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DIVIDEND AND CAPITAL GAINS TAX CUTS UNLIKELY TO YIELD TOUTED ECONOMIC GAINS

Benefits of These Tax Cuts Flow Disproportionately To The Well-Off

By Joel Friedman¹

Summary

Supporters of the dividend and capital gains tax cuts, which were enacted in 2003 and are slated to expire at the end of 2008, have started a full-court press extolling the virtues of these provisions. This effort is aimed at building support for proposals Congress is expected to consider in coming months to extend these provisions, most likely without offsetting their costs. Proponents of these tax cuts have pointed in particular to recent developments, including the findings of several studies and the decision by Microsoft to initiate dividends, that they claim provide evidence that the dividend tax cut is having a major impact on corporate dividend policies and will lead to substantial economic gains. In this vein, the President's Council on Economic Advisers contends that the response to this tax cut "has been unprecedented in the recent history of tax changes."

A closer review of the available evidence, however, indicates that the supporters of the dividend and capital gains tax cuts tend to overstate the positive effects of these tax cuts and ignore their negative effects.

- Although current research shows that some companies initiated or increased dividends following enactment of the dividend tax cut, the findings also indicate that some corporate dividend policies may be ineffective at achieving the economic and corporate governance improvements that the tax cut's supporters assert will result from increased dividend payouts.
- The high cost of the dividend and capital gains tax cuts continues to add to the deficit, and the resulting increase in deficits has negative long-term economic consequences. Economists at the Congressional Research Service and the Brookings Institution, for example, have concluded that the adverse effects of the increased deficits cancels out, and may even outweigh, any positive effects from these tax cuts themselves.

¹ The author appreciates helpful assistance and comments on earlier drafts from Jason Furman, Bill Gale, Bob Greenstein, David Kamin, Cheng Lee, and Isaac Shapiro.

- Further, while there may be open questions about the economic impact of the dividend and capital gains tax cuts, there is no question that the benefits of these tax cuts flow overwhelmingly to those with the highest incomes. The Urban Institute-Brookings Institution Tax Policy Center estimates that more than half — 53 percent — of the benefits of these tax cuts in 2005 will go to the 0.2 percent of households with incomes over \$1 million. More than three-quarters of the benefits in 2005 will go to the 3.3 percent of households making more than \$200,000.

Corporate Dividend Policies after the Tax Cut Not Always Consistent With Objective of Improved Corporate Governance and Economic Efficiency

Supporters of the tax cut on dividend income maintain that the tax cut is needed to address economic distortions that arise from the “double taxation” of dividend income, which can be taxed at both the corporate and shareholder levels. While the extent of such “double taxation” is often overstated by tax-cut supporters, the theory is that reducing “double taxation” of dividends will reduce distortions that can deter investment in the corporate sector, cause corporations to rely too heavily on debt financing and to become saddled with high interest payments, and encourage firms to maintain high cash balance levels that may be put to poor uses such as perks for company executives. Reducing such distortions could yield gains for the economy, although by most estimates, the gains would be fairly modest. In theory, a tax cut that resulted in a sustained increase in dividend payments would be a sign that some of these distortions in the economy were being addressed.

Aggregate data on the level of dividend payments in the one-year period after the dividend and capital gains tax cuts were enacted in 2003 yield few insights into what effect these tax cuts actually are having on corporate dividend payments. To study this question, researchers have had to parse the data more finely. Several studies have concluded that some companies have increased dividends or started to pay new dividends in response to the tax cut. There is some evidence that factors other than the tax cut also may have influenced the extent of the changes. But at least three findings imply that the impact of these changes may be smaller than tax-cut supporters acknowledge.

- Not all of the new dividends are in the form of ordinary dividends paid on a regular basis. Rather, a portion of the dividend payouts are coming in the form of one-time, special dividends.² Unlike a regular dividend that commits the company to future payouts, these one-time payouts give no indication of a company’s future plans. The one-time nature of special dividends mitigates the positive effects that regular dividends are believed to yield in terms of improved corporate governance and economic efficiency over the long run.

²Raj Chetty and Emmanuel Saez, “Dividend Taxes and Corporate Behavior: Evidence from the 2003 Dividend Tax Cut,” National Bureau of Economic Research Working Paper 10841, October 2004; and Jennifer Blouin, Jana Smith Raedy, and Douglas Shackelford, “Did Dividends Increase Immediately After the 2003 Reduction in Tax Rates,” National Bureau of Economic Research Working Paper 10301, February 2004.

Using the Budget “Reconciliation” Process to Extend Tax Cuts

The Administration’s budget calls for making permanent most of the tax cuts enacted during its first term that are slated to expire by the end of 2010, including the capital gains and dividend tax cuts that expire at the end of 2008. The budget resolutions currently being considered in the House and Senate also assume that these expiring tax cuts are extended. The House budget assumes tax cuts totaling \$106 billion between 2006 and 2010, while the Senate resolution would reduce revenues by \$70 billion over this five-year period.

