

Show Me the Money!

Dividend Payouts after the Bush Tax Cut

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The centerpiece of President Bush's tax cut in 2003 was a sharp reduction in the individual dividend tax rate. The dividend tax cut was designed to spur investment and boost the stock market by increasing the after-tax return on corporate earnings, thus raising stock valuations. The tax cut also reduced the tax bias against dividends to spur larger payouts to shareholders. That reduces the amount of discretionary cash available to executives and will likely reduce the number of Enron-style corporate financial scandals.

This study examines the impact of the dividend tax cut after one year. We gathered data on dividend payouts before and after the 2003 tax cut for all Standard & Poor's 500 companies. We found a highly positive response to the tax cut:

- Annual dividends paid by S&P 500 compa-

nies rose from \$146 billion to \$172 billion, an increase of \$26 billion.

- In addition, special dividends of \$7 billion have been paid, raising the total first-year dividend increase to \$33 billion.
- Thus, dividends increased 18 percent without special dividends and 23 percent with special dividends.
- Twenty-two companies that did not previously pay dividends have initiated regular dividends.
- Equity values rose more than \$2 trillion after the tax cut.

The large and positive response to the dividend tax cut, which is scheduled to expire at the end of 2008, suggests that Congress should make it permanent.

The dividend and capital gains tax cuts in May 2003 rocketed the stock market back to life.

Introduction

In January 2003 President Bush introduced a tax cut plan to help spur capital investment and economic growth. The centerpiece of his plan was the elimination of the double taxation of dividends. Corporations pay a 35 percent federal tax on their earnings. Prior to the tax cut, if they distributed their earnings, shareholders paid income tax at rates up to 38.6 percent on dividends received. (Under the 2001 tax law, the top individual tax rate was slowly phased down from 39.6 percent to 35 percent.) Hence, under prior law the combined effective tax rate on dividends was as much as 60 percent.

President Bush was not able to fully eliminate the double tax on dividends, but the Jobs and Growth Tax Relief Reconciliation Act passed in May 2003 reduced the top capital gains and dividend tax rates to 15 percent (and 5 percent for lower-income families).

Proponents of the dividend tax cut argued that it would help the economy in a number of ways. First, it would boost the sagging stock market by raising the after-tax return on corporate earnings. That would increase investment and spur growth. Second, cutting the tax barrier to paying out dividends would spur firms to increase their payments to shareholders. In the wake of recent corporate scandals, with scores of firms falsifying their financial statements, this new incentive to pay out profits to shareholders would improve corporate governance by discouraging firms from cooking their books. Dividends force firms to show investors their profits in hard cash, not just on paper. Third, the dividend tax cut would help reduce the corporate financing bias in favor of debt. With the tax cut, corporations are expected to reduce excessive debt loads and increase equity financing over time.

Critics of the dividend tax cut argued that it would 1) have little impact on the stock market, 2) create few short- or long-term economic benefits, and 3) benefit only the rich.

In this study, we examine the impact of the dividend tax cut after one year. We assem-

bled dividend payout information for all S&P 500 companies to determine the effect of the tax cut on dividend payments. We also examined how the stock market responded to the tax cut and other economic effects. We find that the tax cut has had a powerfully beneficial effect, creating both short-term and long-term economic benefits.

Stock Market Impact of the Dividend Tax Cut

The dividend and capital gains tax cuts in May 2003 rocketed the stock market back to life. After years of stock market weakness following the collapse of the dot-com bubble, stocks are up more than 20 percent since the dividend and capital gains tax rate were cut. The S&P 500, which was hovering between 800 and 900 in early 2003, shot up to around 1100 by the end of 2003, and it remains there today. The tech-heavy NASDAQ is up by more than 25 percent since the tax cuts passed. Those large gains have held even after the correction of recent months. The result is an increase in investor wealth of more than \$2 trillion, which dwarfs the entire tax cut's 10-year \$350 billion revenue loss to the government.

