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Group of House Democrats Support Tax Preferences for Wealthy Investor Class that President Reagan Ended

Forty-seven House Democrats have reportedly written a letter to Speaker Nancy Pelosi calling for an extension of the Bush tax cuts on investment income for the richest two percent of Americans.[1] These Democrats would preserve the historically low income tax rate of 15 percent for capital gains and stock dividends for the wealthiest taxpayers. This stance places them to the right of Ronald Reagan and illustrates a surprising lack of familiarity with history and economics.

Very generally, a "capital gain" is the profit you have if you sell an asset for more than you paid to purchase it. Capital gains are a type of income and are therefore subject to the federal income tax. For people who spend most of their time buying and selling assets, capital gains are most of their income. It would make sense to tax this income just like any other income.

Unfortunately, lawmakers have, at various points in history, decided to tax capital gains at lower rates than apply to other types of income. The explanation for this is not so much in any sound view of economics as in the disproportionate influence that wealthy investors have always had on the political process.

Reagan's Good Deed and the Democrats Who Undermine It

But the wealthy investor class is not politically invincible. In 1986, President Ronald Reagan signed into law the Tax Reform Act that ended the tax preference for capital gains and taxed all types of income at the same rates. Conservatives have long complained about this Reagan tax reform, and have even incorrectly claimed that capital gains tax revenue actually fell as a result of it.

Actually, right before the Reagan reform took effect, capital gains tax revenue rose temporarily as many people sold their assets to recognize gains before the new rates went into effect. Not surprisingly, reported capital gains fell from this artificial high point for a few years thereafter. But by the 1990s, taxable capital gains began to rise rapidly along with the Clinton-era stock market, and eventually reached record highs. They have since fluctuated along with prices of stock and real estate.

Today, conservative critics of President Reagan have been joined by a group of House Democrats who also seem to feel that Reagan was not sufficiently devoted to tax preferences for the wealthy investor class.

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[1] This is not to be confused with another letter, signed by 31 House Democrats, supporting an extension of all the tax cuts for the richest taxpayers. See Citizens for Tax Justice, "Most House Democrats Supporting Tax Cuts for the Rich Have Lower than Average Percentage of High-Income Households in Their Districts," September 21, 2010. http://ctj.org/pdf/letterwith31.pdf

President Obama's plan would extend the reduced rates for capital gains and dividends that were enacted under President George W. Bush for all but the richest 2.1 percent of taxpayers. These richest taxpayers would have to pay taxes at a rate five percentage points higher on most of their capital gains and dividend income than they do today. (This would still be roughly half the top rate paid by the rich on other types of income.) But a letter has been reportedly signed by 47 House Democrats asking that the current, extremely low rates for capital gains and dividends be extended for the richest two percent as well.[2]

George W. Bush's Policy to Let Paris Hilton Pay at a Lower Tax Rate than You

By the time President George W. Bush took office, the capital gains rate had been lowered to 20 percent. Meanwhile, stock dividends were still taxed just like any other income. In 2003, Bush and his allies in Congress lowered the top rate for capital gains to 15 percent and created a brand new tax preference for stock dividends by also taxing them at a top rate of 15 percent — 20 percentage points below the top rate on regular income, which was set at 35 percent.

One problem with the rate reductions for capital gains and stock dividends is that most of this income goes to the very rich.[3] Citizens for Tax Justice estimated that in 2009 over 70 percent of the benefits of these tax cuts went to the richest 1 percent of taxpayers.[4]

A second problem with these rate reductions is that it is fundamentally unfair that a person who lives off of his or her investment income can pay taxes at a lower rate than someone with equal or less income who works for a living. (See the box below for an example of this.)

The Unfairness of Lower Tax Rates for Investment Income

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 brokerage 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 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.

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[2]Brian Beutler, "Democratic House Member Presses Pelosi For More Tax Cuts For Wealthy," Talking Points Memo, Sept. 23, 2010. http://tpmdc.talkingpointsmemo.com/2010/09/44-house-dems-press-pelosi-for-more-upper-income-tax-cuts.php?ref=fpb

[3]It's true that many middle-class people have investments, but 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.

[4]Citizens for Tax Justice, "Capital Gains and Dividends Tax Cuts Offer Almost No Benefit to Middle-Income Americans and Add to the Nation's Fiscal Problems," May 13, 2008. www.ctj.org/pdf/capgainsdivtaxcuts.pdf

A third problem is that the more Congress expands tax preferences for investment income, the more incentive there is for people to disguise other types of income as investment income. For example, the "carried interest" loophole is used by extremely wealthy managers of buyout funds so that they can pretend that the compensation they earn for managing other people's money is actually capital gains and therefore subject to the lower tax rate.[5]

Supporters of tax cuts for investment income are undeterred by these facts. They argue, ludicrously, that the Bush tax cuts increased investment and asset sales so much that the amount of tax revenue collected actually increased. This is the mirror image of the false argument they made years earlier that the Tax Reform Act of 1986 led to reduced capital gains tax revenue because it ended the capital gains tax break.

The problem with their argument this time, just like last time, was that they presented "facts" wildly out of context.