Moreover, these budget resolutions include special “reconciliation” instructions to the tax writing committees — the House Ways and Means Committee and the Senate Finance Committee. Reconciliation is a fast-track process for considering legislation that is protected from a filibuster in the Senate. In the Senate, these instructions cover all of the tax cuts assumed in the resolution, while in the House they cover \$45 billion of the tax-cut total. The resolutions and the reconciliation instructions in the House and Senate measure would accommodate the \$23 billion cost between 2006 and 2010 of extending the capital gains and dividend tax cuts.

The reconciliation process was originally designed as a way to provide procedural protections to deficit-reduction measures in order to facilitate their passage, given the difficulties that legislation cutting spending or raising taxes can face. In 2001 and 2003, however, reconciliation was used to *cut* taxes. For this year’s budget, Congressional leaders again appear determined to use the procedural protections that the reconciliation process provides to aid the passage of tax cuts that increase, rather than decrease, the deficit — a complete reversal of the way that reconciliation was originally used. Further, these tax cuts are being pursued in the context of budget that seeks significant reductions in domestic spending in the name of deficit reduction. While these program cuts will affect millions of Americans, the benefits of the tax cuts — and particularly the capital gains and dividends tax cuts — will flow primarily to those with the highest incomes.

- Questions have been raised as to whether companies that have introduced or increased dividends actually are increasing their total payout to shareholders. The concern is that companies may be substituting dividend payments for share repurchases, an alternative method of payout that boosts the price of the company’s stock for shareholders (see box on page 8). Without a total increase in payout, the economic gains from increasing dividends are diminished. The extent to which companies are substituting dividends for repurchases is not clear, because the data are difficult to interpret. According to a study by economists from the National Bureau of Economic Research and the Federal Reserve Bank, for instance, about half of the companies that have introduced or increased dividends have *not* increased their total payout to shareholders.³ Another NBER study, however, did not find evidence of such substitution, but could not rule out the possibility that some may have occurred.⁴
- Finally, several studies found that the companies mostly likely to respond to the tax cut by initiating or increasing dividends are those in which top executives hold substantial shares in the company and thus stand to benefit personally from the change in dividend policy.⁵ Corporate

³ Jeffery Brown, Nellie Liang, and Scott Weisbenner, “Executive Financial Incentives and Payout Policy: Firm Responses to the 2003 Dividend Tax Cut,” National Bureau of Economic Research Working Paper 11002, December 2004.

⁴ Chetty and Saez, “Dividend Taxes and Corporate Behavior.”

⁵ Brown, Liang, and Weisbenner, “Executive Financial Incentives and Payout Policy;” Chetty and Saez, “Dividend Taxes and Corporate Behavior;” and Jouahn Nam, Jun Wang, and Ge Zhang, “The Impact of Dividend Tax Cut and

managers should change dividend policies consistent with the best interest of the company and its shareholders. When managers act out of self-interest, there is no guarantee that the actions will be aligned with the broader interests of the company or the shareholders. Whether a firm initiates dividends should be a function of what is most productive for the firm, not the size of the shareholdings of the firm's top executives.

Supporters of the dividend tax cut will likely argue that any shortcomings in the nature of the response to the tax cut is a reflection of the fact that the tax cut is set to expire in 2008, and that companies would respond differently if it were made permanent. That seems improbable, however. Typically, the response to a tax cut perceived as temporary would be stronger, not weaker, as taxpayers rush to take advantage of the tax cut before it expires. Further, arguments that corporations have avoided initiating or increasing dividends because they may be forced to reverse this change if the tax cut expires seem unfounded. Although corporations that reduce dividends typically fear they will be penalized by investors, who may perceive the change as a sign of financial weakness, it is hard to believe that investors would react negatively if a company reduced dividend payments in response to the expiration of the tax cut.

Over the long run, factors besides the tax cut are likely to be more influential than the dividend tax rate in shaping corporate dividend policies. Economic research has generally found that the tax rate a company's shareholders face when they receive a dividend payment is not the most important determinant of a company's decision about whether to pay dividends. Studies indicate that the tax rates that shareholders pay on dividend income ranks well below other factors that executives consider, such as the stability of the company's future earnings, when making dividend decisions. A recent study based on a survey of corporate executives concluded that "increases in dividends are considered only after investment and liquidity needs are met" and that "tax considerations are not a dominant factor in their decision about whether to pay dividends, to increase dividends, or in their choice between payout in the form of [share] repurchases or dividends."⁶

The Tax Cut's High Cost Will Mitigate Any Positive Effects on the Economy Over the Long Run

Even if the dividend and capital gains tax cuts were to generate meaningful economic benefits, such effects would be mitigated as long as the high cost of this tax policy adds significantly to the deficit. As the federal government borrows to finance the deficit, it shrinks the pool of saving available for investment, ultimately leading to lower future incomes for Americans (see box on page 10). As a result, analyses by economists at the Congressional Research Service and the Brookings Institution have concluded that the dividend and capital gains tax cuts, which are being financed by increased borrowing, are unlikely to boost the economy in the long run.

- The Joint Committee on Taxation estimates that the dividend and capital gains tax cuts, which are scheduled to be in effect through 2008, will cost \$148 billion. Making these tax cuts permanent would reduce revenues by an additional \$148 billion through 2015, according to Congressional Budget Office estimates. Because this lost revenue increases the deficit, an

Managerial Stock Holdings on Firm's Dividend Policies," January 2004, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=492802.