Show Me the Money: Dividend Payouts after the Tax Cut

Prior to the 2003 tax cut, corporations had a strong disincentive to pay dividends because distributions faced a top individual tax rate of 39 percent. Rather than paying dividends, many firms retained earnings and allowed them to be capitalized into stock prices. Individuals were taxed at a lower 20 percent rate on realized gains when they sold their shares. For this reason, dividend payments fell out of favor in the 1980s and 1990s. Thomas Smith, president of Prescott Associates, a Connecticut investment firm, points out, "The tax code severely penalized a dividend payout, because the corporation pays a 35 per-

Table 1
S&P 500 Aggregate Dividend Changes, May 2003 to May 2004

| Dividend Payout Change | \$ Billions |
|------------------------|-------------|
| Increases | \$32.4 |
| Initiations | \$2.7 |
| Decreases | -\$1.7 |
| Total | \$33.4 |

Source: Authors' calculations based on data from Yahoo! Finance. Does not include Microsoft's recent announcement of a one-time special dividend of \$32 billion.

cent tax on the profits and then the shareholder pays an additional punitive 40 percent tax rate if the profits are passed through in dividends." Hence, paying a dividend under the old tax regime was not a "tax-rational option."¹

Cutting the dividend tax reduces the tax bias against dividends and should increase dividend payouts. That is precisely what happened after the 2003 tax cut. Our analysis found that S&P 500 companies have responded to the dividend tax cut as expected—by returning more cash to shareholders.

We examined dividend payouts for each of the S&P 500 companies in May 2003, before the tax cut was enacted, and in May 2004, a year after the tax cut was in place.² We multiplied each company's dividend payout rate by outstanding shares to calculate total annual payouts and found the following:

- Within a year of the tax cut, annual dividends paid by S&P 500 companies rose from \$146 billion to \$172 billion, an increase of \$26 billion.
- In addition, special dividends of \$7 billion have been paid, raising the total first-year dividend increase to \$33 billion, as summarized in Table 1.
- That amounts to a dividend increase of 18 percent without special dividends and 23 percent with special dividends.
- In the second year after the tax cut, the payout could be about \$60 billion higher, including Microsoft's special dividend of \$32 billion later this year.

Some prominent companies have made headlines in the past year with dividend payout announcements. Microsoft announced its first-ever dividend in early 2003. Then last September it announced that it would double its per share annual dividend. This summer Microsoft announced that it would distribute \$32 billion of its huge cash hoard later this year in a special dividend of \$3 per share. Thus, in just two years Microsoft has gone from paying no dividend at all to paying growing annual dividends and the largest one-time payout in history.

There is little doubt that the lower dividend tax is what triggered the Microsoft payouts. In fact, the timing of the special dividend and its massive size suggest that the company fears a change in tax law after the 2004 election. Robert Willens, a tax analyst with Lehman Brothers, explained that Microsoft's decision to pay a huge one-time dividend rather than just increase its regular quarterly dividend was a hedge against John Kerry winning the election and repealing the dividend tax cut: "Other factors undoubtedly contributed, but I'm 100 percent convinced that the lower rate was central to the decision for Microsoft to pay out this dividend now. I feel there was a hedging of their bets based on their timing."³

Microsoft was one of many firms that responded to the dividend tax cut. Our analysis found 22 S&P 500 companies that did not pay dividends before the tax cut but are now paying regular dividends, as shown in Table 2. Those companies include well-known names:

Microsoft announced that it would distribute \$32 billion of its huge cash hoard later this year in a special dividend of \$3 per share.

