The Effects of Dividend and Capital Gains Tax Increases on Job Creation

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Executive Summary

With the end of the year fast approaching, there is a lot of work remaining for Congress. Getting the budget in fiscal order is imperative and represents the single most important item to address. Much of the ongoing fiscal debate has centered on whether income taxes would increase and to what extent, as well as the reining in of federal spending. A subset of this debate and somewhat less controversial for the general media has been the pending increases in dividend and capital gains tax rates. With the current rates set to expire at the end of the year, dividend and capital gains tax rates will increase significantly – with the top tax rate for dividends increasing from 15% to 43.4% (including a new investment surcharge) and capital gains from 15% to 23.8%.

As policymakers deal with the ongoing fiscal crisis, investors face uncertainty and that uncertainty is being reflected in stock market prices. If tax rates go up, the after-tax value of stocks and mutual fund investments will decrease -- but there is also an impact on economic growth and jobs.

This paper analyzes the potential effects on jobs if capital gains and dividend tax rates increase. The major findings of the analysis are:

- The increase in tax rates will affect market capitalization;
- When market capital decreases, so will private business investment in plant and equipment; and
- The reduction in private investment will lead to fewer jobs in the economy.

Using a conservative scenario, this analysis finds that the increase in capital gains and dividend tax rates will reduce private investments by 6% and result in job losses totaling nearly 2 million. Additional risks for other tax increases and the potential of recessionary risk were not factored into these numbers.

The actual effects of these tax rate changes cannot be known for certain, but the results highlight the direction and potential consequences. This analysis illustrates the potential economic effect of increasing dividend and capital gains tax rates, and these effects on investments and jobs deserve some consideration as policymakers move forward in dealing with the fiscal crisis.

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The Taxman Cometh

As the deadline for the extending the Bush-era income tax cuts approach, much of the "fiscal cliff" debate centers on whether or not some individuals will be spared the increase in federal income tax rates. However, a somewhat less obvious part of the public debate has focused on other tax components set to expire, specifically those directly affecting capital gains and dividend income taxes. Unless extended before year's end, the top tax rates will increase from 15% to 23.8% for capital gains income and nearly triple from 15% to 43.4% for dividend income.[2]

If these tax rates do increase as scheduled, there would be a number of direct and indirect effects to watch. The direct effects of capital gains tax rate increases are somewhat straightforward, including a stock market selloff as some investors may choose to dump stock and stock options, as well as sell appreciated assets and small businesses in 2012 in order to avoid higher taxes in 2013. This corresponds with the historical record, where increased capital gains tax rates triggered a selloff and resulted in lower stock market prices.[3] Once higher tax rates are in place, more investors will be discouraged from realizing capital gains income to avoid higher taxes, while others may be encouraged to take losses.[4]

Similarly, qualified (stock-derived) dividends will be taxed at the ordinary income tax rates, with a top rate of 43.4%. This means that investors and consumers with mutual funds and stocks may choose to sell dividend paying stocks or reshuffle portfolios. The selloff of stock will reduce stock prices and the value of mutual funds, leading some investors to anticipate a decline and cash out as the deadline approaches. This is consistent with some analyst reports that the pending tax rise is already depressing stock prices, and analysts are advising investors to sell, thus prompting a selloff.[5]

Even tax-deferred retirement accounts will be affected, albeit indirectly. This is because dividend taxation occurs in taxable brokerage accounts. Since IRAs, 401(k)s and other retirement plans mostly consist of stock mutual funds, these shares are priced to reflect their after-tax value to investors, which ultimately is reflected in the value of retirement accounts for senior citizens and others. In other words, whether you hold stock in a taxable brokerage

[2] While dividend taxes will increase to 39.6% in 2013, they will be subject to the new national healthcare plan's 3.8% investment surcharge, bringing the top tax rate to 43.4%.
[3] Margaret Collins and Richard Rubin, "Wealthy Advised to Sell for Gains before Unfriendly 2013 Taxes," *Bloomberg*, October 19, 2012. The authors cite a National Tax Journal report as the source.
[4] Gerald Auten, "Capital Gains Taxation," *The Encyclopedia of Taxation and Tax Policy*, Joseph J. Cordes, Robert D. Ebel and Jane G. Gravelle (eds.), Urban Institute, Oct. 1, 1999, http://www.urban.org/publications/1000519.html.
[5] Jonathan Cheng, Laim Pleven and Alexandria Scaggs, "Tax Threat Prompts Selloff: Investors Dump Winning Stocks amid Prospect of Jump in Capital-gains Rate," *Wall Street Journal*, Nov. 12, 2012, p. C1.