⁶ Alon Brav, John Graham, Campbell Harvey, and Roni Michaely, "Payout Policy in the 21st Century," National Bureau of Economic Research Working Paper 9657, April 2003. (An updated version of this paper can be found at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=571046.)

additional \$110 billion in costs will be incurred through 2015 for higher interest payments on the debt. In total, these tax cuts, if extended, thus would add \$405 billion to the debt from the time they were enacted in 2003 through 2015.

- The large cost of these tax cuts is crucial for understanding their impact on the economy. Supporters of the tax cuts often refer to Treasury Department estimates generated for a 1992 report that examined options to cut dividend taxes. In that report, the Treasury estimated that these options — all of which cut dividend taxes more substantially than the 2003 change — could generate slightly higher economic growth.⁷ *But all of these Treasury estimates assumed that the tax cuts would be fully offset and would not increase the deficit.*
- The Congressional Research Service analyzed the 2003 tax cut under a number of assumptions and concluded that, if made permanent, it “would harm long-run growth as long as it is based on deficit finance.”⁸ Similarly, Brookings Institution economists William Gale and Peter Orszag concluded that even if the more optimistic assumptions about the positive effects of the dividend and capital gains tax cuts on the economy proved accurate, as long as these tax cuts continued adding to the deficit, “the net effects would be roughly a zero effect on long-term growth.”⁹

Benefits of the Tax Cuts Skewed to High-Income Households

While the effect of these tax cuts on corporate dividend policies may be subject to different interpretations, what is clear is that the benefits of these tax cuts flow overwhelmingly to households with the highest incomes.

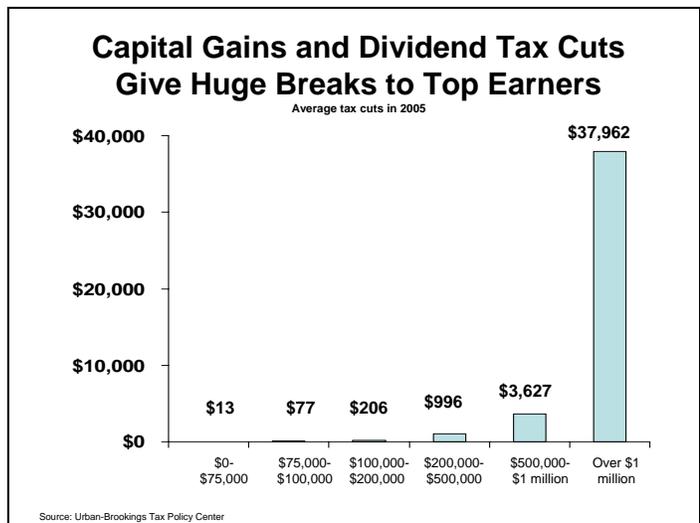
- In 2005, some 53 percent of the benefits of the dividend and capital gains tax cuts will flow to the 0.2 percent of households with incomes of over \$1 million, according to an analysis by the Urban Institute-Brookings Institution Tax Policy Center. These households will receive an average tax cut of \$37,962 in 2005. These tax-cut benefits are in addition to the generous benefits such high-income households are receiving from the other tax cuts enacted since 2001.
- Households with incomes over \$200,000 will receive more than three-quarters of the dividend and capital gains tax-cut benefits; those with incomes above \$100,000 will receive 90 percent of the benefits. Only 10 percent of the benefits of the dividend and capital gains tax cuts will flow to the 86 percent of households with income under \$100,000 in 2005.

⁷ Treasury Department, “Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once,” January 1992.

⁸ Jane Gravelle, “Dividend Tax Relief: Effects on Economic Recovery, Long-Term Growth, and the Stock Market,” Congressional Research Service RL31824, updated February 14, 2005.

⁹ William Gale and Peter Orszag, “An Economic Assessment of Tax Policy in the Bush Administration, 2000-2004” Boston College Law Review, Vol. 45, No. 5, 2004.

- Supporters of the tax cuts may try to argue that the benefits are more widespread, pointing to the growing number of families that own stocks. Despite this growth, however, stock ownership remains highly concentrated at the top of the income spectrum. Moreover, high-income households are much more likely to hold stocks in taxable accounts than middle-income families, who hold a larger share of their savings in retirement accounts that are not subject to tax. Data from the Federal Reserve's 2001 Survey of Consumer Finance show that households in the top five percent of the income spectrum own about half of all stocks and nearly 60 percent of all stocks held in taxable accounts. Only stocks owned in taxable accounts receive a direct benefit from these tax cuts.



The remainder of this analysis is divided into three sections. The first section reviews the economic issues raised by the dividend and capital gains tax cuts. The second section reviews the academic research undertaken to assess the impact of the tax cut on corporate dividend policies. The final section examines which households benefit from the dividend and capital gains tax cuts.

