

REPEALING THE TAX ON DIVIDENDS: BENEFITS AND COSTS

Introduction

On January 7, 2003, President Bush proposed an economic growth package that included tax cuts totaling \$674 billion over 10 years,¹ not counting added interest costs.² It would accelerate the tax rate cuts, the child credit (increased to \$1,000), and the marriage penalty relief provisions of the 2001 Economic Growth and Tax Relief Reconciliation Act (EGTRRA). The centerpiece of the package was a proposal to eliminate the taxation of dividends paid on stock and mutual fund shares. This single proposal is now estimated by the Treasury Department to cost \$360 billion over 10 years.

The Bush Administration has suggested that the repeal of the income tax on dividends would benefit retirees substantially. This Data Digest examines this claim using data on the distribution of dividend income among the age-50-and-older population, then discusses other aspects of the growth package, including its impact on the economy and its immediate and longer-term impact on the federal budget.

Table 1. Persons with Dividend Income by Age Group, 2000

	Aged 65 and older	Aged 50-64	Aged 50 and older
Number of persons (000)	34,835	41,266	76,101
Tax returns (000)	16,731	24,695	41,426
Taxable returns (000)	13,459	24,197	37,656
Returns with dividend income (000)	8,768	8,903	17,671
Persons affected by dividend exclusion (000)	12,222	13,424	25,646
Persons affected as percent of age group	35.1	32.5	33.7

Source: U.S. Census Bureau population projections at <http://www.census.gov/population/projections/nation/summary/np-t3-a.txt>; Tax Year 2000 Individual Complete Report File; Statistics of Income Division, IRS; October, 2002

¹ The president's budget reestimated the package at \$614 billion, \$360 billion attributable to the dividend exclusion.

² The total package cost has been estimated at \$925 billion over 10 years with interest (Kogan, 2003).

How Many People Have Dividend Income?

According to the National Income and Product Accounts, personal dividend income totaled \$376 billion in 2000 (Park, 2002). But well under half of this amount is reported on tax returns, in part because half or more of dividends flow to tax-exempt sources like pension funds, 401(k) plans, and other non-profits (Gale, 2002).

Of the nearly \$150 billion in dividends that were reported on tax returns in 2000, people aged 65 and older (hereafter "retirees") received a highly disproportionate share (48 percent). However, most people aged 65 or older will *not* benefit from the dividend tax repeal because most either pay no income taxes or have no dividend income (see Table 1).

The 16.7 million tax returns filed by persons aged 65 and older in 2000 represented about two-thirds (65 percent) of all persons in that age group (22.7 million individuals, calculated by counting twice those joint returns where both filers were aged 65 or older). The other 12.2 million of the 34.8 million persons aged 65 and older did not file returns generally because their incomes were too low.³ Moreover, only 80 percent of the returns filed (13.5 million) are taxable.⁴ Nearly 8.8 million of the 16.7 million returns (52.4 percent) filed by persons 65 and older reported dividend income. Because of joint returns where both spouses were 65 and older, these returns represented 12.2 million retirees (35 percent).

People aged 50-64 (hereafter "near-retirees") also received a disproportionate share (29 percent) of dividend income in 2000. Among near-retirees, 8.9 million returns

³ In some cases it may be that they have substantial tax-exempt income, e.g., from municipal bonds.

⁴ These 13.5 million returns represented 18.2 million retirees because close to 5 million returns are joint, with both filers aged 65 or older.

(representing 13.4 million people) of 24.7 million tax returns filed (36.1 percent) had dividend income in 2000 (see Table 1). Returns with dividend income covered nearly one-third of near-retirees.

How Are Dividends Distributed?

Table 2 (below) shows how the 8.8 million retiree filers with dividend income were distributed in 2000. Among retirees, about three in 10 filers with less than \$10,000 of income had dividend income, but more than nine in 10 in the \$200,000-and-over income class did. Overall, 52.4 percent of retirees who filed returns had dividend income.