account or a retirement plan, the sharp tax increase means that stock prices will decline and that decline will eventually be reflected in the value of investments.[6]

For consumers, the increases in tax rates will hurt the young and the old, union and nonunion workers, private and public employees, and it will affect wealthy and poor. Since tax-deferred retirement accounts have had limitations on annual contributions, they are generally modest in size and cut across all demographic strata. In fact, an Oliver Wyman study sampled IRA accounts and found 40% to be less than $10,000 in value.[7] Besides, IRAs and 401(k) accounts, the increase in taxes on mutual funds would erode the value of savings across a broad spectrum of workers and retirees, potentially affecting their quality of life. For example, Ernst & Young analyzed tax returns and found 63% of filers aged 50 years and over had qualified dividends, and 40% of filers with incomes less than $50,000 had qualified dividends.[8] The increase in dividend taxes is not a tax on the rich.

Besides the impact on consumers and investors, there will be broader economic consequences too, including negative effects on business investment and subsequent cascading effects on economic output and jobs. A quantification of these consequences will be the focus of the remainder of this paper.

The Loss of Market Capitalization

If tax rates are allowed to increase on January 1, 2013, the U.S. will have the highest integrated dividend and corporate tax rates in the world.[9] These tax rate increases will reduce U.S. stock prices, thereby reducing market capitalization. As a result, equity funding for businesses will decline as a source of capital expenditures. In essence, increasing taxes will curtail private investment and that means fewer workers will be needed.

The decline in stock market value and the correspondingly reduction in investment can be approximated and serve as one potential scenario of the economic effects from increased tax rates. The estimates are approximate, considering the simplifying assumptions that are necessary to work with these complex issues and the likelihood for political compromise. Ideally, a compromise will achieve a number of desirable economic outcomes, including

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[6] In recent years, many groups have written on how these tax increases would affect consumers. For example, see Carole Fleck, "Relying on Dividends for Income? Tax Hikes May Be in Your Future," July 16, 2012, online at http://blog.aarp.org/2012/07/16/relying-on-dividends-for-income-tax-hikes-may-be-in-your-future/; Curtis S. Dubay, "Obama Tax Hikes: Higher Dividend Taxes Hurt Seniors," The Heritage Foundation, September 10, 2010, online at http://www.heritage.org/research/reports/2010/09/obama-tax-hikes-higher-dividend-taxes-hurt-seniors; and Steve Pociask, "Get Set for a New Tax on Your Retirement," The American Consumer Institute, July 27, 2012, online at http://www.theamericanconsumer.org/2012/07/27/get-set-for-a-new-tax-on-your-retirement/.

[7] "Assessment of the Impact of the Department of Labor's Proposed *Fiduciary* Definition Rule on IRA Consumers," Oliver Wyman Inc., New York, NY, April 12, 2011.

[8] "The Beneficiaries of the Dividend Tax Rate Reduction: A Profile of Qualified Dividend Shareholders," Ernst & Young, May 2012.

[9] Dr. Robert Carroll and Dr. Gerald Prante, "Corporate Dividend and Capital Gains Taxation: A Comparison of the United States to Other Developed Nations," Ernst & Young, February 2012.

mitigating negative investor sentiment, curbing of future deficit spending and providing an environment for long term economic growth. This analysis attempts to quantify the consequences at stake, and does not contemplate the complete range of policy solutions and their resulting economic outcomes.

How much will the stock market decline from the combination of increases in capital gains and dividends is truly an open question, but a number of reports peg the decline to be approximately 10%. For example, assuming capital gains produces 20% and dividends 80% of the historical returns from stocks, the "weighted" tax rate will increase from 15% to 27.71% or a 12.7% difference in the top blended rate.[10] The increase in tax rates affect stock prices, and over time, the decline in stock prices will reflect their after-tax value.

