D. Hudson, Marlin R.H. Jensen, and Beverly B. Marshall, "Special Dividends: What Do They Tell Investors About Future Performance?" *Financial Services Review*, Summer 2003, p.139; Blouin, Raedy, and Shackelford, p. 25.

[44] *Wall Street Journal*, "Microsoft to Dole Out Its Cash Hoard," July 21, 2004.

[45] Crutchley, Hudson, Jensen, and Marshall, p. 139; *Wall Street Journal*, July 21, 2004.

[46] Entin, p. 8; Blouin, Raedy, and Shackelford, p. 12.

[47] Congressional Budget Office (CBO), "Budget Options," Revenue Option 3, February 15, 2005, pp. 267-68 – http://www.cbo.gov/ftpdoc.cfm?index=6075&type=1.

Figure 4

Expiration of the 2003 Tax Bill Effects on Dividend and Capital-Gains Tax Rates				
Tax Bracket*	Return on Investment	2008 Rate (Percent)	2009 Rate (Percent)	Tax Increase (Percentage Points)
10 percent (up to $7,950) 15 percent ($7,951-32,350)	Dividends	0	10 - 15	10 - 15
	Capital Gains	0	10	10
25 percent ($32,351-78,400) 28 percent ($78,401-163,600) 33 percent ($163,601-355,750) 35 percent (over $355,750)	Dividends	15	25 - 35	10 - 20
	Capital Gains	15	20	5

Source: Internal Revenue Code.
*Estimated income limits are for single taxpayers in 2009 based on 2005 actual limits adjusted for inflation using CBO inflation-rate projections.

As a result, individuals would retain significantly less of their investment returns to increase retirement savings, finance their children's education, or reinvest in a small business. Correspondingly, the supply of capital would decline and the cost of capital would rise, producing adverse effects for business investment, job creation, and general economic growth. And, as one economist noted, "This impact would not drag out over a 10-year budget horizon, but would hit the economy and markets immediately."[48] Moreover, the improvements in corporate governance would be undone, leading to inefficient investments of corporate earnings and removing one important safeguard against questionable accounting practices.[49]

In the interim, as the expiration date for the dividend and capital-gains tax rates approaches, individual investors at all income levels are certain to react. Since individuals tend to invest for the long term, they will likely respond by trading stocks to take advantage of the temporary low dividends and capital-gains rates. Such behavior could roil the markets as 2008 approaches.[50] Evidence of this potentiality is already apparent – a recent survey indicated that the temporary nature of the dividend and capital-gains tax rates increases the uncertainty of one in five individual investors about their investment decisions.[51] And, for the economy as a whole, that uncertainty "will act like a partial [interest] rate hike, costing the economy in terms of less dynamic capital structure and a loss of productivity."[52]

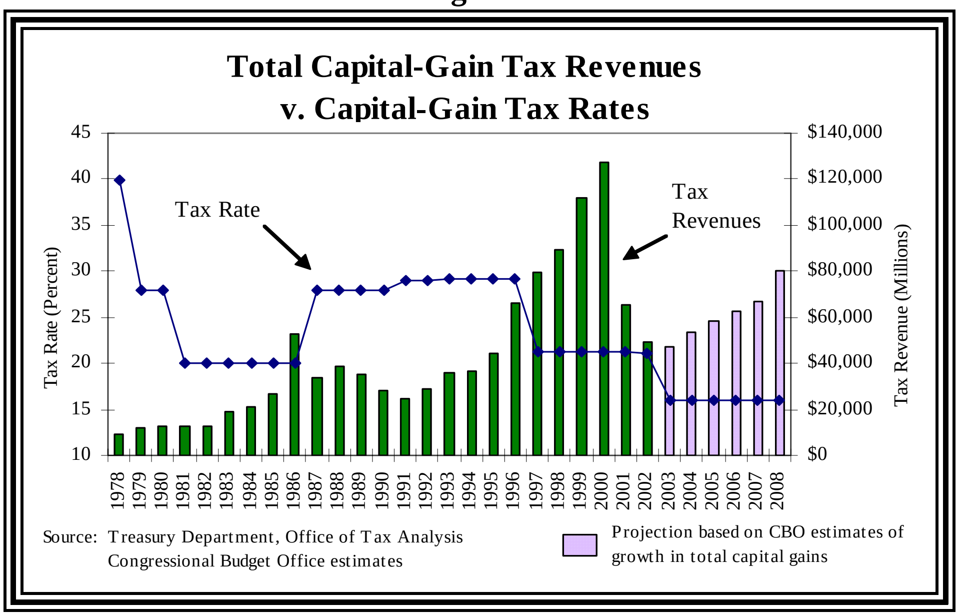
[48]Malpass, p. 1.
[49]Mallory and Kemp.
[50]"Tax Cut Worrywarts," editorial, *Wall Street Journal*, December 16, 2004.
[51]Rivel Research Group, "Findings from Study Regarding Recent Changes to Corporate Dividend Tax Laws,"sponsored by the Securities Industry Association, May 12, 2005.
[52]Malpass, p. 7.