For example, the *Wall Street Journal* wasn't lying when it said that capital gains reported on tax returns increased after the tax rate on capital gains was cut in 2003.[6] The *Journal* simply left out some important information — like the fact that capital gains had plummeted along with the stock market during the recession in 2001, and that *taxes* on capital gains have never recovered in real terms from their high point during the Clinton administration, when the top tax rate for capital gains was higher.[7]

In other words, capital gains fluctuate a lot because of what happens in the economy. But cutting the rate on capital gains has always resulted in less tax revenue collected than would have been the case had the rate not been reduced, no matter what happened in the economy.

The Tax Fight in Congress Today

Like all the Bush tax cuts, the 15 percent tax rate for capital gains and stock dividends will expire at the end of this year, which means Congress must decide whether to extend the low rate or let it expire. President Obama's plan would make permanent the reduced rates for capital gains and dividends for taxpayers with less than $250,000 of adjusted gross income (or $200,000 of AGI for unmarried taxpayers). Citizens for Tax Justice has calculated that only 2.1 percent of taxpayers will have AGI in excess of this amount in 2011.[8]

For the richest 2.1 percent, Obama's plan would tax capital gains and dividends at a top rate of 20 percent. This means that the top tax rate on capital gains and dividends would still be 20

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[5]Citizens for Tax Justice, "Senators Defend 'Carried Interest' Loophole for Investment Fund Managers in the Name of the Poor, Minorities, Small Businesses and Cancer Patients!" June 3, 2010. http://www.ctj.org/pdf/carriedinterestdefense.pdf

[6]A typical editorial opined, "But if anyone still wants to reduce a tax that really would pay for itself, the Congressional Budget Office has the latest data on the revenue boom in the wake of the 2003 capital gains tax cut. Wow. The tax rate fell from 15% to 20%, yet revenue collections have climbed 152% in four years." *Wall Street Journal*, January 29, 2008

[7]Citizens for Tax Justice, "Capital Gains and Dividends Tax Cuts Offer Almost No Benefit to Middle-Income Americans and Add to the Nation's Fiscal Problems," May 13, 2008, page 4. www.ctj.org/pdf/capgainsdivtaxcuts.pdf

[8]Citizens for Tax Justice, "President Obama's FY2011 Budget: Federal Government Should Collect at Least as Much Revenue as Obama Proposes," February 10, 2010, page 4. www.ctj.org/pdf/obamabudgetfy2011.pdf

percentage points below the top regular tax rate, which would revert to the pre-Bush level of 39.6 percent under Obama's plan. The 47 Democrats who wrote to Pelosi want the top rate for capital gains and dividends to remain 15 percent — apparently even if the top rate for ordinary income reverts to 39.6 percent. This would mean investment income would be taxed at a top rate 25 percentage points lower than the top rate for other income.[9]

Controversy Over Stock Dividends

It's possible that Congress will allow the Bush tax cut for dividends to expire completely for the richest 2.1 percent. Democrats in Congress enacted a "pay as you go," or PAYGO, law that requires new tax cuts and new entitlement spending to be paid for. This PAYGO law exempts any extension of the parts of the Bush tax cuts that go to married couples with AGI below $250,000 or unmarried taxpayers with AGI below $200,000. Congress may decide to extend only those tax cuts that they don't have to pay for under this PAYGO exemption.

That would mean that most stock dividends would be taxed like other types of income (at a top rate of 39.6 percent) for the wealthy people who have most of the stock dividends. This would be a big step towards the ideal of fairness that drove the Tax Reform Act of 1986.

The letter signed by 47 House Democrats echoes an argument that has been made by Douglas Holtz-Eakin, who claims that allowing the rate reduction for dividends to expire for the rich would hurt seniors, who receive more stock dividends than other taxpayers.

But the only seniors who would lose any part of their Bush tax cuts under any plan entertained by President Obama or Democratic leaders would be those seniors who are among the richest 2.1 percent of taxpayers.

Holtz-Eakin, the former director of the Congressional Budget Office and adviser to presidential candidate John McCain, recently argued that all seniors who receive dividends (not just those among the richest 2.1 percent) would suffer because corporations would pay out fewer dividends if the tax rate on dividends for rich people went back up to the pre-Bush rate.

This is nonsense. Citizens for Tax Justice recently found that two thirds of the stock dividends paid out by corporations are paid to tax-exempt entities like pension plans, university endowments and charitable endowments.[10] It is highly unlikely that corporations would stop paying out dividends in response to a tax change that affects a minority of their shareholders.

A Better Tax System Is Possible

In our view, President Obama and Congress really should be more ambitious, and should tax capital gains, as well as stock dividends, at the same rates that apply to other types of income, for all taxpayers. Allowing the Bush tax cuts for the wealthiest investors to expire would at least be a step in the right direction.

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[9]In this sense, the position of the 47 Democrats who signed the letter would expand the disparity between tax rates on investment income and tax rates on other types of income, and would increase the problems associated with this disparity.

[10]Citizens for Tax Justice, "Allowing the Bush Dividends Tax Cut to Expire for the Richest 2% Will Not Harm Seniors," July 22, 2010. http://ctj.org/pdf/dividends2010.pdf