AGI Class (\$000)	Returns Having Dividend Income	Percent of Retiree Returns Having Dividend Income	Amount of Dividend Income (\$000)
<\$10	818,252	31.4%	\$1,649,609
\$10-20	1,686,626	39.3%	3,962,789
\$20-30	1,079,567	46.2%	3,177,094
\$30-40	893,347	54.2%	3,312,370
\$40-50	714,174	59.2%	3,767,715
\$50-75	1,457,007	69.7%	8,347,664
\$75-100	800,671	75.8%	6,505,947
\$100-200	914,154	86.4%	13,165,116
>\$200	404,610	92.8%	26,071,100
Total	8,768,409	52.4%	\$69,959,404

Source: Tax Year 2000 Individual Complete Report File; Statistics of Income Division, IRS, October, 2002

Among near-retirees, 15 percent in the low-income groups received dividend income, compared with 88 percent in the highest income class. Overall, 36 percent of near-retiree filers had dividend income (Table 3).

The totals in Tables 2 and 3 show that taxpayers aged 65 and older reported nearly \$70 billion in dividend income, and 50-64-year-olds about \$43 billion in dividends in 2000. Their combined total of \$113 billion was 77 percent of the \$147 billion in total dividend income reported by all taxpayers in 2000, although taxpayers aged 50 and older represented just over half (17.7 million) of the 34.1 million U.S. tax returns having dividend income.

AGI Class (\$000)	Returns with Dividend Income	Percent of Returns with Dividend Income	Amount of Dividend Income (\$000)
<\$10	328,255	15.4%	\$920,113
\$10-20	462,791	15.5%	827,641
\$20-30	620,560	19.7%	847,514
\$30-40	709,746	25.2%	1,016,753
\$40-50	785,604	30.9%	1,399,824
\$50-75	1,875,451	40.2%	3,404,161
\$75-100	1,382,312	52.3%	3,650,176
\$100-200	1,827,358	67.4%	7,820,239
>\$200	910,936	87.5%	23,254,656
Total	8,903,012	36.1%	\$43,141,077

Source: Tax Year 2000 Individual Complete Report File; Statistics of Income Division, IRS, October, 2002

What Share of Income Comes from Dividends?

Dividend income represented eight percent of total adjusted gross income (AGI) for retirees in 2000 (see Table 4). Dividends represented a fairly uniform percentage of income across income classes, although it was slightly higher for incomes above \$100,000. Dividend income was less important to near-retirees (2.3 percent of income overall), ranging from 1.0 to 3.6 percent of AGI for people aged 50-64.

AGI Class (\$000)	Aged 65+	Aged 50-64
<\$10	-174.5%*	-6.5%*
\$10-20	6.2%	1.8%
\$20-30	5.6%	1.1%
\$30-40	5.8%	1.0%
\$40-50	7.0%	1.2%
\$50-75	6.5%	1.2%
\$75-100	7.2%	1.6%
\$100-200	9.3%	2.2%
>\$200	9.2%	3.6%
Total	8.0%	2.3%

*Total AGI for filers in these categories was negative. Negative income occurs due to business losses and other deductions that reduce income, sometimes below zero. Source: Tax Year 2000 Individual Complete Report File; Statistics of Income Division, IRS, October, 2002

What Share of Aggregate Dividend Income Is Received by Those Aged 50 and Older?

Of all dividend income reported by all taxpayers, 48 percent was accounted for by filers aged 65 and older, and 29 percent by those aged 50-64 (see Table 5). Dividend income was equally concentrated among persons 50 and older in each income class except for those earning less than \$10,000. Although retirees had the larger share throughout the income distribution, in the highest income class retiree and near-retiree shares were almost evenly split.