Since using top tax rates overestimates the average impact, a reasonable mid-point comes from Barclays, which estimates that an average increase in the dividends portion from 15% to 25% would result in a 5.8% decrease in stock evaluation. Blending in capital gains tax rate effects from 15% to 23.8%, the resulting impact would be approximately 10%.[11] On the low side, J.P Morgan Chase estimates the increase in both dividend and capital gains tax will reduce market capitalization by 6% or $1.6 trillion by mid-year 2013.[12]

To understand the potential consequences of dividend and capital gains tax increases on jobs, this analysis assumes a stock market decline will produce a reduction in capital expenditures of 6%. The decline may not be immediate, as some projects will continue to be funded and others cutback over time. As a second scenario and for a sensitivity analysis, we will consider a smaller 4% decline in investment. The reality is that broader risks of a stock market decline are certainly possible, but not considered in this analysis. For instance, the Congressional Budget Office estimates that a failure to reach a budget agreement will likely produce a recession and raise the unemployment rate above 9%.[13] At the time of this writing, the Dow Jones Industrial average had already dropped several percent in just one month, possibly anticipating the consequences of the "fiscal cliff," and more declines could be in the offing. This analysis provides just one potential scenario for consideration. For example, the stock market decline could (and probably would) reduce consumption expenditures as consumers perceive themselves to be less wealthy. The effect could be substantial. In any event our analysis should be considered conservative.

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[10] For the top tax rate, the blended capital gains and dividend rates will increase from 15% in 2012 to 27.72% (or 23.8% times a 80% for capital gains plus 43.4% times 20% for dividends) in 2013. Therefore, whether stocks are held in taxable brokerage accounts or a 401(k) plans, the value of stock will decline by the 12.72% (the difference in the blended tax rate before and after the tax change). We owe thanks to Ryan Ellis, the Tax Policy Director of the Americans for Tax Reform for suggesting this shorthand approach.

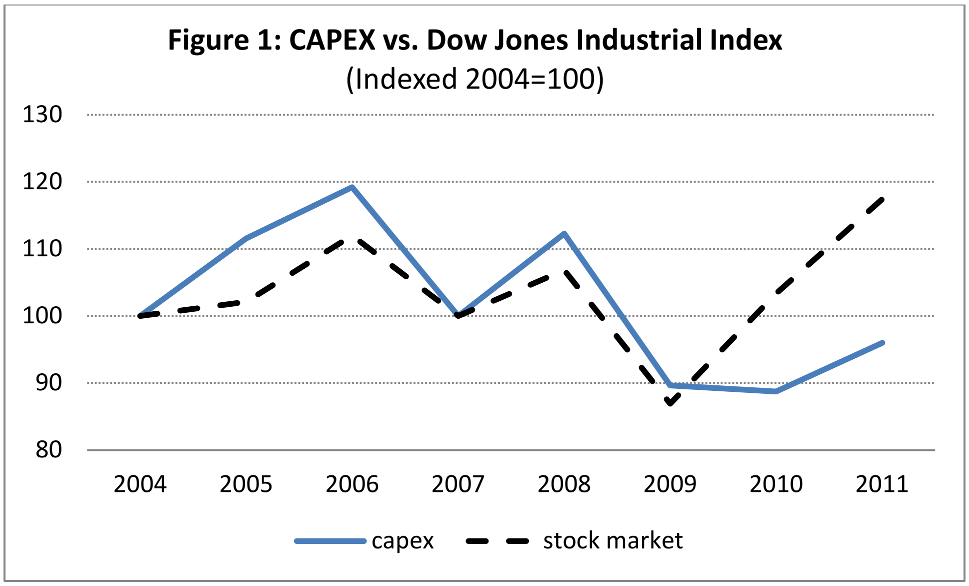
[11] "U.S. Utilities: Extra Innings," Barclays, July 16, 2012, p. 7. See fn. 9 for methodology for a new blended rate of 9.84%.

[12] Jonathan Cheng, Liam Pleven and Alexandra Scaggs, "Tax Threat Prompts Selloff: Investors Dump Winning Stocks Amid Prospect of Jump in Capital-gains Rate," *Wall Street Journal*, Nov. 12, 2012, figures noted on p. C2.