The Cost Myth of Extending the Rate Reductions

If the full potential of the dividend and capital-gains tax cuts is to be realized, Congress must extend this growth-oriented tax policy as a first step toward making the rates permanent. While critics complain that the cost is too high, they overlook the dynamic effects that the reduced dividend and capital-gains tax rates mean for economic growth.

According to a recent paper by N. Gregory Mankiw and Matthew Weinzierl, the government can recover up to 53 percent of the cost of a reduction in capital taxes through the increase in tax revenues that results from greater economic activity.[53] Historic data supports that finding, particularly with respect to reductions in the capital-gains tax rate, as reflected in Figure 5 below.[54]

Figure 5



In 1997, the capital-gains tax rate was reduced from 28 percent to 20 percent.[55] At that time, the Joint Committee on Taxation (JCT) estimated that the 1997 reduction would result in a revenue loss of $21.2 billion over 10 years.[56] Despite that static revenue estimate, the reduced capital-gains tax rate produced dynamic effects on the economy. Looking at the actual results

[53] N. Gregory Mankiw and Matthew Weinzierl, "Dynamic Scoring: A Back-of-the-Envelope Guide," National Bureau of Economic Research, Working Paper 11000, December 2004 – http://papers.nber.org/papers/w11000.pdf.

[54] While the dividend-tax cut is expected to have similar dynamic effects, the available tax data and the multiple tax rates previously applied to dividend income make it extremely difficult to analyze accurately the effects that a reduction in the tax on dividends would have on the resulting tax revenues.

[55] Section 311 of the Taxpayer Relief Act of 1997, H.R. 2014, 105th Congress, 1st Session, Public Law 105-34, August 5, 1997.

[56] JCT, "Estimated Budget Effects of the Conference Agreement on the Revenue Provisions of H.R. 2014, the 'Taxpayer Relief Act of 1997,'" JCX-39-97, July 30, 1997, p. 2 – http://www.house.gov/jct/x-39-97.pdf.

from just the first four years of the rate reduction,[57] capital-gains tax revenues increased by $47.8 billion more than the revenue changes estimated by the JCT.[58]

Initial estimates suggest that the 2003 reduction in the capital-gains tax rate to the current 15 percent is producing similar dynamic results, although there is a two-year lag in the availability of data from individual tax returns.[59] A recent estimate projects that the government's static analysis underestimated capital gains revenues by $14 billion in 2004 and $16 billion in 2005.[60] That $30 billion in unanticipated revenues is actually significantly more than the JCT's cost original estimates for the reduced capital-gains tax rate – $13.4 billion over five years and $22.4 billion over 10 years.[61]

This point is underscored by the dramatic increase in recent tax revenues. In the first three quarters of Fiscal Year 2005, the government has realized a 33-percent increase over the same period in the previous year in tax revenues from non-withheld income – a source that is highly correlated with gains from sales of capital assets.[62] Thus, while the static revenue estimates in 2003 predicted sizeable losses in federal tax revenues over the life of the dividend and capital-gains tax cuts, the dynamic effects of these changes in tax policy have resulted in substantial increases in economic activity, which, in turn, have produced revenue gains for the federal government. Even the CBO conceded in its annual review of the budget and economic activity that the unanticipated increase in tax revenues will partially offset the revenue loss originally estimated to result from the lower tax rates.[63]

Accordingly, to evaluate the real cost of extending (and ultimately making permanent) the lower tax rate on dividends and capital gains, Congress must look at the total picture, considering the static revenue estimates in the context of the dynamic effects that lower taxes on capital investments will have for the economy. Based on the surge in dividend payments and

---

[57]In 2000, the fifth year after the 1997 capital-gains rate reduction, the technology stock "bubble" burst causing an unforeseen decline in the stock market, which reduced capital-gain transactions substantially.

