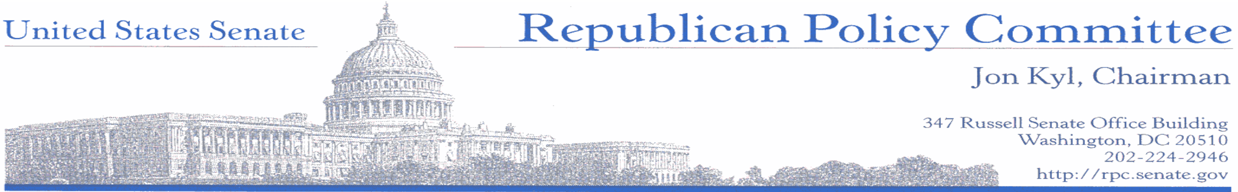

October 4, 2004

The Dividend-Tax Cut: A Success Story with More Potential

Executive Summary

- Despite the opponents' charge that the reduction in the dividend-tax rate enacted in 2003 would amount to little more than a tax cut for the "rich," this improvement in the nation's tax policy has resulted in far-reaching benefits for millions of American households as well as the corporate sector of the economy.
- In each of the three quarters following the 2003 tax bill's enactment, an average of 65 dividend-paying companies increased the size of their dividend by 20 percent or more, compared to an average of only 32 companies in prior years. Moreover, in the year following enactment, 113 publicly traded corporations initiated dividend payments for the first time, compared to an average of 22 companies in prior years.
- The increase in corporate dividends translates into benefits to all taxpayers who own dividend-paying stocks, not just upper-income investors owning stock in taxable accounts, as opponents have argued. With an estimated 79 percent of equity investors participating in tax-deferred retirement plans, an increase in dividends means additional contributions to retirement income that can compound tax-free until they are withdrawn.
- The dividend-rate cut has also resulted in an effective reform of corporate America by providing an incentive for managers to reinvest corporate earnings more efficiently and return unneeded earnings to the shareholders. Additionally, it promotes straightforward corporate accounting since regular dividends can only be paid out of actual cash earnings, and corporate balance sheets benefit from the increased use of common stock, rather than debt, to raise capital.
- While the dividend-tax cut has produced remarkable results to date, its lack of permanence may be constraining it from realizing its full potential. The significant number of new and increased dividend payments over the past year may represent the level that corporate management believes can be sustained in the worst-case scenario – the dividend-rate cut expires, or worse, the opponents succeed in repealing it even sooner.
- If the success of the dividend-tax cut is to continue and reach its full potential, Congress must make this growth-oriented tax policy permanent as quickly as possible.

Introduction

One of the most significant provisions of the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) of 2003 was the reduction of the tax rate applicable to dividends received by individual taxpayers.[1] Prior to that change, dividends were taxed at a taxpayer's marginal tax rate, which in 2002 could be as high as 38.6 percent. JGTRRA reduced the dividend-tax rate to 15 percent for most taxpayers (and to 5 percent for taxpayers in the lowest two tax brackets).[2]

The reduction in the dividend-tax rate was designed to reduce the double taxation of corporate profits. In so doing, it was expected to lower the tax burden on individuals who invest in corporate equities, which in turn would reduce the cost of capital for American businesses. Nevertheless, opponents assailed the dividend-tax reduction as a tax cut for only the "elite" and "wealthiest" Americans.[3] In particular, they claimed that stock ownership is concentrated among wealthy individuals and, as a result, only these taxpayers would be the beneficiaries of the rate reduction.

Despite the opponents' predictions, the dividend-tax cut has been remarkably successful. It has resulted in a dramatic increase in dividend distributions, benefitting all Americans owning dividend-paying stocks. Moreover, it is promoting greater economic efficiency and significant reforms in the corporate sector of the economy. Yet, its lack of permanence may be constraining this important growth-oriented tax policy from reaching its full potential – an issue that Congress should address as quickly as possible.

The Success of the Dividend-Tax Reduction

A Substantial Increase in Dividend Payments

After just one year, the reduction in the dividend-tax rate has produced some very impressive results. Academic research has demonstrated that the rate reduction induced a significant number of publicly traded companies to raise or initiate regular dividend payments.[4]

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[1] H.R. 2, 108th Congress, 2d Session, Public Law 108-27, May 28, 2003. JGTRRA also made the capital-gains tax rate parallel to the dividend tax rate. While that change was also a significant, growth-oriented improvement in tax policy, it is not the primary focus of this paper.

[2] For taxpayers in the bottom two tax brackets, the tax on dividends will be eliminated in 2008. The dividend-tax reduction for all tax brackets expires after 2008.

