

Class Warfare Fact and Fiction

Myth 2: Cutting taxes on dividends and other capital income will generate new investment essential for economic growth



By Bernard Wasow

Nothing written here is to be construed as necessarily reflecting the views of The Century Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

The pitch: “A reduction in capital taxes makes far more sense than simply cutting the marginal tax rate on high-income households, as Reagan did. Lower taxes on capital makes it more profitable to invest while higher rates of investment boost long-term growth and productivity.”

— “Is It Class Warfare?” *Business Week*, January 20, 2003

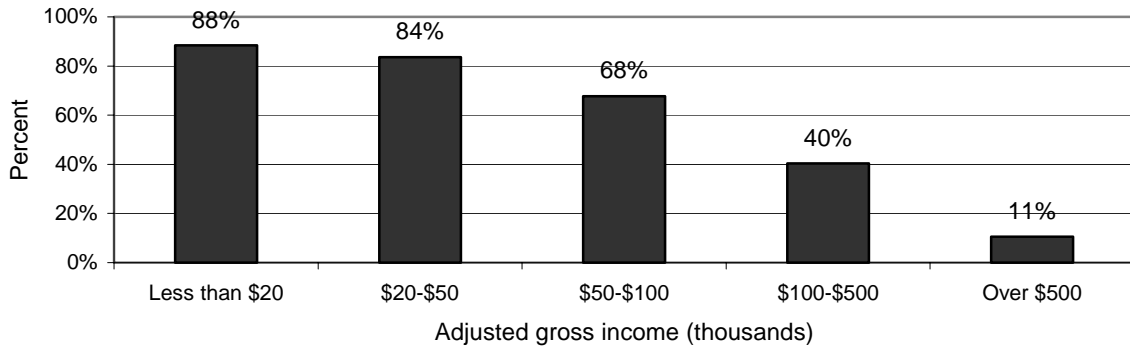
There’s no historical evidence to support this claim. Even the current head of the Council of Economic Advisors, Glenn Hubbard, wrote in 1997, “economists have generally struggled to find a significant impact of tax policy on investment.”¹ Indeed, real productive investment—corporate spending on new buildings and equipment—has been more difficult to forecast than any other major component of the gross domestic product. That is because investment spending depends on long-term expectations and hunches—“animal spirits,” as John Maynard Keynes dubbed them. Expected taxes, along with expected demand, expected interest rates, and other expected costs all influence investment. But the effect of tax policy is small enough that it is very difficult to disentangle, even in sophisticated statistical studies.

What is more, dividends are not even direct returns to real productive investment. Rather, they are returns to those who own stock, overwhelmingly in existing companies, which may or may not have investment plans. If share prices rise because of the elimination of dividend taxes, real investment in factories and equipment might be stimulated—but the connection is indirect and highly uncertain. At the same time, the lost government revenues from the tax cut directly reduce domestic saving levels, which in turn discourages investment.

Investment depends on business prospects, which rise and fall according to what will happen to the majority of Americans. But the proposed elimination of taxes on dividends collected by stock owners would benefit only a small fraction of the public—mostly the very rich—as Figure 1 and Figure 2 show.

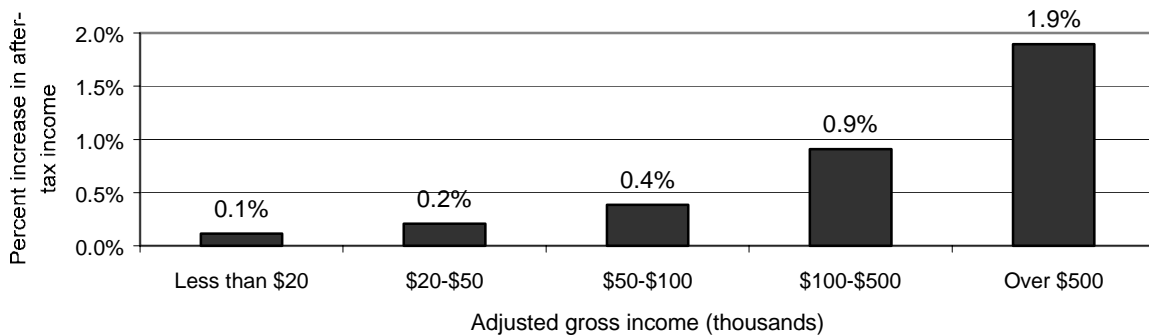
¹ Kevin A. Hassett and R. Glenn Hubbard, “Tax Policy and Investment,” in A. Auerbach, ed., *Fiscal Policy: Lessons from Economic Research* (Cambridge: MIT Press, 1997).

Figure 1. Families That Receive No Taxable Dividend Income



Source: Data from the Tax Policy Center's Tax Policy Microsimulation Model, available at <http://www.taxpolicycenter.org/commentary/dividend/table2.pdf>.

Figure 2. Who Benefits from a Dividend Income Tax Break?



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- Of the nearly 70 percent of taxpayers with adjusted gross incomes below \$50,000 per year, only 14 percent receive any dividend income; this group would receive 9 percent of the tax break on dividend income.
- At the top, among those with adjusted gross income greater than \$200,000 (the top 2.3 percent of taxpayers), 80 percent receive dividend income; this group would receive 53 percent of the tax break.
- More than three-quarters of the tax break would go to the top 10 percent of taxpayers.

Looking at the historical record, there is almost no connection between economic growth and tax cuts or tax increases. When President Clinton pushed a tax increase through Congress in 1993, opponents argued that economic growth and even revenues would suffer. In fact, the 1993 tax increases ushered in one of the biggest economic booms in American history and the only budget surpluses of the late twentieth century.

- Opponents claim that even modest tax increases discourage entrepreneurship, but there was a wave of business start-ups and computer-led innovation in the late 1990s.
- Opponents claim that modest tax increases discourage work, but the employment-to-population ratio reached historic highs in the late 1990s.

Economic growth depends on investment in buildings, equipment, and people, and the introduction of new products and new production technologies. Tax cuts can increase the rewards to investment and innovation, but they also can increase the federal deficit, creating uncertainty about the future and forcing the government to compete with private investors to borrow domestic and foreign saving. No matter how often the claim is repeated, there is no evidence that tax cuts and tax increases on the order of those undertaken 1980–2000 are systematically connected to subsequent economic growth.

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