[13] "Economic Effects of Policies Contributing to Fiscal Tightening in 2012," Congressional Budget Office, November 8, 2012, http://www.cbo.gov/publication/43694.

Methodology

Since stock prices reflect expected future earnings, businesses are likely to curtail investment when the financial outlook dims. This relationship has held in recent years. As **Figure 1** shows, private business investment in fixed assets moves in the general direction of stock prices.[14] This supports the view that a reduction in stock market capitalization will negatively correspond with a reduction in capital expenditures. However, if capital expenditures decline, so will the labor needed to put plant and equipment in working order.



Annual capital expenditures in the U.S. topped $1.8 trillion in 2011.[15] When businesses purchase plant and equipment they may also purchase labor and services necessary to deploy and operate these investments. These direct activities spur indirect effects with suppliers and contractors, who hire and invest to meet the increased demand. In addition to the direct and indirect benefits, the added workforce will spend their earnings for various household purchases, which creates additional economic benefits called *induced effects*. The combination of direct, indirect and induced effects represents the total economic benefit from the initial capital expenditure. Essentially, as a dollar of capital is spent, economic activity cascades along various stages of production and the economy ends up with more than one dollar of final product. This phenomenon is referred to as the *multiplier effect*. These benefits can be measured in terms of their effect on output and jobs. **Figure 2** (below) shows the level of private investment across industries, including a high levels of spending in manufacturing, real estate, information technologies, utilities and mining. This study uses labor multipliers corresponding with these industries to estimate the lost jobs from reduced investment.[16]

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[14] Annualized stock market prices were approximated by averaging the monthly averages of the Dow Jones Industrial Average and indexing the series to a common base. Stock data were downloaded from Yahoo Financial. CAPEX figures are from the BEA, as previously noted, and indexed to the same base year for comparison.

[15] Bureau of Economic Analysis, "Investment in Private Fixed Assets by Industry," Table 3.7ES, August 15, 2012.

[16] All industry multipliers are from the latest BEA's RIMS Model (Type II).

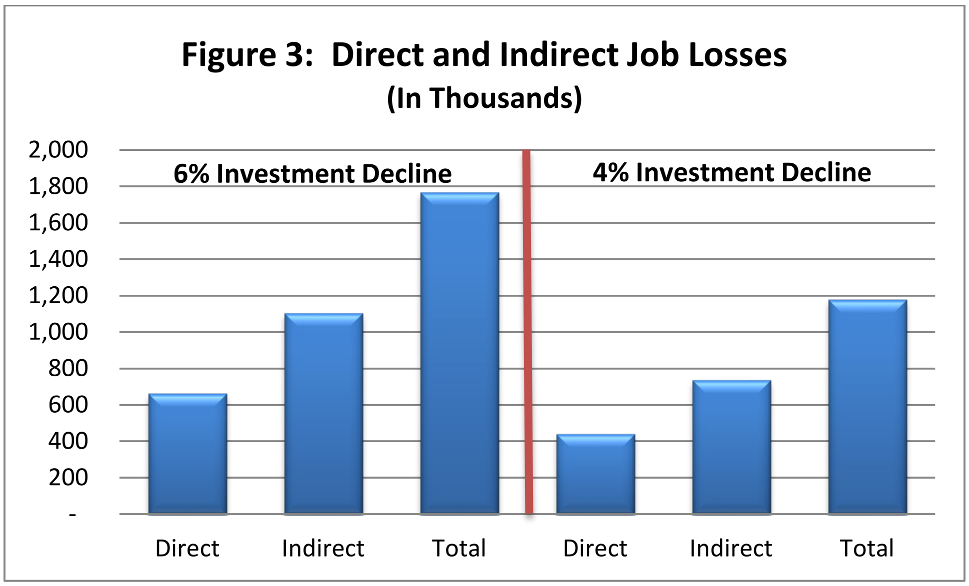
Figure 2: Industry Capital Expenditures in Billions of Dollars - 2011