Economic Issues Surrounding the Dividend and Capital Gains Tax Cuts

Supporters of the dividend and capital gains tax cuts enacted in 2003 argue that these tax cuts address problems with the taxation of corporate earnings and thus can have a positive impact on the economy, particularly if they are made permanent. Such claims, however, typically ignore the adverse economic effects these tax cuts will have over the long term if they lead to higher deficits. Taking into account the negative impact of budget deficits on future national income is crucial to understanding the long-term effects of tax cuts financed by borrowing.

Taxation of Corporate Earnings

Supporters of the dividend and capital gains tax cuts maintain that this tax relief is needed because the earnings of public corporations are taxed twice. This so-called “double taxation” occurs because, in theory, corporate earnings are first subject to the corporate income tax, and these after-tax earnings are then taxed again at the individual level when the company’s shareholders receive a dividend payment or sell shares that have appreciated in value. Prior to the enactment of the dividend and capital gains rate cuts in 2003, the extent of this “double taxation” was greater for dividends than for long-term capital gains; dividends faced individual marginal rates of up to 38.6 percent, while capital gains faced a top rate of 20 percent.¹⁰ The 2003 tax cut lowered the top rate

¹⁰ Prior to the enactment of the 2003 tax-cut package, the top individual income tax rate was 38.6 percent, down from 39.6 percent. In that tax-cut package, however, the top rate was lowered to 35 percent. This rate will be in effect through 2010.

for both dividends and long-term capital gains to 15 percent, substantially reducing the tax on this type of income at the individual level.

Those who support these tax cuts maintain that “double taxation” results in higher tax rates for corporations and therefore may distort investment decisions in the economy. When promoting the President’s dividend tax cut proposal in 2003, the President’s Council of Economic Advisers maintained that double taxation of corporate income can affect economic decisions in ways that “may reduce corporate investment, encourage artificially high debt-to-equity ratios, discourage the payment of dividends, and favor noncorporate organizational forms.”¹¹

The CEA contends, for instance, that a high tax burden on dividends deters firms from paying dividends to shareholders and that this has the effect of favoring investments in those established businesses that generate a steady cash flow and are able to retain earnings to fund future investments. Distributing these earnings through dividend payments, in contrast, would create the opportunity for the funds to be invested in other firms that may have the potential to grow faster, which would be more beneficial for the general economy. The CEA also argued that the payment of dividends can improve corporate governance by offering investors clear signals about a company’s future financial health and by imposing discipline on corporate managers.

But other economists and analysts have responded that “double taxation” is not as severe a problem as it often is presented as being, because more than half of dividend payments do *not* face double taxation. These dividend payments are made to entities — such as pension funds, 401(k) plans, and non-profit institutions — that are not subject to income tax. Further, a significant portion of corporate earnings manage to escape taxation at the corporate level, as firms make use of available tax breaks and other tax-avoidance schemes to lower or eliminate their tax bills. Brookings Institution economist William Gale has found that “[a]bout one quarter of corporate income is taxed at the individual level, but not the corporate level; one quarter is taxed at the corporate level, but not the individual level; and one quarter appears never to be taxed. *While the emphasis and public discussion has been on the so-called double taxation of corporate income, the non-taxation of corporate income is probably even bigger* (emphasis added)”¹²

Not only is the extent of double taxation exaggerated, but it is inappropriately presented as a fairness issue, implying that dividends are being treated unfairly if they are taxed twice. But wages are also taxed twice, being subject to both income and payroll taxes. In general, the number of times income is taxed is not the relevant equity issue. Equity, in the context of taxes, is about how the burden of taxes is borne by different income groups and whether taxpayers in similar circumstance pay similar amounts of tax. The appropriate fairness issue, therefore, is whether the tax cut for dividend and capital gains income shifts the burden of raising revenue on to wages and away from income generated by stocks and whether it weakens the progressivity of the tax code by giving a substantial tax break to those high-income households that own the lion’s share of equities (see discussion of distribution issues starting on page 15).

¹¹ Council of Economic Advisers, *Economic Report of the President*, 2003.

¹² William Gale, “Tax Reform Options in the Real World,” forthcoming.

The Impact of Dividends and Share Prices on Shareholder Wealth

Profitable corporations can either retain their after-tax earnings to use for future investments, or they can pay out these earnings to shareholders. Payouts generally take two forms; corporations buy back shares from shareholders, or firms pay a dividend to shareholders. From the shareholder perspective, retained earnings and share repurchases push up the company's share prices. With a dividend, shareholders receive a cash payment, rather than a higher share price. Thus in all cases, the shareholder's wealth — as reflected by the combination of the share price and dividend payments — increases as the company becomes more profitable.