Table 2
S&P 500 Companies Initiating Dividends Since the 2003 Tax Cut

| Company | Annual Dividends per Share | | Shares Outstanding (millions) | Annual Payout (\$ millions) |
|-------------------------------|----------------------------|----------|-------------------------------|-----------------------------|
| | May 2003 | May 2004 | | |
| Viacom | 0 | 0.24 | 1,730 | \$415.2 |
| Cendant | 0 | 0.28 | 1,020 | \$285.6 |
| Edison International | 0 | 0.80 | 326 | \$260.6 |
| Clear Channel Communications | 0 | 0.40 | 614 | \$245.7 |
| Costco | 0 | 0.40 | 459 | \$183.6 |
| International Game Technology | 0 | 0.40 | 349 | \$139.6 |
| Harrah's Entertainment | 0 | 1.20 | 113 | \$135.4 |
| Best Buy | 0 | 0.40 | 325 | \$130.1 |
| Yum! Brands | 0 | 0.40 | 289 | \$115.8 |
| Staples | 0 | 0.20 | 497 | \$99.5 |
| Phelps Dodge | 0 | 1.00 | 94 | \$93.5 |
| Federated Dept. Stores | 0 | 0.50 | 181 | \$90.3 |
| Analog Devices | 0 | 0.24 | 376 | \$90.2 |
| Xilinx | 0 | 0.20 | 345 | \$69.0 |
| American Power Conversion | 0 | 0.32 | 200 | \$64.1 |
| Quest Diagnostics | 0 | 0.60 | 103 | \$62.1 |
| Manor Care | 0 | 0.56 | 89 | \$49.8 |
| Robert Half International | 0 | 0.24 | 172 | \$41.2 |
| Jones Apparel Group | 0 | 0.32 | 126 | \$40.4 |
| Louisiana Pacific | 0 | 0.30 | 109 | \$32.6 |
| Reebok International | 0 | 0.30 | 60 | \$18.0 |
| Tektronix | 0 | 0.16 | 85 | \$13.5 |
| Total initiations | | | | \$2,676.0 |

Source: Authors' calculations based on data from Yahoo! Finance. Does not include companies that initiated dividends after May 2004.

Table 3
Biggest Dividend Increases Since the Tax Cut

| Company | Annual Dividends per Share | | Aggregate Increase (\$ millions) |
|-------------------|----------------------------|----------|----------------------------------|
| | May 2003 | May 2004 | |
| Citigroup Inc. | 0.80 | 1.60 | \$4,136 |
| Bank of America | 2.56 | 3.20 | \$1,306 |
| Bank One | 0.84 | 1.79 | \$1,066 |
| Wells Fargo | 1.20 | 1.80 | \$1,014 |
| Microsoft | 0.08 | 0.16 | \$863 |
| Wachovia | 1.04 | 1.60 | \$734 |
| Wal-Mart | 0.36 | 0.52 | \$688 |
| Pfizer | 0.60 | 0.68 | \$610 |
| PepsiCo | 0.60 | 0.92 | \$547 |
| Johnson & Johnson | 0.96 | 1.14 | \$535 |

Source: Authors' calculations based on data from Yahoo! Finance. Table does not include companies that had large special dividends.

Viacom, Costco, Staples, and Reebok. Viacom has gone from a dividend of zero before the tax cut to an annual payout of \$415 million.

In addition to dividend initiations, many S&P 500 companies boosted existing dividends. Table 3 shows the largest increases after the tax cut. Citigroup doubled its total annual dividend payout from about \$4.1 billion to \$8.3 billion. Bank of America, Bank One, and Wells Fargo all had increases of more than \$1 billion. Also, Waste Management boosted its annual dividend from 1 cent to 75 cents per share, an increase of \$430 million, and Mattel boosted its dividend from 5 cents to 40 cents per share.

Many other big companies have boosted dividends since the tax cut was passed. Wal-Mart's payout is up 44 percent, Intel's is up 100 percent, Lockheed Martin's is up 100 percent, Home Depot's is up 42 percent, Kinder Morgan's is up 275 percent, Starwood Hotels' is up 320 percent, and Harley-Davidson's is up 185 percent. Northrop Grumman boosted

its dividend for the first time in 11 years.