AGI Class (\$000)	Aged 65+	Aged 50-64	Aged 50+
<\$10	35.8%	20.0%	55.8%
\$10-20	67.6%	14.1%	81.7%
\$20-30	62.2%	16.6%	78.8%
\$30-40	61.4%	18.9%	80.3%
\$40-50	59.9%	22.3%	82.2%
\$50-75	57.3%	23.4%	80.6%
\$75-100	51.8%	29.0%	80.8%
\$100-200	49.0%	29.1%	78.1%
>\$200	39.7%	35.4%	75.0%
Total	47.6%	29.4%	76.9%

Source: Tax Year 2000 Individual Complete Report File; Statistics of Income Division, IRS, October, 2002

How Concentrated Is Dividend Income among the Highest Income Classes?

Among taxpayers aged 50 and older, dividend income is *heavily* concentrated among those with incomes above \$100,000, and even more so among those aged 50-64 than among those aged 65 and older (Table 6). More than half (56 percent) of all dividend income of retirees went to filers with incomes above \$100,000. More than one-third (37.3 percent) went to filers with incomes in excess of \$200,000. Dividend income was more concentrated among near-retirees, with nearly three quarters (72 percent) going to those with incomes greater than \$100,000, and more than half (53.9 percent) going to those with incomes in excess of \$200,000.

AGI Class (\$000)	Aged 65+	Aged 50-64
<\$10	2.4%	2.1%
\$10-20	5.7%	1.9%
\$20-30	4.5%	2.0%
\$30-40	4.7%	2.4%
\$40-50	5.4%	3.2%
\$50-75	11.9%	7.9%
\$75-100	9.3%	8.5%
\$100-200	18.8%	18.1%
>\$200	37.3%	53.9%
Total	100.0%	100.0%

Source: Tax Year 2000 Individual Complete Report File; Statistics of Income Division, IRS, October 2002

Of particular note is that, of all dividend income received in tax year 2000 (\$147 billion), 48 percent (\$70.3 billion) was received by tax filers aged 50 and older with incomes in excess of \$100,000 (see Tables 2 and 3).

Retirees earning \$100,000 and over received \$39.2 billion (26.7 percent) of all dividend income,⁵ and near-retirees in that income range received another \$31.1 billion (21.2 percent). These filers represented about 4 million (3.1 percent) of the 129 million filing units in the U.S., or about 3.1 percent.

Caveats

The figures cited above come from IRS tabulations of tax returns, so we have good reason to trust their accuracy. However, they do not reveal the entire picture of who benefits because not all items reported as dividends to the IRS are actually dividends, and not all dividends will be tax-free under the president's proposal. The dividend amounts above are overestimated because the IRS

⁵ See the last column of Table 2 for retiree dividends and Table 3 for near-retiree dividends. Total dividends were \$147 billion. The Urban-Brookings Tax Policy Center has estimated that 63 percent of the tax benefits from the dividend exclusion would go to those aged 65 and older with incomes in excess of \$100,000. See their estimate at www.taxpolicycenter.org/commentary/dividend/table6.xls.

requires distributions from mutual funds to be reported as dividends regardless of whether their underlying assets pay interest or dividends (Esenwein and Gravelle, 2003). In tax year 1999, an estimated \$54 billion of the \$129 billion in dividends reported in AGI (42 percent) was actually interest income, leaving a net total of \$75 billion (58 percent) in actual dividends (Esenwein and Gravelle, 2003). For tax year 2000, the comparable figure for interest income reported as dividend income was \$61.7 billion (Park, 2002), leaving a net of about \$85 billion in actual dividends of \$147 billion (58 percent).

In addition, there are some circumstances in which dividends will still be taxed under the new proposal, such as when a firm pays no federal taxes, or its dividends exceed its taxes paid. Therefore, a substantial percentage of the dividend income reported by retiree tax filers will not benefit from the dividend tax repeal, so their tax benefits will be smaller than the tables above suggest.

