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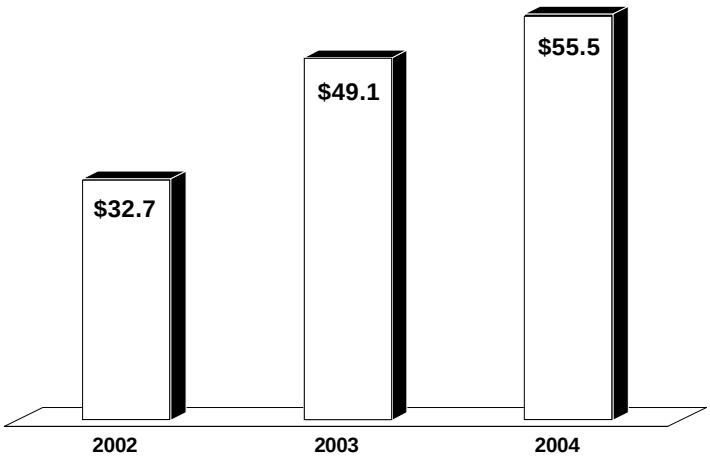
Benefits of the Bush Dividend Tax Cut

by Bruce Bartlett

One of America's largest publicly owned corporations recently announced the biggest stock dividend payment in history: some $37 billion. Tens of thousands of workers and retirees will benefit from Microsoft's decision to distribute some of its profits to shareholders, as well as millions of 401(k) participants whose mutual funds invest in high-tech stocks. In the past year, other companies have paid dividends for the first time, including Target, Bank of America and Proctor & Gamble. Previously, these companies reinvested profits themselves, and shareholders only realized a gain when they sold their stocks.

These announcements occurred because the Job Growth and Taxpayer Relief Reconciliation Act of 2003 cut the maximum individual income tax rate that stockholders pay on dividends to 15 percent. The new rates have made a difference since becoming law in May 2003. The tax cut not only reduced the burden on individuals, it also reduced the cost of capital to corporations. The economic benefits of the lower dividend tax rates will increase over time, and they will be even greater if Congress makes the rate cuts permanent — and greater still, if the taxation of dividends is completely eliminated.

High Taxes, Low Dividends. Prior to the Bush administration's tax cut, dividends were subject to a 35 percent corporate income tax and an individual income tax of up to 38.6 percent. Among developed countries, only Japan topped these acidic tax rates. As a result, most American corporations chose not to pay out dividends destined to be eaten away by taxes; rather, they invested annual profits in new and existing programs that increased the capitalized stock value and realized a higher rate of return. Since the late 1970s, the number of U.S. companies paying dividends to their shareholders has steadily declined. For example, the percentage of large companies paying dividends in a given year fell from 68.5 percent in 1978 to 21.3 percent in 1998.



* Dividend payments to individuals by corporations in Standard & Poor's 500 index of U.S. corporations. S&P projection for 2004.

Source: "Jobs and Growth Tax Relief Reconciliation Act, ASA Dividend Scorecard, June 4, 2004," American Shareholders Association.

High tax rates on dividends not only discouraged saving and investment, they encouraged corporations to assume more debt, since interest on debt is deductible from corporate income for tax purposes. Increasing levels of debt hurt corporations during economic downturns and sometimes caused them to go bankrupt. By contrast, the Bush administration's lower tax rates on dividends have encouraged companies to raise money by selling more shares rather than by borrowing. According to the American Shareholders Association, in the first 12 months of lower rates (May 2003 to May 2004):

- There were 298 announcements of initial or increased dividend payments by firms in Standard & Poor's index of 500 largest corporations, compared with just 192 in the preceding year.
- Net individual dividend income from Standard & Poor's 500 firms increased 50 percent in 2003, from $32.7 billion to $49.1 billion, and is projected to total $55.5 billion in 2004. [See the figure.]

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Though critics have complained that the dividend tax cut benefited the "rich," 46 percent of taxpayers who report dividend income earn less that $50,000 annually.

Reducing the Cost of Capital. Dividends represent part of a company's cost of capital. Lowering the tax on dividends made it easier for companies to return money to investors because it lowered the cost of doing business and undertaking new projects.

When the cost of capital falls, business managers tend to increase their firms' investment in equipment and buildings. These investments usually result in new job creation, and new jobs and new business investment mean higher incomes for employees. Over time, the effects of lowering the cost of capital will lead to higher economic growth.

Former Council of Economic Advisers Chairman Glenn Hubbard has been the driving force behind the idea of eliminating double taxation. His 2001 article in the *Journal of Public Economics* rebutted the commonly held view that high tax rates have no effect on share prices. Hubbard showed that taxes on dividends are in fact capitalized in stock prices. Thus, it was reasonable to assume that if dividend taxes are removed, stock prices will rise significantly and increase long-term economic growth. Over the long run, according to recent estimates from the National Bureau of Economic Research:

- The level of dividends paid out by corporations will rise 24 percent, amounting to an $86 billion increase from 2002 levels.
- The reduction of taxes on future dividends will increase the value of the stock market by $690 billion, a 6 percent increase over the market's value as of March 2003.

There are also long-term effects. The study calculates that it will take three years after the tax change for just one-fourth of the long-run effects on dividend payouts to occur. NBER researchers also suggest that cutting dividend taxes reduces the tax burden on investors who purchase new equity issues in expectation of future dividend payout.

Restoring Investor Trust. Dividend payments are the best assurance investors have that corporate profits are "real." The disappearance of dividends over the last 25 years eliminated an important element of investor control over management — it is much easier to manipulate earnings statements in order to boost the stock market value of shares than to come up with cash to pay dividends. Because Enron didn't pay any dividends, the company could easily hide its debt and report bogus profits.

New research by Thomson Financial has shown that there is an important link between dividends and insider trading: The dollar volume of stock sold by corporate management falls off the more a company pays in dividends.

- Insiders at Standard & Poor's 500 firms with a 4 percent annual dividend sold only $763,041 worth of stock on average each quarter during the past five years.
- By contrast, managers at corporations with no dividend cashed in $8.4 million, on the average.
- Additionally, the stocks of companies with heavy insider selling underperformed the New York Stock Exchange average by 11 percent in the six months after the sales.

The Thomson analysis showed there is no significant difference in insider trading based on the size of a company or its involvement in high technology. This models show insider selling is tied to dividend size, not stock movements.

Conclusion. Unless Congress acts, in 2009 the top tax rate on dividends will increase from 15 percent to 35 percent. Additionally, the tax on capital gains will climb from 15 percent to 20 percent. In 2011, the rate relief, new 10-percent tax bracket, death tax repeal, marriage penalty relief, and all the remaining tax reliefs enacted over the past three years will sunset, resulting in substantial tax increases for every American man or woman who pays income taxes.

Dividend tax relief was exactly what this country needed to pull itself out of the recession. The positive effects of the Bush tax cuts are just beginning to be seen. If made permanent, their positive benefits could be even more substantial than currently predicted.

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