[3] See Senator Max Baucus, *Congressional Record*, May 22, 2003, p. S6950 ("This tax cut [with respect to dividends] alone is heavily weighted to the elite. . . . So the overwhelming majority of Americans will get little or no benefit from this provision. But look how much this single provision will benefit the elite who do profit from it."); Senator Bob Graham, *Congressional Record*, May 22, 2003, p. S6951 ("Since generally only the wealthiest of Americans will benefit by this proposal to make the remainder of dividends which are subject to taxation free of taxes, the practical effect is going to be to have these high-income Americans put the money into some account, not to spend it, and create the demand that our economy needs.").

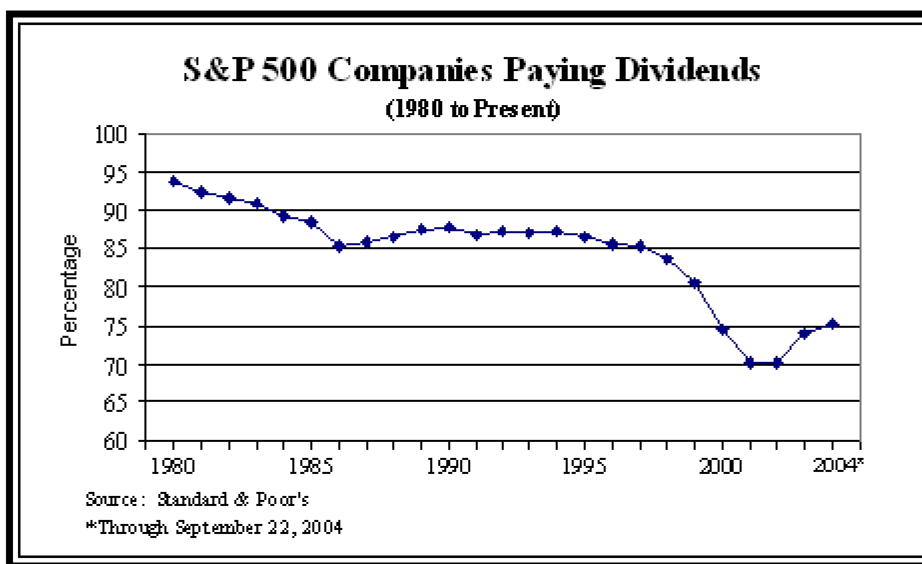
[4] Raj Chetty and Emmanuel Saez, "Do Dividend Payments Respond to Taxes? Preliminary Evidence from the 2003 Dividend Tax Cut," NBER Working Paper 10572, June 2004, p. 5 – http://papers.nber.org/papers/w10572.pdf.

For example, in each of the three quarters following the enactment of the dividend-tax cut on May 28, 2004, an average of 65 companies that were *already paying* dividends raised the size of their dividend payments by 20 percent or more. In contrast, an average of only 32 companies raised their dividends by similar amounts in prior years.[5] More recently, the Securities Industry Association found that in the first six months of 2004, companies reporting dividend increases rose by 13.6 percent compared with the same period in 2003, and by 19.8 percent over the same period in 2002.[6]

Even more impressive is the fact that the number of *new* dividend-paying companies increased significantly in the year following the enactment of the dividend-tax cut – 113 publicly traded corporations initiated dividend payments for the first time, compared to an average of 22 companies in prior years.[7]

In short, the dividend-tax cut reversed the negative trend in the percentage of firms paying regular dividends, which has occurred over the past two decades. As Figure 1 below illustrates,

Figure 1



the percentage of publicly traded corporations making up the Standard & Poor's index of the 500 leading U.S. companies that pay dividends had fallen from over 90 percent in 1980 to 70 percent in 2002, before rebounding to more than 75 percent so far in 2004.[8] More broadly, a study of companies listed on the major U.S. stock exchanges found a similar rebound in the percentage of companies paying regular dividends.[9]

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[5]Chetty and Saez, pp. 16-17.

[6]Frank A. Fernandez, "Dividend Tax Cuts Deemed Effective," SIA Research Report, Volume V, No. 8, August 2, 2004, p. 7 – http://www.sia.com/research/.

[7]Chetty and Saez, p. 3.

[8]Standard & Poor's Quantitative Services.

[9]Chetty and Saez, p. 3.