Table 7. Distribution of Dividend and Taxable Interest Income among Filers Aged 65+, 2000

AGI Class (\$000)	Percent of returns with dividend income	Percent of returns with interest income	Dividend income as percent of AGI	Interest income as percent of AGI
<\$10	31.4%	74.7%	-174.5%*	-451.4%*
\$10-20	39.3%	85.6%	6.2%	18.9%
\$20-30	46.2%	89.5%	5.6%	15.3%
\$30-40	54.2%	92.2%	5.8%	14.2%
\$40-50	59.2%	93.3%	7.0%	12.9%
\$50-75	69.7%	97.1%	6.5%	11.9%
\$75-100	75.8%	97.0%	7.2%	11.2%
\$100-200	86.4%	98.0%	9.3%	9.9%
>\$200	92.8%	99.1%	9.2%	8.4%
Total	52.4%	89.0%	8.0%	11.8%

*Total AGI for filers in these categories was negative. Negative income occurs due to business losses and other deductions that reduce income, sometimes below zero.
Source: Tax Year 2000 Individual Complete Report File; Statistics of Income Division, IRS, October, 2002

We cannot determine whether the dividend income from mutual funds that is actually interest income is distributed differently from the dividend totals reported above. However, we do know that taxable interest income is distributed more widely among the retiree population than is dividend

income (see Table 7), and that it accounts for more of total AGI (about 12 percent) for filers aged 65 and older. Nearly nine in 10 elderly tax filers have taxable interest income, compared with just over half who have dividend income.

What Are the Impacts on Tax Burdens?

Both the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 and the president's new tax proposal conferred nearly half of their tax benefits on the top 5 percent of the income distribution. EGTRRA and the growth package provided 47 percent and 48 of their tax benefits, respectively, to the top 5 percent of taxpayers, and 38 percent and 32 percent respectively to the top 1 percent of taxpayers (Citizens for Tax Justice, 2001; 2003). By comparison, the top 5 percent of taxpayers pay less than 40 percent of all federal taxes, and the top 1 percent pay only about 23 percent of all federal taxes (Congressional Budget Office, 2001).

Some advocates for EGTRRA and for the president's new tax proposal reasoned that tilting the distribution of tax benefits toward higher income classes was warranted by the disproportionate share of *income* taxes paid by very-high-income people. For example, those in the top income quintile (fifth) in 1979 paid 66 percent of all federal income taxes. By 1997, they paid 78 percent of income taxes (CBO, 2001). The top income quintile paid a disproportionate share (relative to its numbers) of income in taxes for two reasons. First, this group received a disproportionate share of total income (46 percent in 1979 and 53 percent in 1997), so that even a proportional tax would result in the top fifth paying a disproportionate share of taxes relative to their numbers. Second, because we have a moderately progressive income tax, those at the top pay a higher proportion of their income in taxes than those in the middle or at the bottom. It is worth noting, though, that even after taxes, the income distribution has become more unequal—the income share of the top fifth has actually grown larger over

time, from 40 percent of all income in 1979 to 50 percent in 1997.

The argument that the affluent pay a disproportionate share of taxes also tends to focus only on income taxes and ignores social insurance taxes,⁶ which are the second most important federal revenue source and higher than income taxes for the bottom four income quintiles of the population (CBO, 2001). In fact, although the top income fifth has the highest effective income tax rate of all taxpayers, it has the *lowest* effective social insurance tax rate (CBO, 2001).

A comprehensive Congressional Budget Office (CBO) report on trends in tax burdens over the previous two decades showed that effective tax rates (taxes paid as a percentage of income) *fell* for every income quintile, or fifth, of the U.S. population between 1979 and 1997 (2001).

Furthermore, although tax shares for the top fifth increased from 57 to 65 percent between 1979 and 1997 (14 percent), their pre-tax income increased by more than 50 percent between those two years, while the pre-tax income of the bottom fifth *declined* by 4 percent. No other income fifth increased by more than 15 percent. Thus, the higher effective tax rate paid by the highest fifth of income earners has not diminished the income advantage they have over the rest of the population. On the contrary, in spite of the progressive income tax, that advantage has increased rather than decreased over the past two decades.

