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Assessing the Effects of a Dividend and Capital Gains Tax Increase

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About IMPA The Institute for Macroeconomic & Policy Analysis (IMPA), housed at the Economics Department of American University, is a nonpartisan research institute focused on macroeconomics, inequality, and economic policy. The IMPA model emphasizes the widespread prevalence of market power in goods and labor markets, heterogeneity among sectors and firms in the economy, and income and wealth inequality.
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Key Takeaways

- Reductions in dividend and capital gains taxes over the last decades have contributed to the overall decline in tax progressivity in the US, exacerbating wealth inequality.
- The president's 2024 budget proposes an increase in the tax rate on dividend income and capital gains from the current 20% to 39.6% for households earning over $1.0 million.
- IMPA's evaluation of this proposal suggests that these tax increases would raise government revenue effectively without compromising economic growth.
- In the long run, the proposed tax increases together could raise government revenue by approximately 5% and yield a small but positive increase in GDP of approximately 1%.
- Because dividend income and capital gains are enjoyed largely by the wealthiest members of society, increasing taxes on income from these sources can play a crucial role in mitigating income and wealth inequality.

Growing Wealth Inequality, Declining Tax Progressivity

In the past few decades, wealth inequality in the United States has surged dramatically. In 1990, the country's wealthiest 1% possessed 20.1% of total wealth in the economy. Today, this figure has surged to 27.1%. In terms of stock market wealth, since 1990, the share held by the top 1% of households has risen by 8 percentage points and today represents nearly half of US households' total stock market wealth, with the remaining 99% jointly holding the other half. Even within the 99%, stock market wealth is severely unevenly distributed, with the bottom 50% of households possessing only 1% of such wealth (Batty et al., 2021).

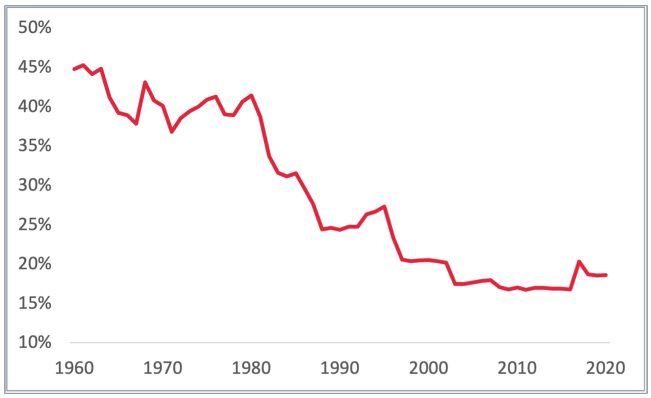
The increase in wealth inequality in recent decades has been driven by several factors, but two are particularly relevant for our purposes in this report. First, wealthier households earn, on average, higher returns on the wealth that they hold. This difference in returns impacts income inequality and has generated a snowball effect that helps explain the observed yawning wealth inequality (Fagereng et al., 2020; Xavier, 2021). An important reason why the wealthy see higher returns on their assets is that they have equity-dominated portfolios, such that they benefit from both capital gains and the higher yields typically associated with equity markets (Kuhn et al., 2020). Meanwhile, most nonwealthy households' main asset is the house they live in, so their wealth can grow only from rising house prices, and such gains often remain unrealized given that the asset serves first and foremost as a residence.

Second, changes in the US tax system have shaped the changes in wealth inequality. Piketty et al. (2018) and Saez and Zucman (2020) describe the significant shift in the US tax system over time. In the 1950s, the tax system was progressive, characterized by high effective corporate tax rates and high top marginal personal income tax rates. However, considered as a whole, today's tax system resembles a flat tax, even becoming regressive at the highest income levels. Kaymak and Poschke (2016) and Hubmer et al. (2021), employing macroeconomic models similar to the one used in this report, identify the decline in tax progressivity as a primary contributor to the post-1980 increase in wealth inequality. While the discussion about the magnitude and contribution of the decline in progressivity remains open, the data undeniably indicate that the era of increasing inequality has coincided with a significant decrease in tax system progressivity.