Some people mistakenly view dividend payments as if they were “bonus payments,” or funds received by shareholders above and beyond the value of the shares. From this perspective, dividends would be a bit like “manna from heaven.” But this is not the case. When earnings are used to pay out dividends, the funds cannot be used in other ways that increase shareholder wealth. As Microsoft explained to its shareholders before making its one-time \$3 per share special dividend payment: “Mathematically, after a company makes a large one-time distribution, the overall value of the company declines by the amount of the distribution, which in turn reduces the stock prices by a similar amount.”*

To elaborate, when a corporation has retained earnings, they are included in the assessment of the firm's net worth; these funds are essentially “money in the bank” that can be used by managers for future investments. By adding to the company's net worth, retained earnings push its share price higher than it would be if these funds were not held by the firm. So when a firm pays out these funds to shareholders, either through share repurchases or dividends, then the company's net worth falls — the money that was at the company's disposal has been transferred out of the company to the shareholders. A lower net worth results in a lower share price. With a dividend, the shareholder receives a cash payment, which compensates for the lower share price. With share repurchases, the company buys back shares, reducing the total number of shares outstanding; this has the effect of making the remaining outstanding shares more valuable, so their price rises.

Retained earnings, share repurchases, and dividends all have their advantages and disadvantages from the perspective of the firm's management and its shareholders. There is an extensive literature examining these preferences. From the tax perspective of the shareholder, rising share prices implies higher capital gains taxes, while dividend increases mean higher dividend taxes. Some shareholders prefer capital gains taxes, because they have to be paid only when the shares are sold. Because shareholders can control when they will sell shares, they can potentially defer capital gains taxes for many years. Some shareholders favor dividends, even though they lack the advantages associated with deferral, preferring the flexibility that comes with cash dividend payments. This liquidity allows investors to more easily manage their financial affairs, re-directing funds to new investments or to meet other needs. Further, some prefer dividends believing that they offer important means to judge the firm's financial health and future prospects.

*“Microsoft Outlines Quarterly Dividend, Four-Year Stock Buyback Plan, and Special Dividend to Shareholders,” Microsoft Press Release, July 20, 2004.

Long-Term Economic Impact of the Tax Cut

The most detailed study of the effect of reducing the impact of the so-called double taxation of corporate income was conducted by the Treasury Department in 1992.¹³ The analysis looked at a number of options, which involved more substantial tax reductions than those enacted in 2003, and concluded that all of the options would have a positive impact on the economy. It concluded such a tax change “will encourage capital to shift into the corporate sector” and “stimulate improvements in overall economic well-being.” Treasury reached these conclusions in large part because it assumed that the cost of the tax cuts would have *no* impact on the deficit. As explained in the box on the next page, to the extent that the cost of tax cuts increases the deficit, the tax cuts will reduce national saving and thereby lower investment and reduce long-term growth.

Impact of Lower National Saving on Long-Term Growth

National saving is a key determinate of long-term economic growth, because saving is needed to fund new investment without borrowing from abroad. Investment by businesses in factories and equipment ultimately leads to growth in the economy. Economic growth is desirable, as it generally raises the standard of living of Americans.

A fundamental issue with tax cuts is whether they have been “paid for.” When the revenue losses associated with tax cuts are not offset, the tax cuts increase the budget deficit. This has the effect of reducing national saving, which is the combination of saving by the private sector and the positive or negative saving (i.e., surplus or deficit) by government. As the government borrows to finance the deficit, it shrinks the pool of saving available for investment. Increases in the deficit and declines in national saving can reduce the future incomes of Americans in one of two ways:

- The decline in national saving can lead to a decline in domestic investment.* If this occurs, long-term economic growth will be reduced. Slower economic growth will result in a lower standard of living for Americans in the future.
- Alternatively, the effects of increased government borrowing on national saving can be offset by an inflow of foreign capital. In this case, investment does not decline and economic growth does not fall, but the extent to which Americans benefit from this growth in the economy is diminished. The reliance on foreign capital to fund investment means that the returns on these investments flow back to the foreign investors rather than to Americans.

Thus, tax cuts that increase the deficit and reduce national saving will lower the incomes of Americans in the future, regardless of whether the decline in national saving leads to lower investment, an inflow of foreign capital, or some combination of both.**

* Typically, this decline in domestic investment is facilitated by higher interest rates. Interest rates are, in essence, the “price” that businesses must pay to borrow funds for investment purposes. As saving declines and funds available for investment become scarcer, their price (in the form of interest rates) rises.

** For a detailed discussion of this topic, see William Gale and Peter Orszag, “Budget Deficits, National Savings, and Interest Rates,” Tax Policy Center, October 2004.

¹³ Treasury Department, “Integration of the Individual and Corporate Tax Systems.”

More recently, a study published in the *National Tax Journal* showed that the type of dividend tax cut enacted in 2003 would result in lower marginal effective tax rates on corporate investments, which could be expected to have some positive effect on the economy.¹⁴ But this study, as well, assumed that the cost of the tax cut would be fully offset. It noted that its “calculations overstate any implied benefits to the economy” from the tax cut if the lost revenues resulted in higher deficits.

It is therefore essential when examining the dividend and capital gains tax cuts to take into account its impact on the deficit. If extended past its 2008 expiration date and ultimately made permanent without offsets, the dividend and capital gains tax cuts will add \$405 billion to the debt by 2015, reflecting the \$148 billion cost of the enacted tax cuts before they are slated to expire at the end of 2008, another \$148 billion for the cost of extending the tax cuts, and \$110 billion in additional interest payments associated with the higher level of debt caused by the tax cuts. Analyses that take these deficit effects into account find that if the tax cut is made permanent, it is likely to have little if any positive impact on long-term growth.