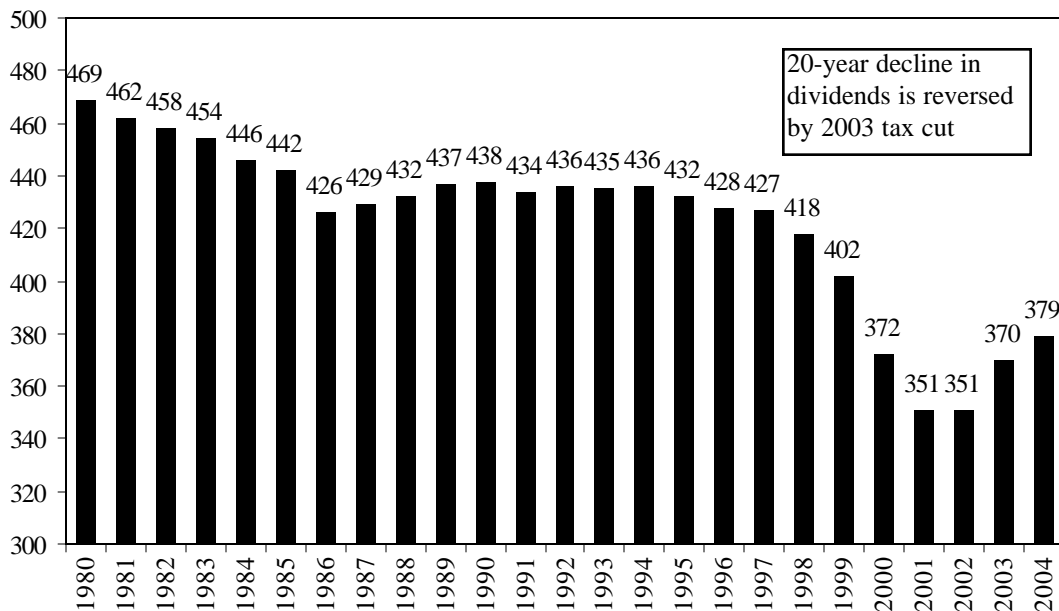
Several companies responded to the tax cut by paying out one-time special dividends. After Microsoft's upcoming \$32 billion payout, the biggest special dividend was by Merck, whose \$2.876 per share dividend was worth \$6.5 billion.

Other Data Support Finding of Higher Dividends

Other evidence shows the positive effects of the dividend tax cut. Figure 1 shows that the number of S&P 500 companies that pay regular dividends is rising, reversing a long-term downward trend.⁴ That dramatic turnaround is surely explained only by the new pro-dividend incentive of the 2003 tax cut. Months after the tax cut passed, Standard and Poor's researchers said, "We are seeing massive increases in the number of compa-

The number of S&P 500 companies that pay regular dividends is rising, reversing a long-term downward trend.

Figure 1
Number of S&P 500 Companies Paying a Dividend



Source: American Shareholders Association and Standard and Poor's. Data for 2004 are through July.

A June 2004 study by Raj Chetty and Emmanuel Saez found a sharp and widespread surge in dividend distributions following the tax cut.

nies increasing and using dividends,” which “reverses a 20-year decline.”⁵

A June 2004 study by Raj Chetty and Emmanuel Saez for the National Bureau of Economic Research looked at detailed dividend payment data from 1980 through the first quarter of 2004. The study found a strong response to the 2003 tax cut. The authors’ conclusions are worth quoting at length:

We find a sharp and widespread surge in dividend distributions following the tax cut, along several dimensions. First, the fraction of publicly traded firms paying dividends began to increase precisely in 2003 after having declined continuously for more than two decades. Nearly 150 firms initiated dividend payments after the tax cut, adding more than \$1.5 billion to aggregate quarterly dividends. Most of these firms initiated regular, recurrent payments rather than one-time special distributions. Second, many firms that were already paying dividends prior to reform raised regular dividend payments significantly after the tax cut. Third, special dividends also rose, but the magnitude of this effect is likely to be small relative to the increase in regular distributions in the long run. All three of these effects are significant among company sizes, and are robust to controls for profits and other firm characteristics. The surge in regular dividend payments after the 2003 reform is unprecedented in recent years.⁶

Similarly, a February 2004 NBER study by James Poterba found that the 2003 tax cut should increase dividend payouts substantially. His study looked at the historical relationship between dividend and capital gain tax rates and dividend payouts. He found that the 2003 tax cuts “could ultimately increase dividends by almost twenty percent.”⁷ In sum, a range of analyses supports our conclusion that the 2003 tax cut promoted higher dividend payments.

Tax Cut Changes Corporate Incentives

It appears that the 2003 tax cut reversed the previous corporate culture regarding dividend payments. In the go-go 1990s as stock values soared, paying dividends was interpreted as a sign of corporate weakness, especially in the technology sector. Paying a dividend was seen as a management concession that it had no better use for company profits. Until last year, Microsoft never paid a dividend, even though the firm was like a plump mother hen sitting atop some \$50 billion in cash reserves.