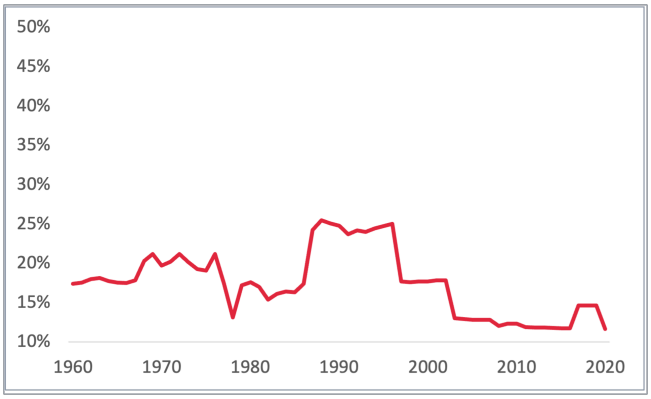
The Evolution of Dividend and Capital Gains Taxes

Since the early 1980s, a series of tax cuts, heavily skewed toward capital income and top earners, has dampened the progressivity of the US tax system. These cuts have included significant reductions in the top marginal tax rate, a substantial decline in effective corporate taxes, and reductions in the federal estate tax via successive increases in exemptions. This trend culminated in the 2017 Tax Cuts and Jobs Act (TCJA), which reduced the top marginal tax rate from 39.6% to 37%, lowered the corporate tax rate from 35% to 21%, and doubled the estate tax exemption to nearly $12 million.

In addition to these cuts, several modifications to capital gains taxes and dividend income taxes further contributed to the decline in progressivity. First, dividend income was taxed as ordinary income until 2003 and therefore benefited from the reductions in top marginal tax rates that occurred during this



(a) Average marginal effective tax rate on dividends. Source: Own calculations from NBER TAXSIM and IRS SOI data.



(b) Average marginal effective tax on capital gains. Source: Own calculations from NBER TAXSIM and IRS SOI data.

Figure 1: Changes in average marginal effective rates (1960–2020)

period.[1] Dividend income also benefited from expansions of tax-favored retirement accounts, resulting in discrepancies in the tax treatment of income from different sources. Finally, the Jobs and Growth Tax Relief and Reconciliation Act of 2003 fundamentally changed the taxation of qualified dividends—dividends from a corporation whose stocks the taxpayer had held for at least 60 days—by setting a tax rate equal to the rate on capital gains, which was capped at 15% at that time. As a result of these changes, the average marginal effective tax rate on dividends substantially declined during the period, as shown in Figure 1(a).

Capital gains taxes also underwent several modifications over this period. First, the capital gains tax rate was reduced from 28% to 20% by the Economic Recovery Tax Act of 1981. This reduction was reversed by the Tax Reform Act of 1986, which mandated that capital gains be taxed at the same rate as ordinary income, raising the maximum tax rate on long-term capital gains back to 28% from 20%. However, the Taxpayer Relief Act of 1997 once again reduced capital gains taxes, lowering the top rate from 28% back to 20%, with a 10% or 0% rate for the lower brackets. The Jobs and Growth Tax Relief and Reconciliation Act of 2003 further reduced the top capital gains tax rate to 15% until 2013, after which the long-term capital gains tax rate became 20%. In addition, higher-income individuals with long-term capital gains (and dividends) were also subject to the Net Investment Income Tax (NIIT) of 3.8%. The TCJA retained the preferential tax rates on long-term capital gains and qualified dividends, as well as the NIIT. However, for 2018-2025, the TCJA separated the brackets for capital gains and dividend income from the ordinary income brackets. Figure 1(b) illustrates the evolution of the average marginal effective tax on capital gains resulting from these legislative changes.

The reduction in dividend and capital gains taxes boosted after-tax returns from stocks. Again, because stocks are held mainly by wealthier households, the declines in these taxes have exacerbated income and wealth inequality while also reducing the federal government's revenue capacity. In this report, we utilize

[1]These reductions were implemented through several key pieces of legislation: the Economic Recovery Tax Act of 1981 (which reduced the top marginal rate from 70% to 50%), the Tax Reform Act of 1986 (which further reduced the top rate from 50% to 28%) and the Economic Growth and Tax Relief Reconciliation Act of 2001 (which temporarily reduced the top rate from 39.6% to 35%). The top rate was raised only once after 1981 (from 28% to 39.6%, with the Omnibus Budget Reconciliation Act of 1993, which partially reversed the 1986 decrease).

IMPA's macro model to simulate the macroeconomic impact of the current proposal to increase these taxes. We show that increasing them could generate significant revenue and alleviate inequality without harming economic growth.

How Do Taxes on Corporate Distributions Affect Economic Activity?

Traditionally, proposals to lower taxes on corporate distributions have been based on the assumption that such reductions stimulate corporate investment and foster economic growth. However, since taxes on corporate distributions are levied on profits after investment, they in fact have little influence on firms' investment decisions. This is especially true for mature firms that do not rely on equity issuance, which represent the majority of the capital stock in the corporate sector (Korinek and Stiglitz, 2009). Hence, although these taxes affecting after-tax returns are expected to have a negative effect on equity valuations, they should not affect long-term growth or the capital stock (McGrattan and Prescott, 2005).