- The Congressional Research Service examined a number of scenarios, using different assumptions about the response to the dividend and capital gains tax cuts, and found that under *all* of the cases, the effect of the tax cuts on private saving was not large enough to offset the negative effects caused by higher deficits. The study concluded that “the dividend relief proposal would harm long-term growth as long as it is based on deficit finance.”¹⁵
- Brookings Institution economists William Gale and Peter Orszag found that the dividend and capital gains tax cuts “could help to reduce biases in the allocation of capital by reducing the generally higher tax imposed on capital invested in the corporate sector.” Gale and Orszag concluded, however, that as long as the tax cuts continue to add to the deficit, “the net effects would be roughly a zero effect on long-term growth” under optimistic assumptions about the effects of the tax cuts on capital allocation.¹⁶ Under less optimistic assumptions, the effects on long-term growth could be negative.

Recent Evidence on the Dividend Tax Cut

Since the tax cuts were enacted, there has been a flurry of research investigating the impact of the tax cuts on corporate behavior, with emphasis on whether the tax cuts are encouraging companies to pay out dividends. So far, researchers have learned little from aggregate data on the level of dividends. Because there has not been a dramatic shift in the total amount of dividends being paid, these data have not provided sufficient information to determine the extent to which corporate dividend policies have changed as a result of the tax cuts.

The aggregate data on dividends are hard to interpret in large part because the level of dividends paid by corporations has, since the 1980s, been increasingly dominated by a relatively small number of large corporations.¹⁷ Although there is a general belief that dividends have declined precipitously

¹⁴ Robert Carroll, Kevin Hassett, and James Mackie, “The Effect of Dividend Tax Relief on Investment Incentives,” *National Tax Journal*, Vol LVI, No. 3, September 2003.

¹⁵ Gravelle, “Dividend Tax Relief.”

¹⁶ Gale and Orszag, “An Economic Assessment of Tax Policy in the Bush Administration, 2000-2004.”

¹⁷ Harry DeAngelo, Linda DeAngelo, and Douglas Skinner, “Are Dividends Disappearing? Dividend Concentration and the Consolidation of Earnings,” USC Finance and Business Economics Working Paper No. 02-9, July 2002.

over the past two decades, this has more to do with the number of firms paying dividends than the amounts being paid out. While the number of firms paying dividends has declined by 50 percent over the past two decades, the total amount of dividends paid grew slightly in real terms over this period. The result has been a concentration of dividends among the largest dividend payers. Small actions by these large companies can overwhelm actions by smaller companies. As a result, a decision by several smaller companies to increase dividends can be offset in the aggregate data by the decision of one large company to lower its dividend. Such concentration makes it difficult not only to detect shifts in dividend policies, but to explain with precision why these shifts are occurring.

Indeed, the Congressional Research Service could not detect any noticeable surge in the aggregate dividend data, released by the Bureau of Economic Affairs, for the period through the middle of 2004. (The BEA data show a big jump at the end of 2004, when Microsoft made a massive \$32 billion one-time payment.¹⁸) To overcome these problems, researchers have looked at subsets of firms to try to isolate the effects of the tax cut on dividend policy. Although the studies generally find that the tax cut has influenced corporate decisions to initiate or increase dividend payments, some evidence indicates that the dividends were not always well-suited to achieve desired improvements in corporate governance or economic efficiency, weakening their potential to yield long-term economic gains.

Executives with Large Stockholdings in Companies React to Tax Cut

Several studies have found that the most important factor influencing firms' decisions to start paying dividends or to increase existing dividends is the composition of the stock holdings of company executives. In companies where top executives hold company shares and thus would directly benefit from the dividend tax cut, there has been a much greater likelihood of the company initiating or increasing dividends in the aftermath of the 2003 tax cut. A study by NBER and Federal Reserve economists found that about half of the increase in the number of firms initiating or increasing dividend payments could be attributed to the influence of executive stock ownership.¹⁹

The dividend tax cut offered significant benefits to corporate executives that owned company shares. Assuming these executives are in the 35 percent bracket, the tax cut boosts the after-tax value of dividend payments by 31 percent, as \$100 of dividends is now worth \$85 after taxes rather than \$65. This is a larger increase than shareholders who are in lower tax brackets would receive, particularly those shareholders who receive no benefit from the tax cut because they hold their shares in nontaxable retirement accounts. Moreover, by increasing dividend payouts, executives are able to overcome constraints they typically face on their ability to sell shares in their company, either in terms of contractual restrictions or implicit restrictions imposed by the market which may view insider selling negatively. Receiving a payout in the form of a dividend gives executives with large holdings of company stock a way to diversify their portfolios.

Given the outsized benefits that executives with sizeable holdings of their companies' shares would receive from increased dividends, it is probably not surprising that they have reacted favorably to the tax cut.²⁰ While these actions come at a high price to the Treasury, it is unclear

¹⁸ Note that Microsoft, in addition to paying a \$32 billion special dividend in 2004, initiated regular dividends in 2003 and then increased these regular dividends in 2004.