Some corporations that have increased their dividends have publicly attributed it to the dividend tax cut. Citigroup CEO Sandy Weill noted: “The recent change in the tax law levels the playing field between dividends and share repurchases as a means to return capital to shareholders. This substantial increase in our dividend will be part of our effort to reallocate capital to dividends and reduce share repurchases.”⁸ Home Depot CEO Bob Nardelli said, “Given the recent changes in the tax law, the increased dividend is an effective way for the company to return capital to shareholders.”⁹ Brad Anderson of Best Buy explained that “changes in the federal tax code have made dividend payments more attractive to our investors.”¹⁰

Some financial analysts have argued that the full impact of the dividend tax cut has yet to be realized. For example, Bob Grusky of Hope Capital Management maintains that because the management and boards of directors of many firms are paid substantially through stock options, those executives feel less incentive to pay dividends. Their compensation is not affected, at least not in the short term, by whether dividends are paid or not. If that is correct, then once current stock options are exercised (typically within three to five years) incentives will change and dividend payouts could rise.

Interestingly, Microsoft stopped granting employee stock options just weeks after the div-

idend tax cut passed.¹¹ At the time, Don Luskin correctly predicted, “Microsoft’s announcement after the close yesterday that it will discontinue granting employee stock options—and instead, grant restricted stock—may be preparatory to a major long-term shift toward less cash-retention and more dividends.”¹² Other companies are likely to shift toward dividends as stock options become less of a factor in corporate board incentives.

A Demand- and Supply-Side Tax Cut

Critics of the dividend cut argued that it was an inefficient economic stimulus because it would not increase demand for goods and services, which some observers believe is a driving force of the economy. With regard to long-term growth, this widely held superstition is wrong: growth is driven by entrepreneurship, investment, savings, work, and risk taking. Consumers cannot consume if producers do not produce. Consumer incomes cannot rise if businesses are not investing in new plant, equipment, and the technologies that create higher wages.

Nonetheless, in the very short term, consumption can help lift the economy. To the extent that that is true, the dividend tax delivered. Data from the American Shareholders Association show that individual dividend income increased from \$33 billion in 2002 to almost \$50 billion in 2003 and to an estimated \$55 billion in 2004.¹³ That increase in family incomes was bigger than the effect of some of the 2003 tax cuts. For example, the child credit tax cut provided just \$14 billion of tax relief in 2003, and the marriage penalty relief provided just \$5 billion.¹⁴

Recent increases in dividends have had an even more dramatic impact on family income because dividends themselves face lower taxation. The tax cut reduced the top dividend rate from 39 percent to 15 percent. For lower-income families, the dividend rate is now just 5 percent. The dividend tax cut saved families \$4 billion in 2003 and will save them \$18 bil-

lion in 2004 and rising amounts after that.¹⁵ Thus, the dividend tax cut has been both a short-term stimulus and a longer-term reform for the U.S. economy. It was both a demand-side and a supply-side stimulus.

The Benefits of Dividends

The 2003 tax cuts and the growth in dividends are great news for investors and the overall economy for three reasons. First, the dividend tax cut helped restore confidence in the stock market. This has been critical for ensuring that investors return to the markets in the wake of corporate accounting scandals and the dot-com and telecom busts. Dividends will bring new stability to the markets because they cannot be faked the way earnings reports can be. Investors do not have the same confidence in stock repurchases, the other mechanism for returning cash to stockholders, that they have in dividend payments. They trust checks for cold hard cash.