What Are the Impacts on the Economy?

Leading fiscal experts agree that the tax bill will provide little economic stimulus in the short run and will magnify long-term fiscal problems (Gale, 2003; Esenwein and Gravelle, 2003). The main arguments for the bill as stimulus are that accelerating the lower EGTRRA tax rates may spur consumption and

that the dividend tax repeal may increase consumption indirectly by raising stock prices, thereby encouraging people to spend more.

Even if withholding tables were altered to expedite the tax reduction, the likely lags in enactment and implementation will probably diminish its impact. In addition, accelerating the lower EGTRRA tax rates will benefit primarily the most affluent, who are more likely to save than consume the added income. The dividend tax repeal will have a small direct impact on income, because, as noted earlier, only about \$85 billion (less than 1 percent of GDP) in dividends is taxable on individual returns. If stock prices increase by 5 percent of market value (roughly \$425 billion) and people consume only 3 to 5 percent of wealth (the most common estimates), then consumption will increase by between \$13 and \$21 billion, or up to 0.2 percent of GDP (Gale, 2003). The small amount of stimulus may account for the Bush Administration's more recent emphasis on the tax bill as a "growth package."

Impact on the Deficit

Since the publication of its January, 2001 baseline, the CBO has projected a steadily deteriorating budget forecast. In 2001, CBO forecast 10-year surpluses of \$5.6 trillion. The enactment of EGTRRA and a recession-weakened economy, aggravated by the uncertainty caused by the September 11 catastrophe and corporate bankruptcies, shrank the 2002 10-year surplus forecast to \$2.3 trillion. In CBO's latest report, the 10-year surplus is down to \$1.3 trillion. The \$4.3 trillion reversal was due entirely to the \$3.1 trillion on-budget surplus turning into a \$1.2 trillion on-budget deficit. In fact, the off-budget surplus outlook (mostly Social Security) has actually increased by \$80 billion during that time.

These worsening deficit figures do not truly reflect the depth of the future fiscal problem, however, because CBO baselines reflect current law only. Table 8 only shows how quickly the fiscal situation has already

⁶ The taxes which finance Social Security, Medicare, and unemployment insurance.

deteriorated. The future looks much bleaker. CBO projected only a \$157 billion deficit for 2004, but the president's own budget projects the highest federal deficit in U.S. history (\$307 billion in 2004), and cumulative deficits of \$1.4 trillion over 2004-08. The growth package, along with making EGTRRA permanent and the administration's other tax proposals, would cost \$1.5 trillion through 2013. Interest costs would add another \$360 billion to the deficit, for a total of nearly \$1.9 trillion. Adding to this the original impacts of EGTRRA, the administration's tax cuts would increase deficits by \$4.4 trillion through 2013 (Friedman, et al., 2003).

Deficit (-) or surplus	FY2002-11	FY2003-12	FY2004-13
Off-budget	2,488	2,505	2,568
On-budget	3,122	-242	-1,231
Unified budget	5,610	2,263	1,336

Source: Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2004-13*, Washington, DC: U.S. Government Printing Office.

Even these figures do not tell the entire story. The administration has acknowledged that it intends to address the individual Alternative Minimum Tax after the next election, and doing so will cost an estimated \$675 billion, including interest costs (Friedman, et al., 2003). The imponderable cost of a war with Iraq was not included in the president's budget, but his former chief economic advisor estimated it at \$250 billion, which may be optimistic.

The administration's 2004 budget identifies the long-term costs of Social Security (\$4.6 trillion) and Medicare (\$13.3 trillion) as "the real fiscal danger." "The longer the delay in enacting reforms, the greater the danger, and the more drastic the remedies will have to be."⁷ Yet the administration's enacted, proposed, and promised tax cuts plus interest costs add more than \$4 trillion to the debt in the short term,

and risk creating long-term structural deficits as the boomers begin to retire.

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⁷ Office of Management and Budget, 2003, p. 32