¹⁹ Brown, Liang, and Weisbenner, "Executive Financial Incentives and Payout Policy."

²⁰ Chetty and Saez, "Dividend Taxes and Corporate Behavior," found that the likelihood of a company initiating or increasing dividends increased not only when executives had large shareholdings, but also when taxable institutional shareholders and independent directors held large numbers of shares. They concluded that "firms with neither executive

whether they are consistently in the best interest of the firms and the shareholders. Executive compensation packages should in theory be designed to align the executive's self-interest with the best interest of the firm and its shareholders, but this goal is not always achieved, as recent corporate scandals indicate.

Some Dividends Are One-Time, Or Substitutes for Share Repurchases

The studies to date indicate that the number of firms paying dividends has grown since the tax cut, although the total number of companies paying regular dividends is still below the levels seen in the 1980s and the 1990s. But not all of the dividends paid out in response to the tax cut have been regular dividends; some have come in the form of one-time, special dividends. Unlike a regular dividend, a special dividend indicates that a company has not committed itself to any future dividend payouts, mitigating some of the important effects that an ongoing, regular dividend payment can have, particularly in terms of corporate governance. To meet the demands of regular dividend payments, managers in theory become more accountable to shareholder interests.

Among the one-time payouts, Microsoft's \$32 billion special dividend has received the most attention, but special dividends are also being utilized by smaller, closely held companies.²¹ The Council of Economic Advisers writes that "nearly 150 firms started paying dividends after the tax cut, adding more than \$1.5 billion to total quarterly dividends," but about 40 percent of this dollar total represents one-time, special dividends.²² Only the regular dividends will continue to be paid out in the future; there are no guarantees that special dividend payments will be repeated.

The studies have also raised the issue about the extent to which firms that increased or initiated dividends used these dividend payments to replace share repurchases, which is the other approach that firms use to pay out their earnings to shareholders (see box on page 8). Failure to increase total payout undermines one of the stated goals of the dividend tax cut, which is to reduce the proportion of earnings that are retained by the corporations. These goals can be achieved only if total payout — repurchases and dividends combined — increases.

The study by NBER and Federal Reserve economists shows that firms that increased or initiated dividends did not increase their total payout about half the time.²³ The effect was particularly strong for companies that were paying dividends for the first time. The authors estimate that the observed reduction in repurchases offset nearly three-quarters of the newly paid dividends, significantly

incentives nor powerful principals [large-shareholding independent directors or taxable institutions] hardly responded to the tax change, while firms with one of the two elements are 6-10 times more likely to initiate dividends in response to the tax cut."

²¹ Blouin, Raedy, and Shackelford, "Did Dividends Increase Immediately After the 2003 Reduction in Tax Rates." The Council of Economic Advisers in its latest *Economic Report to the President* used the findings of this study when it noted that "corporate boards of directors increased dividends by 9 percent at their first opportunity following enactment." What CEA did not mention was that the study found that this entire increase could be accounted for by one-time, special dividends paid by 17 companies, even though those companies constituted only 1.4 percent of the sample of companies examined.

²² Council of Economic Advisors, *Economic Report of the President*, February 2005. CEA cites data from Chetty and Saez, "Dividend Taxes and Corporate Behavior." Chetty and Saez found that firms initiating or increasing dividends added on average about \$800 million per quarter to regular dividends in the 18 months after the President announced his dividend tax proposal.

²³ Brown, Liang, and Weisbenner, "Executive Financial Incentives and Payout Policy."

lowering the increase in total payout. Another NBER study by economists from the University of California, Berkeley, however, could not detect among firms initiating dividends a reduction in the level of repurchases relative to the period prior to the tax cut, and thus concluded that substitution of dividends for repurchases had not occurred.²⁴ But, given the limitations of the data, the study could not rule out the possibility that some substitution may have occurred.

Other Factors Affecting Dividend Payments

Studies have clearly found that the dividend tax cut prompted some firms to increase or initiate dividends, particularly those where the top executives had large amounts of company stock. Researchers have asked whether other factors may also have influenced these decisions and the size of the reaction to the tax cut. For instance, the NBER study by the economists from the University of California, Berkeley, found that the reaction to the 1986 tax reform, which also set the tax rates for dividend and capital gains income at the same level, was noticeably different. Firms responded to the 1986 reforms with one-time, special dividends to a much greater extent than has been the case after the 2003 tax cut. While the different responses may have had to do with the type of tax changes enacted in 1986, the study suggests that it may also have been due to the particular circumstances facing firms in 2003.

- For instance, firms may have increased regular (as opposed to one-time) dividends more after the 2003 tax cut because firms had unusually high levels of cash on hand prior to enactment of that tax cut, giving them the resources needed to begin paying out dividends. Indeed, BEA data reported by the Congressional Budget Office show that corporate retained earnings jumped significantly during 2003; as a share of the economy, they reached levels not seen since the 1960s.
- The study also notes that firms in 2003 may have been influenced by the well-publicized corporate scandals, which created an environment where corporations were feeling pressure to reassure shareholders. Companies may have turned to dividends as a way to send a positive signal to shareholders about the financial integrity of the companies following the tax cut.