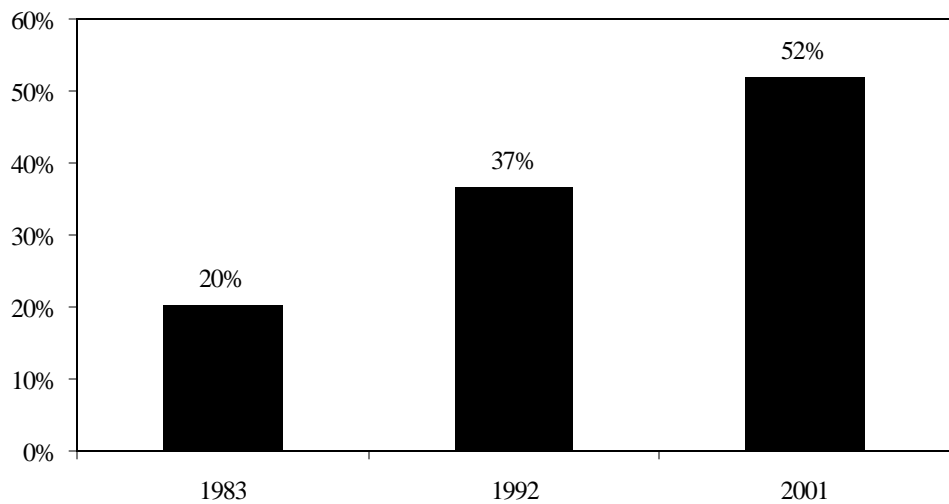
Second, dividends increase the efficiency of capital allocation in the economy. When corporate boards build stockpiles of cash that they cannot put to productive use, it creates a drag on productivity. Returning that money to investors in the form of dividends allows it to be redirected to more efficient uses, thus boosting the stock market and economic growth.

According to Luskin: “As companies become free to pay out money that had previously been held captive behind a tax barrier, economy-wide resource allocation is improved for the long term. By both making resource allocation more efficient, and by raising the after-tax expected returns to risky investing, the economy’s capital stock will begin to increase and improve.”¹⁶ The 2003 tax cut appears to have put America on a path toward greater economic efficiency in the corporate sector and therefore on a path to long-term sustainable growth.

Third, dividends reduce the volatility of the stock market and the potential for sharp drops in stock prices. Because dividend yields, the ratio of a stock’s price to its dividend,

Dividends will bring new stability to the markets because they increase the efficiency of capital allocation in the economy.

Figure 2
Share of American Households That Owns Stocks



Source: Federal Reserve Board, "Survey of Consumer Finances," www.federalreserve.gov/pubs/oss/oss2/2001/scf2001home.html.

Congress should make the dividend tax cut permanent so that Americans can continue to benefit from rising stock market values, more ethical and efficient corporate behavior, and greater investment and growth.

increase as the stock price declines, a dividend-paying stock has more value to attract new investors as its price declines.

Dividends Are Not Just for the Rich

Sen. John Kerry and other politicians are arguing for the elimination of the dividend tax cut because it supposedly benefits just wealthy Americans. The reality is that the benefits of the dividend tax cut are being widely disbursed to American households thanks to the broadening of stock and pension fund ownership in recent years.

Today, more than half of U.S. households own corporate equities, either directly or indirectly through mutual funds. This percentage is up from just 20 percent in the early 1980s, as shown in Figure 2. The burgeoning shareholder class in America has benefited in two ways from the dividend cut. First, dividend payments have increased. Second, the value of shares has risen in general, thus increasing the value of all family nest eggs. Even lower-income households that own

mutual funds or pensions, but pay little in income taxes, have benefited from the rising stock market. In addition, the dividend and capital gains tax cuts have reduced the cost of capital for businesses, thus generating greater capital investment. That will increase productivity and the wages of all workers. For all of those reasons, the dividend cut is very democratic in its effects; it is a fair tax cut for all Americans.

Conclusion

The 2003 dividend tax cut has accomplished its objectives. Many major companies have initiated dividends for the first time. Hundreds of others have increased their regular dividend payments. Tens of billions of dollars have been paid to investors, and a badly needed measure of confidence in the stock market has been restored. The result is a bull market that has generated two trillion dollars in wealth for the more than half of American households that own stock.

Unfortunately, the dividend tax cut is set to expire at the end of 2008, and that is already

reducing the benefits of the cut because companies may be tentative in reorienting themselves toward greater use of equity and increased dividend payments. Congress should make this successful change in tax policy permanent so that Americans can continue to benefit from rising stock market values, more ethical and efficient corporate behavior, and greater investment and growth.

Notes

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