



Budget Model

Policy Options: Increase Tax Rates on Capital Gains & Dividends

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Summary: We estimate the budgetary and economic effects of increasing the top rate on long-term capital gains and qualified dividends from 20 percent to 24.2 percent, which is enacted on January 1st, 2021. We project that it will raise around \$60 billion of additional revenue on a conventional basis over the 10-year budget window and increase GDP by 0.1 percent by 2050.

What is a capital gain?

A capital gain is realized when a capital asset (such as corporate stock, a closely-held business or a parcel of land) is sold at a price higher than its purchase price. If the asset was held for under a year, it is classified as a short-term asset and is taxed like regular income at ordinary tax rates. But, if the asset was held for a year or more, it is classified as a long-term asset and is taxed at lower ("preferential") rates. Similarly, dividend income is taxed at preferential rates if the asset has been held for a year or longer.

Current law:

For tax year 2019, no capital gains tax is owed if taxable income is below \$39,375 for single filers (\$78,750 for joint filers). For taxable income above this threshold, any income from capital gains and qualified dividends are subject to preferential tax rates. The lowest rate is 15 percent for filers with taxable income between \$39,375 and \$434,550 for single filers and between \$78,750 and \$488,850 for joint filers. Beyond these thresholds, capital gains and qualified dividends face a rate of 20 percent. These thresholds are indexed for inflation over time.

Under current law, the Net Investment Income Tax (NIIT) also applies to certain investment income. This tax adds an additional 3.8 percent rate on qualifying investment income faced by high-income taxpayers. Some qualifying investments include interest, dividends, capital gains, rents and income from businesses that do not pay the corporate income tax. Taxpayers are subject to the NIIT if their modified adjusted gross income exceeds \$200,000/\$250,000 (single/married filing jointly). This threshold is not indexed for inflation.

Policy option:

We estimate a policy option to raise the highest marginal tax rate on capital gains to a combined 28 percent (24.2 percent plus the 3.8 percent NIIT). This rate is in the range of [tax researchers' estimates](#) of the "revenue-maximizing" top capital gains rate -- that is, the rate at which additional tax increases raise less revenue (or even lose revenue) as taxpayers change their behavior to avoid paying the tax.

Shareholders exercise considerable control over when and how frequently to realize capital gains, and this policy would increase the existing incentive to defer realizations. A large body of empirical research finds that taxpayers reduce the frequency of realizations when capital gains taxes are increased,¹² effects that PWBM includes in its estimates.

PWBM's estimate assumes that taxpayers do not anticipate this tax change. If they did, some investors would choose to realize gains in the months leading up to the tax change in order to take advantage of lower rates. Such behavior would reduce the amount of revenue raised by this policy. In practice, however, proposals often have look-back provisions to reduce anticipation effects.

Because this policy would increase the tax rate on equity-financed corporate investments, it would further exacerbate the existing tax preference towards debt over equity finance. The policy would also encourage firms to fund investment projects out of retained earnings rather than issuing new stock, and to pay dividends less frequently.

Budget estimates:

On a conventional basis, PWBM estimates this policy would raise about \$66 billion over the period 2021 to 2030.

Table 1. Conventional and Dynamic Budget Estimate, FY2021-2030

Billions of Dollars, Change from Current-Law Baseline

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Policy	Conventional										Dynamic			
	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2021-2025	2021-2030	2021-2025	2021-2030
Increase tax rates on capital gains & dividends	4.7	6.3	6.4	6.5	6.8	6.4	6.8	7.2	7.4	7.8	30.7	66.3	14.0	59.3

Economic effects:

Table 2. Dynamic Macroeconomic Effects

Percent Change from Baseline

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Year	GDP	Capital stock	Labor income	Weeks worked
2030	0.0%	0.1%	0.0%	0.0%
2040	0.0%	0.1%	0.0%	0.0%
2050	0.1%	0.3%	0.1%	0.0%

Note: Consistent with [empirical evidence](#), the projections above assume that the U.S. economy is 40 percent open and 60 percent closed. Specifically, 40 percent of new government debt is purchased by foreigners.

As shown in Table 2, PWBM estimates that raising tax rates on corporate distributions would very modestly increase output, capital and labor income in the long run. The policy has two competing effects on capital accumulation:

1. a disincentive to save and invest, which reduces economic long-run economic growth
2. lower public debt, which increases private capital investment and long-run economic growth

PWBM finds that effect (2) dominates effect (1), hence, the overall small positive effect.

Effect (1) is quantitatively small, consistent with economic theory. In general, changing taxes on capital gains and dividends are expected to have a more muted economic impact than changing other taxes on capital. As Gravelle (2018) notes:

...unlike some other tax cuts (such as expensing or corporate rate cuts) that occur at the firm level and have the potential to draw capital from abroad as well as potentially increase saving, capital gains are on the savers side, which means their effects operate solely through saving with some of that saving leaking into investments in other countries.³

Therefore, increasing capital gains and dividend taxation is more likely to be effective at raising revenue with less harm to savings and investment incentives in the U.S. relative to competing policy options, including raising the corporate tax rate or moving to longer depreciation schedules.

1. Dowd, Tim, and Robert McClelland. "The Bunching of Capital Gains Realizations." *National Tax Journal* 72, no. 2 (June 1, 2019): 323–58. <https://doi.org/10.17310/ntj.2019.2.02>. ↩
2. PWBM uses a realization elasticity of -0.66. ↩
3. Gravelle, Jane. "Indexing Capital Gains Taxes for Inflation". Congressional Research Service 7-5700 (July 2018). <https://fas.org/sgp/crs/misc/R45229.pdf>. ↩