[58]Treasury Department, Office of Tax Policy, "Long-Term Capital Gains and Taxes Paid on Long-Term Capital Gains, 1977-2002" – http://www.treas.gov/offices/tax-policy/library/capgain2-2004.pdf. Actual capital-gain revenues increased by $10.8 billion in 1997, $11.0 billion in 1998, $10.8 billion in 1999, and $20.1 billion in 2000. In contrast, the JCT estimated that the 1997 capital-gains rate reduction would increase revenues by $1.3 billion in 1997, $6.4 billion in 1998, and $171 million in 1999, with a revenue loss of $3.0 billion in 2000. JCT, JCX-39-97. See also, Stephen Moore and Phil Kerpen, "A Capital Gains Tax Cut: The Key to Economic Recovery," Institute for Policy Innovation, Policy Report 164, October 2001, pp. 4-6 – http://www.ipi.org/.

[59]Sections 301 of the Jobs and Growth Tax Relief Reconciliation Act of 2003, H.R. 2, 108th Congress, 2d Session, Public Law 108-27, May 28, 2003.

[60]Daniel Clifton and Elizabeth Karas, "Two Years Later: Tax Cut Still Paying Dividends for American Shareholders," American Shareholders Association, June 2005, p. 17 – http://www.americanshareholders.com/news/asataxcut06-08-05.pdf.

[61]JCT, "Estimated Budget Effects of the Conference Agreement for H.R. 2, the 'Jobs and Growth Tax Relief Reconciliation Act of 2003,'" JCX-55-03, May 22, 2003 – http://www.house.gov/jct/x-55-03.pdf.

[62]U.S. Department of Treasury, "Monthly Treasury Statement of Receipts and Outlays of the United States Government," June 30, 2005, Table 4. In the third quarter of FY 2005 alone, when final payments for 2004 tax liabilities were generally due, tax revenues from non-withheld income rose by more than 45 percent over the third quarter of FY 2004. See American Shareholders Association, "ASA Budget Scorecard," August 17, 2005, p. 2 – http://www.americanshareholders.com/news/asa-budget-08-16-05.pdf.

[63]CBO, "The Budget and Economic Outlook: Fiscal Years 2006 to 2015," January 25, 2005, p. 85 – http://www.cbo.gov/ftpdocs/60xx/doc6060/01-25-BudgetOutlook.pdf.

stock repurchases, growth in stock prices, and increase in capital gains since the rates were cut in 2003, can the country really afford *not* to make this critical investment in future economic growth?

Conclusion

The reduction in the tax rate applicable to dividend and capital gains was included in the 2003 tax legislation to decrease the double taxation of corporate profits, equalize the taxation of returns on capital, and ease the tax burden on individuals who invest in corporate equities. In so doing, it has lowered the cost of capital for American businesses, encouraged investment, and stimulated economic growth. After just a year, the benefits of this rate reduction have been well proven. Investors are seeing larger dividend payments and higher equity values – in both taxable and tax-deferred accounts – and corporate America is benefitting from lower capital costs and more efficient use of business earnings.

Nevertheless, if the success of the dividend and capital-gain tax cuts is to continue – and reach its full potential – Congress must extend the lower rates by at least two years. Such action would help settle the uncertainty that surrounds the tax rates today and would demonstrate Congress' support for continuing this important tax policy on a permanent basis. Yet, time is clearly of the essence. After weathering with remarkable resilience the uncertainties that came with terrorist attacks, a recession, corporate-management scandals, and the continuing war on terror, the U.S. economy would welcome the stability that a permanent tax rate would provide. With the potential for even better economic results from this growth-oriented tax policy, this is an opportunity that Congress simply cannot afford to miss.