This theoretical prediction is supported by empirical evidence. For instance, Yagan (2015) examines the impact of the 2003 dividend tax cut by comparing C-corporations, which were directly affected by the tax cut, with S-corporations, which were not. He finds that the tax cut yielded no significant changes in C-corporations' investment or employee compensation relative to their S-corporation counterparts.

From a policy perspective, given today's high income and wealth inequality and pressing revenue needs on the part of the government, there is a compelling rationale for raising these taxes. Both types of taxes can serve as a reliable revenue source, effectively addressing the reduction in progressivity by targeting the returns of wealthy households while simultaneously avoiding any adverse effects on firms' investment or long-term GDP growth.[2]

The Macroeconomic Effects of Dividend and Capital Gains Tax Increases

To analyze the distributional and aggregate effects of dividend and capital gains tax changes, we utilize IMPA's macroeconomic model. The following features of the model are relevant for this analysis:

- Households' portfolios are heterogeneous. The share of corporate equity owned by a household depends on where it is located in the wealth distribution. We calibrate this feature using the Survey of Consumer Finances.

- The model incorporates a bequest motive. Similarly to most models used to study the macroeconomics of public finance, our model accounts for the behavior of overlapping generations of households of different ages whose members not only save for their own retirement but also leave bequests for their heirs. The inclusion of the bequest motive in our model is essential for it to be able to approximate the levels of wealth inequality observed in the data.

- Households insure themselves against income uncertainty by accumulating savings in the form of either stocks or standard low-yield assets. As a consequence, the demand for equity is not perfectly

[2]In addition, recent research has shown that capital gains taxes might help reduce stock market volatility. See Belda (2022).

Indicators	Dividend tax [1]		Capital gains tax [2]		Both tax changes [3]	
	10-year	Long-run	10-year	Long-run	10-year	Long-run
GDP	0.22%	0.56%	0.18%	0.46%	0.43%	1.06%
Capital Stock	0.40%	0.99%	0.33%	0.82%	0.77%	1.91%
Equity Value	-1.88%	-4.67%	-1.57%	-3.91%	-3.29%	-8.21%
Employment	0.15%	0.37%	0.12%	0.30%	0.28%	0.70%
Wages	0.08%	0.19%	0.06%	0.15%	0.14%	0.35%
Govt. Revenue	0.88%	2.19%	1.03%	2.57%	1.91%	4.76%

[1] Effect of an increase in the dividend tax rate from 20% to 39.6%.
[2] Effect of an increase in the capital gains tax rate from 20% to 39.6%, assuming an annual (nominal) capital gain of 8%.
[3] Combined effect of the dividend and capital gains tax increases.

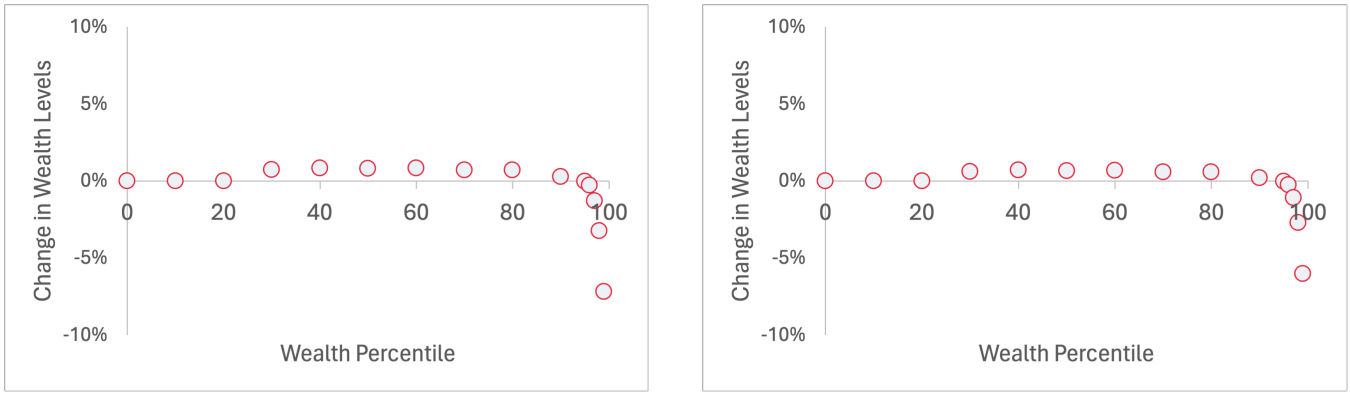
Table 1: IMPA model–predicted effects of tax increases on key macroeconomic indicators (*percentage change in indicator relative to baseline with no tax changes*).

elastic; rather, it is increasing in the rate of return offered by equity. This model feature, which research has proven to be important for explaining capital accumulation dynamics and wealth inequality in the post-1980 period (Hubmer et al., 2021; Moll et al., 2022), is also essential for modeling the macroeconomic effects of taxes and their incidence (Domeij and Heathcote, 2004).