Real Benefits for All Owners of Dividend-Paying Stock

While opponents have argued that the dividend-tax cut would benefit only the wealthy, research has demonstrated a variety of flaws in their argument. First, a survey of equity ownership in this country shows that 49.5 percent of American households – representing 84.3 million individuals – owned equities such as stock or mutual funds in 2002.[10] As Figure 2

Figure 2
Characteristics of Equity Investors
by Household Income

	Household Income		
	Less than $50,000	$50,000 to $99,999	$100,000 or More
Percent of All Equity Owners	49%	22%	29%
Median Age	46 Years	44 Years	47 Years
Median Household Income	$34,000	$70,000	$125,000
Median Household Financial Assets	$37,500	$100,000	$421,500

Source: "Equity Ownership in America, 2002" Investment Company Institute and Securities Industry Association, Figures 17 and 79.

illustrates, nearly half of these equity owners have household incomes of less than $50,000 and 71 percent have household incomes of less than $100,000 – hardly the elite and wealthiest Americans. In addition, with the median age in each household-income category being approximately 45 years old, a significant number of equity owners in this country are nearing retirement or are already retired. As a result, the dividend-tax cut is particularly important to those individuals in the final years of saving for retirement as well as retirees who are relying heavily on dividend payments for a large part of their retirement income.

Moreover, the opponents suggest that taxpayers who own equities in a tax-deferred account, such as an Individual Retirement Account or a pension plan, do not benefit from the rate cut because any dividends received in such an account are not subject to taxes until they are withdrawn. What this argument overlooks is that the dividend-tax cut has stimulated significant increased corporate dividend distributions.

[10] "Equity Ownership in America, 2002" Investment Company Institute and Securities Industry Association, p. 17 – http://www.sia.com/research/pdf/equity_owners02.pdf.

Figure 3
Hypothetical Portfolio of Stock Held
in a Taxable vs. Tax-Deferred Account

.	Taxable Account		Tax-Deferred Account	
	2002	**2003**	**2002**	**2003**
Annual Dividend Income*	$94	$204	$94	$204
Taxes Due**	(36)	(31)	(0)	(0)
Net Dividend Income	$58	$173	$94	$204

*Based on a hypothetical portfolio of 100 shares of each of the following stocks: Citigroup ($0.70 per share dividend in 2002; $1.10 per share dividend in 2003); McDonalds ($0.24 per share in 2002; $0.40 per share in 2003); Microsoft (no dividend in 2002; $0.24 per share in 2003); and Reebok (no dividend in 2002; $0.30 per share in 2003).
**Assuming the maximum individual-tax rate in 2002 of 38.6 percent (rounded to the nearest dollar) and the reduced dividend-tax rate in 2003 of 15 percent.

As Figure 3 illustrates, an individual owning a hypothetical portfolio of four stocks in an Individual Retirement Account or employer-based 401(k) retirement plan saw the dividend income rise from $94 per year to $204 per year, in large measure because the dividend-tax reduction stimulated increased dividend payments. Moreover, with an estimated 79 percent of equity investors participating in or covered by tax-deferred retirement plans,[11] the increase in corporate dividends translates into additional contributions to retirement income, which can then compound tax-free until they are withdrawn.[12]

Similarly, for individuals owning stock in taxable accounts – approximately 31.4 million households[13] – the lower tax rate on dividends allows them to keep more of the dividends they receive. Using the hypothetical portfolio in Figure 3, an investor would have seen the after-tax income increase substantially – from $58 per year to $173 per year – because of the reduced tax on the dividends as well as the fact that the rate cut stimulated larger dividend payments.

In addition, to the extent that rising dividends result in increased stock prices,[14] shareholders receive an added benefit. As a stock's price increases, investors realize a larger capital gain when they choose to sell the equity investment, again regardless of whether it is held in a taxable or tax-deferred account.[15] In short, the impressive results of the dividend-tax reduction translate into real benefits for *all* individuals who receive dividends from corporate investments, potentially benefitting nearly half of all households nationwide.

[11]Equity Ownership in America, 2002, p. 19.

[12]Joint Economic Committee, "Who Benefits from Ending the Double Taxation of Dividends?" February 2003, p. 9 – http://jec.senate.gov/_files/DividendDoubleTax.pdf.

[13]Fernandez, p. 6.

[14]James Poterba, "Taxation and Corporate Payout Policy," NBER, Working Paper 10321, February 2004, pp. 6-7 – http://papers.nber.org/papers/w10321.pdf; Kevin A. Hassett, "Dividend Tax Cut Makes Sense," American Enterprise Institute, December 1, 2003 – http://www.aei.org/news/filter.,newsID.19615/news_detail.asp.

[15]Joint Economic Committee, p. 8.