Agriculture, forestry, fishing, and hunting	**$53.6**
Farms	$45.6
Forestry, fishing, and related activities	$8.0
Mining	**$176.6**
Oil and gas extraction	$150.1
Mining, except oil and gas	$12.3
Support activities for mining	$14.2
Utilities	**$98.6**
Construction	**$31.4**
Manufacturing	**$192.1**
Wood products	$2.1
Nonmetallic mineral products	$4.5
Primary metals	$10.0
Fabricated metal products	$10.2
Machinery	$12.4
Computer and electronic products	$28.8
Electrical equip. appliances, components	$3.7
Motor vehicles, bodies and trailers, parts	$18.7
Other transportation equipment	$7.2
Furniture and related products	$1.5
Miscellaneous manufacturing	$6.1
Food and beverage and tobacco products	$23.0
Textile mills and textile product mills	$1.3
Apparel and leather and allied products	$0.4
Paper products	$8.3
Printing and related support activities	$2.8
Petroleum and coal products	$17.0
Chemical products	$25.1
Plastics and rubber products	$9.0
Transportation and warehousing	**$69.0**
Air transportation	$9.4
Railroad transportation	$14.2
Water transportation	$2.6
Truck transportation	$18.9
Transit and ground passenger transportation	$3.3
Pipeline transportation	$11.9
Other transportation and support activities	$6.1
Warehousing and storage	$2.5
Wholesale trade	**$62.7**
Retail trade	**$69.5**
Information	**$159.0**
Publishing industries (includes software)	$24.2
Motion picture and sound recording	$3.3
Broadcasting and telecommunications	$90.2
Information and data processing services	$41.3
Finance and insurance	**$132.7**
Federal Reserve banks	$0.6
Credit intermediation and related activities	$73.2
Securities, commodity contracts, investm'ts	$18.8
Insurance carriers and related activities	$31.3
Funds, trusts, and other financial vehicles	$8.8
Real estate and rental and leasing	**$401.2**
Real estate	$358.6
Rental and leasing services and intangibles	$42.6
Professional, scientific, technical services	**$84.8**
Legal services	$3.7
Computer systems design and services	$16.5
Miscellaneous professional, scientific, tech.	$64.6
Management companies and enterprises	**$46.1**
Administrative and waste management	**$36.4**
Administrative and support services	$30.7
Waste management and remediation	$5.7
Educational services	**$27.9**
Health care and social assistance	**$109.4**
Ambulatory health care services	$36.7
Hospitals	$64.4
Nursing and residential care facilities	$5.5
Social assistance	$2.7
Arts, entertainment, and recreation	**$14.5**
Performing arts, sports, museums, etc	$5.1
Amusements, gambling, and recreation	$9.4
Accommodation and food services	**$22.2**
Accommodation	$10.6
Food services and drinking places	$11.6
Other services, except government	**$22.6**
****Total Private fixed assets****	**$1,810.3**

Source: Bureau of Economic Analysis, "Investment in Private Fixed Assets by Industry," Table 3.7ES, August 15, 2012.

Results

An increase in capital gains and dividend tax rate rates will cause stock prices to fall, which will reduce business capital for investment. Given the assumption for a decrease in private business investment and using industry multipliers, direct and indirect employment effects can be estimated. **Figure 3** shows that a conservative 6% decline in private investments will require nearly 1.8 million fewer workers to deploy plant and equipment in working order. This loss in jobs includes both direct and indirect (including induced) effects. If this scenario is realized, the effect would decrease total U.S. non-farm employment by 1%. Using an even more conservative assumption of a 4% decline in investment, job losses still exceed one million workers. While not estimated here, another likely scenario is that investment impact will be higher than 6%, perhaps 10% as some have noted, which would lead to even greater employment losses.



Concluding Thoughts

This analysis shows that the increase in dividend and capital gains tax rates will have negative consequences on the job market. While there could also be other job impacts, these are outside of the scope of this analysis. For example, if the fiscal crisis is not adequately resolved and this leads to an economic contraction, the jobs losses could be much more severe than estimated here. As mentioned, consumption spending could decrease, leading to substantial job losses. Also not discussed in this analysis are the other pending income tax increases, which, if they take effect, will reduce consumer expenditures and negatively affect economic growth. There could also be job losses associated with reducing government spending.

Whatever the actual effects will be, the scenarios presented in this analysis demonstrate the clear direction of change – that allowing dividend and capital gains tax rates to increase will unequivocally lead to job losses in the economy. In developing a final solution, policymakers are holding these investments and jobs in the balance.