CTJ

Citizens for Tax Justice

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Contact: Bob McIntyre (202) 299-1066 x22

Time to Stop Subsidizing Wall Street

Eliminate the Tax Loopholes for Capital Gains and Dividends

Americans are in no mood to subsidize Wall Street. This became clear Monday, when the House of Representatives rejected the financial rescue plan that was supported by leaders from both parties as well as the President. Reasonable people can differ on whether the government should step in to prop up the financial system right now. There are progressives and conservatives on both sides of that issue. But what seems indisputable is that Wall Street has mismanaged its affairs and Americans are in no mood to pay for its mistakes.

So if Congress is going to enact some rescue plan (which is still uncertain at this point) it would be sensible to include provisions ending the subsidies we are currently doling out to Wall Street. The biggest and most unjustified of these subsidies is the special low tax rate on capital gains and dividends. These tax loopholes subsidize people whose income comes from investments rather than wages, as well the Wall Street brokers who rely on their business.

Oddly, the conservative Republicans who say they oppose the financial rescue plan because they don't want to subsidize Wall Street have simultaneously called for more subsidies for Wall Street in the form of a further reduction in taxes on investment profits! We think these GOP conservatives are seriously confused.

President Bush's Policy of Taxing People Who Work More than People Who Live Off Their Wealth

Imagine that a woman who is the heiress of a hotel chain is so wealthy that she does not have to work. She has a huge amount of stocks and other investments. She gets an excellent income from two sources. She receives stock dividends, and when she sells assets (through her broker, of course) for more than their original purchase price, she enjoys the profit, which is called a capital gain. On these two types of income, she only pays a tax rate of 15 percent, thanks to the tax cuts enacted under President Bush.

Now let's imagine a receptionist that works in the investment bank that handles some of the heiress's dealings. Let's say this receptionist earns $50,000 a year. Unlike the heiress, his income comes in the form of wages, because, alas, he has to work for a living. His wages are taxed at progressive rates, and a portion of his income is actually taxed at 25 percent. (In other words, he faces a marginal rate of 25 percent, meaning each additional dollar he earns is taxed at that amount).

But that's just the federal income tax. He also pays the federal payroll tax of around 15 percent. (Technically he pays only half of the payroll tax and his employer pays the other half, but economists generally agree that it's all ultimately borne by the employee.) So he pays taxes on his income at a higher rate than the heiress who lives off her wealth. Most Americans would say this sounds pretty unfair, and they'd be right.

Tax Loopholes Even Ronald Reagan Opposed

There was a time when the federal income tax, at least, treated all income equally. President Reagan actually signed a tax reform law that applied the same income tax rates to all income, regardless of whether it came in the form of wages or investment income. But then loopholes were put back in place for investors, and these were expanded significantly under President George W. Bush. This means that everyone who is paying taxes under the normal progressive rates is subsidizing — through the tax code — those who live off their investments.

The Tax Subsidy for Capital Gains and Dividends Mostly Goes to the Richest One Percent

Supporters of this tax subsidy must know that it is wildy unfair, because they have spent a great deal of time devising complicated justifications for it. First, they ignore the inherent unfairness of it and just say that many middle-class people have some investments now, so the Bush tax cuts for investment income are beneficial to the middle-class.

Bush Tax Cuts for Capital Gains and Dividends in United States

Income group	Ave. 2009 Income	Average tax cuts 2009	% of tax cut 2009
Lowest 20%	$ 11,600	$ –1	0.1%
Second 20%	26,200	–9	0.4%
Middle 20%	43,700	–36	1.7%
Fourth 20%	70,100	–88	4.0%
Next 15%	121,900	–262	9.0%
Next 4%	272,200	–1,559	14.4%
Top 1%	1,661,900	–30,525	70.4%
ALL	**$ 75,400**	**$ –431**	**100.0%**
Addendum: Bottom 60%	$ 27,200	$ –16	**2.1%**

Source: Institute on Taxation and Economic Policy Tax Model, May 2008

This is simply untrue. Using estimates from the tax policy model of the Institute on Taxation and Economic Policy, we released a report a few months ago showing that around 70 percent of the benefits of Bush's tax cuts for capital gains and dividends will go to the richest one percent of Americans next year. The poorest 60 percent of Americans will get only 2 percent of the benefits.

For the richest one percent, the average tax cut is in the tens of thousands of dollars, while for the poorest sixty percent, the average is enough to buy one solid meal for one person. (The average tax breaks for all income groups are probably less now because everyone will have less investment income due to the market's recent downturn, but the distribution of these tax cuts is likely unchanged.)

But President Bush and his allies nonetheless speak as though every American is sitting on a huge pile of stocks. For example, a few months back, Senator McCain said on ABC's "This Week" that it would be a terrible idea to allow the Bush tax cut for capital gains and dividends to expire because "100 million people have investments."

The reality is that most stock owned by middle-income people is in 401(k) plans, Individual Retirement Accounts (IRAs) or other similar retirement savings vehicles. Taxes on these investments are deferred until retirement, at which point they are taxed as "ordinary income," meaning they don't benefit from the tax cuts for capital gains and dividends. This is supported by IRS data showing that in 2005, fewer than 22 million taxpayers received any benefit at all from the special low rates for capital gains and dividends — far fewer than the 100 million implied by Senator McCain.

Tax Subsidies for Investment Income Have Not Led to Stellar Economic Growth

Another argument made by supporters of these tax loopholes is that they are vital for economic growth. If anything, the past year has proven that President Bush's tax cuts for investment income have utterly *failed* to bring about the economic benefits that were promised.