A Significant and Effective Reform of Corporate America

The success of the dividend-rate cut, however, is not limited just to shareholders – it has also resulted in greater economic efficiency and significant reforms in the corporate sector of the economy. Historically, the tax laws created a bias that encouraged corporations to reinvest their earnings in new equipment or the development of new products or services that produced a positive return on investment. To the extent that such reinvestments led to higher stock prices, shareholders would realize capital gains, which were taxed at a 20-percent rate prior to JGTRRA. In contrast, companies that distributed their earnings as dividends produced ordinary income for their shareholders, which prior to JGTRRA was taxed at as much as 38.6 percent.

By equalizing the dividend and capital-gain rates, JGTRRA largely eliminated that bias. Consequently, managers now have an incentive to invest only in the best capital projects available to their company – new equipment and/or development of products or services that produce superior returns. And the unneeded earnings can be distributed to the shareholders, who now pay the same 15-percent tax on dividends as they do on capital gains. The result is a more efficient use of reinvested earnings to provide capital for corporate growth and expansion.[16]

In addition, new and increased dividends lead to greater corporate accountability to shareholders. The corporate scandals in 2002 revealed that some companies have used questionable accounting practices to overstate their profitability or mask losses. The dividend-tax cut, in contrast, promotes straightforward accounting of a company's earnings since regular dividends can only be paid out of actual cash remaining after the company pays its expenses.[17]

Similarly, the current trend toward dividend-paying stock can be viewed as strengthening corporate balance sheets. The reduction in the dividend-tax burden has made it easier for many corporations to raise capital through dividend-paying common stock, when they previously might have turned to debt or other forms of financing to raised needed capital for the business.[18] By encouraging companies to utilize more equity financing, the dividend-tax cut takes some of the pressure off corporate borrowing (although debt still retains a tax benefit due to the deductibility of interest), which makes corporate balance sheets less susceptible to interest-rate fluctuations.[19]

The Record of Success is Limited by Uncertainty

The significant increase in new and existing dividends is anecdotal evidence that corporations are responding to tax policy affecting their shareholders.[20] Nevertheless, the

[16]Fernandez, p. 10.

[17]Dan Clifton, "Incentives Matter: A Lesson," *Tech Central Station*, July 23, 2004 – http://www2.techcentralstation.com/1051/defensewrapper.jsp?PID=1051-350&CID=1051-072304F.

[18]Joint Economic Committee, p. 7; Trevor S. Harris, R. Glenn Hubbard, and Deen Kemsley, "The Share Price Effects of Dividend Taxes and Tax Imputation Credits," NBER Working Paper 7445, December 1999, p. 33 – http://papers.nber.org/papers/w7445.pdf.

[19]Fernandez, p. 3; Bill Ford, "Accelerate the Recovery," *Wall Street Journal*, May 13, 2003.

[20]Jennifer L. Blouin, Jana Smith Raedy, Douglas A. Shackelford, "Did Dividends Increase Immediately After the 2003 Reduction in Tax Rates?" NBER Working Paper 10301, February 2004, p. 25 – http://papers.nber.org/papers/w10301.pdf.

dividend-tax cut is set to expire at the end of 2008, and opponents have repeatedly threatened to repeal it even sooner. As a result, its lack of permanence may be constraining this growth-oriented tax policy from realizing its full potential.

A fundamental principle that corporations follow when setting a regular dividend policy – as opposed to declaring an extraordinary, or non-recurring, dividend – is conservatism. Corporations usually limit the level of their regular dividend to one that can be maintained for the foreseeable future.[21] A subsequent reduction in a company's regular dividend generally evokes a severe negative response from the market with respect to the company's stock price. The dividend cut signals that the company is facing economic difficulties and has no other choice but to cut its regular dividend.[22]

Based on this principle, the significant increases in regular dividend payments and new dividend offerings by publicly traded companies over the past year may represent the level of dividends that management believes can be sustained in the worst-case scenario – the dividend-rate cut expires, or worse, the opponents succeed in repealing it at an earlier date.[23] In other words, in a more certain environment in which the dividend-tax cut were permanent, the dividend increases may have been even higher.

The same can be said for companies that are still considering whether to start paying a dividend for the first time. Since they are generally reluctant to initiate one if it cannot be sustained,[24] the current uncertainty surrounding dividend-tax policy may be inhibiting more companies from paying dividends.

The increase in extraordinary dividends since the 2003 dividend-tax cut also suggests that corporations are uncertain about the continuity of the lower dividend rate. Extraordinary dividends allow companies to return earnings to shareholders, but because management carefully describes such dividends as non-recurring distributions, they avoid the adverse signaling effects discussed above.[25]

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[21] Alan Levinsohn, "Does it make sense to pay dividends?" *Strategic Finance*, May 2003.