Using this framework, we assess the impact of the current proposals to raise the dividend tax from the current 20% to 39.6% and the capital gains tax from 20% to 39.6% only for households earning over $1 million. Under this proposal, the wealthiest households would have the same marginal tax rate on their dividend income and capital gains as on their ordinary income. We assume for our estimates going forward that annual capital gains are 8%. One-fourth of that gain is assumed to come from economic growth, another one-fourth from inflation, while the remaining two-fourths is assumed to come from (real) valuation effects. These assumptions are consistent with standard estimates of long-run economic growth, long-run inflation targets, and the observed capital gains of the last decades (Robbins, 2018; Jordà et al., 2019). Of course, the quantitative results presented below are sensitive to these assumptions, but results derived under other reasonable estimates of capital gains are similar.[3]

Table 1 shows that the increases in the dividend and capital gains taxes would significantly raise

[3]Tax collections from capital gains are hard to predict, as both capital gains and their realization are highly cyclical, fluctuating substantially more than aggregate income. For example, according to the Congressional Budget Office, realized capital gains in the US have ranged from 2% to 7% of GDP in recent decades (CBO, 2023). Among other factors, the realization of capital gains might be sensitive to the capital gains tax rate, as investors may choose to defer liquidating their assets until rates are lower, or to exploit the stepped-up basis loophole. For simplicity, this analysis abstracts from dynamic changes in the realization rate. Hence, our results should be understood as reflecting the macroeconomic effects of changes in the effective tax rate of dividends and capital gains.



(a) Increase in dividend tax rate from 20% to 39.6%

(b) Increase in capital gains tax rate from 20% to 39.6% (assuming an annual capital gain of 8% of GDP)

Figure 2: IMPA model–predicted effect of tax changes on wealth inequality. The plots show the change in wealth level experienced by households at each percentile under the specified tax rate increases.

government revenue in the long-run—by 2.19% and 2.57%, respectively. The tax increases would also be mildly expansionary. They would increase long-run GDP by approximately 0.5% each, and they would increase employment by 0.37% and 0.30% and wages by 0.19% and 0.15%, respectively.

Increasing the dividend and capital gains taxes would have a strong equalizing effect on incomes and wealth. Figure 2 shows the effect of each tax increase on the distribution of wealth across the economy. Each graph shows the change in wealth for households at each wealth decile. The estimates for the top 5 percentiles are plotted individually to illustrate the effect at the top of the wealth distribution more clearly. In both cases, households at lower and middle wealth levels would experience small but positive gains from the tax increases on capital gains and dividends, while households at the top would see a decline in wealth. The gains of the bottom 90% of the distribution reflect the higher savings by these households due to the mildly expansionary effects of the tax increases and an increase in transfers from the additional government revenue.[4] In contrast, the impact at the top reflects the adjustment of after-tax market returns, which becomes more pronounced among the wealthiest segments.

Why would the dividend and capital gains tax increases reduce inequality so strongly? As discussed above, these taxes target income derived from stock market wealth, which tends to be highly concentrated among the wealthiest. Taxing this income at a higher rate would reduce both the after-tax capital income of the rich and the market value of their stocks, thus reducing simultaneously the concentration of income and wealth.

In terms of aggregate effects, however, these tax changes would not directly affect long-run investment, as articulated in McGrattan and Prescott (2005). Consequently, they are not expected to have long-term detrimental effects on growth. Unlike textbook capital income taxes, which negatively affect the supply of capital stock and have negative effects on labor productivity and wages (in what we might characterize

[4]In the current calibration, transfers are not specifically targeted toward low-income households; instead, to keep spending effects as neutral as possible, we assume that the transfers are equally distributed. This assumption reflects the idea that all households benefit equally from the government budget, although the relative effects might differ across households by income and wealth.

as a trickle-down mechanism), these taxes on corporate distributions primarily alter the valuation of stock market wealth, leaving the economy's long-run productive capacity unaffected. In fact, the general equilibrium effect of reducing the return on equity indirectly benefits firms because they can access financing at cheaper rates, as in Anagnostopoulos et al. (2012) and Brun et al. (2023). This translates into a small increase in output, investment, employment, and wages, as shown in Table 1.

Our analysis demonstrates that higher taxes on dividends and capital gains have the ability to generate government revenue at no cost to the overall economy. An implication is that the presumed trade-off between equity and efficiency is misleading in this context. Instead, raising the marginal tax rate on dividends and capital gains for the affluent decreases inequality without compromising economic efficiency. The raised revenues, in turn, can be allocated to productive and socially desirable uses.

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