Another study suggests that the increase in dividend payers may reflect the growing number of “mature” firms. Companies that first became public corporations in the 1980s and 1990s have matured and thus tend to have more stable cash flows and to be better positioned to pay dividends.²⁵ Microsoft, which reportedly was not influenced by the 2003 tax cut when making its decision to initiate regular dividends, is an example of such a firm. The authors of this study found that “some portion of the increase in dividend payouts by US firms is due to young firms maturing and moving into this new stage in their life.”

In summary, a range of factors likely helped create an environment conducive to increases in dividend payments following enactment of the tax cut, affecting the extent to which firms responded to the tax change. A key question is the extent to which these and other factors, rather than the tax cut, will influence corporate decisions on dividend payouts in the future.

²⁴ Chetty and Saez, “Dividend Taxes and Corporate Behavior.”

²⁵ Brandon Julio and David Ikenberry, “Reappearing Dividends,” Working Paper College of Business, University of Illinois, July 2004. This study also finds that, while the tax cut appears to have influenced corporate dividend policy, the trend of corporations initiating or increasing dividends began before the tax cut was enacted.

Distribution Effects of the Capital Gains and Dividend Tax Cuts

Supporters of the dividend and capital gains tax cuts often argue that the benefits associated with these tax cuts flow to large numbers of households.²⁶ They point out that about half of American households now own stock and that a majority of these stock holders have incomes below \$100,000. What this story leaves out is the fact that while large numbers of households own small amounts of stock, a relative small percentage of households own the bulk of equities.

- The Survey of Consumer Finance (SCF), conducted by the Federal Reserve, shows that in 2001 the top one percent of households owns about 23 percent of all stock, and the top 5 percent of households owns half. In contrast, the bottom 60 percent of households owns only 10 percent of all stock.
- Furthermore, high-income households are more likely to hold these shares in taxable accounts than middle-income families, who are more likely to save through retirement accounts that are not taxable (such as 401(k)s and Individual Retirement Accounts). Only securities held in taxable accounts benefit from the capital gains and dividend tax cuts. According to the SCF data, households in the top one percent of the income spectrum hold 79 percent of their stocks in taxable accounts, compared with about half of the stock that middle-income families own.

Given the distribution of stock ownership and the fact that those with the highest incomes received the largest dividend tax cut, with the tax rate they pay on dividend income reduced from 35 percent to 15 percent, it is not surprising that the Tax Policy Center found the following:

- More than half — 53 percent — of the benefits of the capital gains and dividend tax cuts in 2005 will flow to the top 0.2 percent of households, those with incomes over \$1 million. These households will receive an average tax cut from these provisions of \$37,962 in 2005.
- Households with income over \$200,000 will receive more than three-quarters of the tax-cut benefits. And those with incomes over \$100,000 will receive 90 percent of the benefits. Only 10 percent of the benefits of the dividend and capital gains tax cuts will flow to the 86 percent of households with incomes under \$100,000.
- While the dividend and capital gains tax cuts would boost the after-tax income of those with income over \$1 million by 1.9 percent in 2005, it would raise the after-tax income of households with incomes under \$75,000 by 0.1 percent or less.

Finally, it has been argued that anyone who owns shares in a company that either initiates a dividend or increases an existing dividend will benefit from this change, even if the shares are held in a non-taxable retirement account. The implication is that this new or higher dividend payment is a type of “bonus payment” that will benefit all shareholders, regardless of whether they receive a tax break (see box on page 8). But this logic misses a key point, which is that the price of a share of stock in a company that makes a dividend payment is lower than the share price would be if the earnings were retained, with the result that the overall value of owning the stock — which reflects the combination of the dividend payment and the share price— is essentially unchanged by the

²⁶ See, for example, Republican Policy Committee, “The Dividend Tax Cut: A Success Story With More Potential,” October 4, 2004.

dividend payment. Thus, only those shareholders who hold these shares in taxable accounts benefit from the tax cut.

Conclusion

The findings to date indicate that some companies have increased or started to pay dividends in response to the tax cut. Other factors (including high levels of cash on hand and post-Enron pressures to reassure stockholders) may also have influenced these corporate decisions and the magnitude of the reaction to the tax cut. Further, some companies have undertaken dividend policies — such as using one-time, special dividends, or substituting dividends for share buybacks — that may dilute the extent to which the policy change will lead to long-term benefits for the economy.

When it comes to the cost of these tax cuts and who benefits from them, the evidence is unequivocal. Official cost estimates indicate that if these tax cuts are extended and their costs are not offset, they will add \$405 billion to the debt from the time of their enactment to 2015. This high cost is crucial for understanding the full impact of the tax cuts on the economy. Higher debt reduces national savings, leading to lower national income in the future. When these negative effects are taken into account, the net economic impact of the tax cuts is near zero or negative.

Further, the flip side of the large revenue loss is the large tax-cut benefit that flows disproportionately to high-income households, who are the largest holders of stocks. The Tax Policy Center estimates that the 0.2 percent of households with incomes over \$1 million will receive nearly half of the benefits of these tax cuts in 2005, amounting to an average annual tax cut of \$35,500 for these households.