[22] Zahid Iqbal and Mohammad Habibur Rahman, "Operational Actions and Reliability of the Signaling Theory of Dividends: An Investigation of Earnings Anomaly Following Dividend Cuts and Omissions," *Quarterly Journal of Business and Economics*, Winter 2003, p. 15; H. Kent Baker, Gary E. Powell, and E. Theodore Veit, "Revisiting Managerial Perspectives on Dividend Policy," *Journal of Economics and Finance*, Fall 2002, p. 278.

[23] *Wall Street Journal*, "Paying Dividends," July 22, 2004 ("The timing of the Microsoft decision tells us something. . . . the company was clearly concerned with the possibility that John Kerry might be elected President and carry out his promise to return dividends to their former status as ordinary income (thus raising the dividend tax back to the nearly 40 percent Clinton-era top rate from today's 15 percent."); Robert D. Arnott and Clifford S. Asness, "Surprise! Higher dividends = higher earnings growth," *Financial Analysts Journal*, January/February 2003 ("We found that the empirical facts conform to a world in which managers possess private information that causes them to pay out a large share of earnings when they are optimistic that dividend cuts will not be necessary and to pay out a small share when they are pessimistic, perhaps so that they can be confident of maintaining the dividend payouts.").

[24] Alon Brav, John R. Graham, Campbell R. Harvey, and Roni Michaely, "Payout Policy in the 21st Century," NBER, Working Paper 9657, April 2003, p. 35 – http://papers.nber.org/papers/w9657.pdf.

[25] Claire E. Crutchley, Carl D. Hudson, Marlin R.H. Jensen, and Beverly B. Marshall, "Special Dividends: What Do They Tell Investors About Future Performance?" *Financial Services Review*, Summer 2003, p.139; Blouin, Raedy, and Shackelford, p. 25.

For example, while Microsoft recently announced a significant dividend increase, only $3.5 billion relates to the doubling of the company's regular annual dividend, while the company plans to spend $32 billion on a one-time extraordinary dividend in 2004 rather than larger regular dividends for the shareholders.[26] Similarly, other non-financial S&P 500 companies are reported to be holding more than $500 billion in cash, making it likely that many will follow a similar course to Microsoft or hold back on any permanent changes to their policy with respect to regular dividends until the future is more certain.[27]

Unlike ordinary dividends, extraordinary dividends do not have the same positive effects over the long term on a company's stock price and cost of capital because they are isolated distributions of corporate earnings.[28] And so, to the extent that these extraordinary dividends are taking the place of increases in a company's regular dividends, they are limiting the beneficial changes that the dividend-tax cut is promoting in the corporate sector, as described above.

When taken together, these factors strongly suggest that shareholders may not be realizing the full extent of the dividend increases that might otherwise be possible due to the uncertain future of the dividend-tax cut.[29] In addition, corporations may be continuing to reinvest earnings less efficiently rather than paying them out as dividends that they may not be able to sustain in the future.

Conclusion

The reduction in the dividend-tax rate was included in the 2003 tax bill to reduce the double taxation of dividends in order to lower the cost of equity capital, encourage investment, and stimulate the economy. After just a year, the benefits of this rate reduction have been well proven. Investors are seeing larger dividend payments – in both taxable and tax-deferred accounts – and corporate America is benefitting from the lower cost of capital and more efficient use of business earnings.

Nevertheless, if the success of the dividend-tax cut is to continue – and reach its full potential – Congress must make the dividend-rate reduction permanent, and time is clearly of the essence. After weathering with remarkable resilience the uncertainties that came with terrorist attacks, a recession, corporate-management scandals, and the continuing war on terror, the U.S. economy would welcome the stability that a permanent dividend-tax rate would provide. And with the potential for even better economic results from this growth-oriented tax policy, it is an opportunity that Congress simply cannot afford to miss.

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[26] *Wall Street Journal*, "Microsoft to Dole Out Its Cash Hoard," July 21, 2004.

[27] American Shareholders Association, "Jobs and Growth Tax Relief Reconciliation Act, ASA Dividend Scorecard – June 4, 2004" – http://www.americanshareholders.com/news/asadividend06-03-04.pdf.

[28] Crutchley, Hudson, Jensen, and Marshall, p. 139; *Wall Street Journal*, July 21, 2004.

[29] Blouin, Raedy, and Shackelford, p. 12.