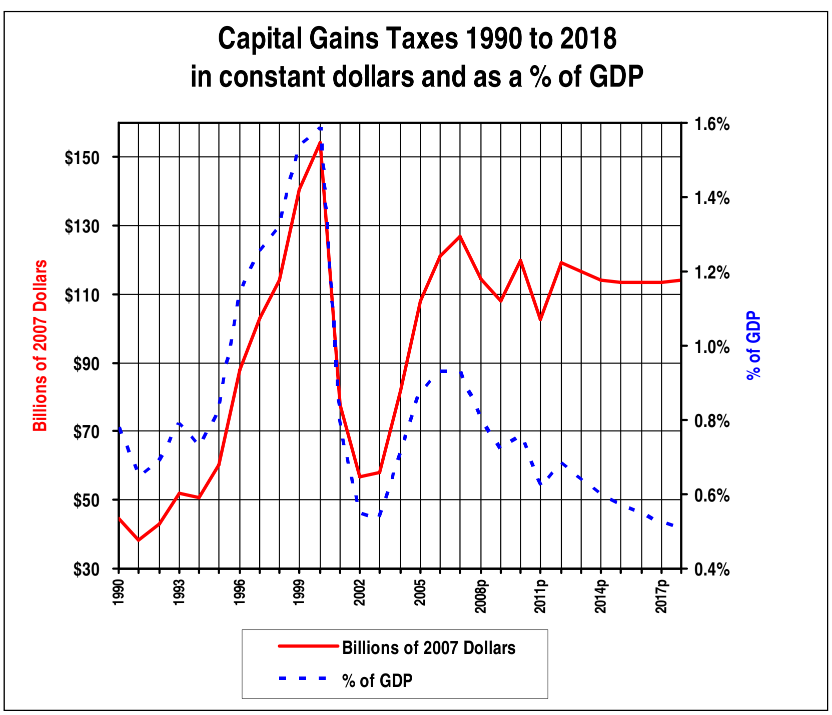
President Clinton did increase a loophole for capital gains (lowering the top rate from 28 percent to 20 percent) under pressure from the Republican Congress, and that is unfortunate.

But President Bush took the party for Wall Street to a whole new level when he lowered the top rate for capital gains further, down to 15 percent, and then created a new loophole for corporate dividends, which had been taxed as ordinary income but are now also subject to a top rate of 15 percent. (And of course, President Bush enacted several other tax cuts, and when they are finally phased in, about 51 percent of the benefits will go to the richest one percent of taxpayers.)

It's hard to see how exactly the economy has improved in response to these tax cuts. Real median household income, which grew during the Clinton years, has [fallen in the Bush years](). The poverty rate, which declined under Clinton, has inched back up during the Bush years. Unemployment, which fell under Clinton, has risen under Bush.

Tax Cuts for Capital Gains and Dividends Have Contributed to the Budget Deficit

Supporters of these tax subsidies nonetheless argue that they cause an increase in investment and that this will in turn lead to more investment income — so much more that the taxes paid will actually cause revenues to *increase*. You read that right. They argue that a tax cut can lead to an increase in revenue.



Supporters particularly make this case about capital gains. Because it fluctuates so wildly with economic cycles, a person looking at a chart illustrating the revenue collected from taxing capital gains can be easily confused into believing any strange story about the cause of the upturns or downturns.

As illustrated in the nearby chart using numbers from the Congressional Budget Office, revenue collected from taxing capital gains fell greatly after the economy tanked in 2001, which is to be expected because capital gains themselves drop off during a downturn. In the years following that, it climbed back up from this low-point, which is what always happens regardless of any change in tax policy. But supporters of tax subsidies for investors point out that the upturn coincided with the tax cut signed by Bush that lowered the top rate on capital gains (as well as dividends) to 15 percent. This they claim, proves that capital gains tax cuts increases revenue collected from taxing capital gains.

But there's a problem with this story: This revenue was far higher at the end of the Clinton years, when the top rate on capital gains was *higher*.

This argument might seem entirely arcane except for the fact that the United States has trouble paying its bills. The Clinton budget surpluses have turned into giant deficits under Bush, despite Bush's promise to have a balanced budget and his suggesting that revenues increase in response to tax cuts. Continuing to subsidize investors when the government cannot pay its bills simply makes no sense.

Now Supporters of Tax Subsidies for Investors Want to Expand Their Failed Policies

Anti-tax activists and their friends in Congress see no problem with tax subsidies for investment income. In fact, their response to the economic crisis is to *expand* these very loopholes that have utterly failed to provide the economic benefits that were promised.

They want the tax rate on capital gains to be lowered to zero for both individuals (who already benefit from a special low rate of 15 percent for capital gains) and corporations (which pay taxes at a nominal rate of 35 percent on all taxable income). This tax cut would allegedly last only for two years, at which point the rates would go back to their current levels, except that they would still be reduced by an adjustment for "inflationary gains."

One might note that it is entirely disingenuous for those proposing this tax cut to call it a "two-year suspension" of taxes on capital gains. There is no such thing as a temporary tax cut under the logic of anti-tax lawmakers and their supporters. They sometimes talk unwary members of Congress into supporting a tax cut by saying that the cost will be small because the tax cut will be temporary. But, inevitably, when the expiration date nears, the anti-tax lawmakers propose making the tax cut permanent, and accuse anyone who opposes their efforts of wanting a "tax increase." (This is exactly what has happened with the Bush tax cuts.)

Most important, Congressional leaders who are trying to round up votes to support a financial rescue plan should not even consider this irresponsible proposal. It would be the height of hypocrisy to abolish a tax on the main income of the investor class and expect middle-income people who earn wages to pick up the tab.

Conclusion

If House Republicans are sincere about protecting middle-income taxpayers and not giving away the store to Wall Street, then they should abandon their proposed tax cuts for Wall Street. Instead, they should join us in advocating a return to President Reagan's approach of taxing investment profits at the same income-tax rates as wages and other kinds of income.

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