

Dividend Tax Cuts

BY ANDREW FOERSTER

On May 28, 2003, President Bush signed the second major tax cut of his presidency, a \$350 billion plan that has a number of provisions:

- Increasing the child tax credit from \$600 to \$1000;
- Lowering marginal income tax rates;
- Eliminating the “marriage penalty”; and
- Lowering the capital gains and dividend tax rates.

The dividend tax cut lowers the rate to either 15 or 5 percent, depending on income, and is set to expire in 2008. It will have to be extended or made permanent to continue beyond that date. What will be the likely effects of the dividend tax cut?

Companies probably will start paying out more dividends. According to Austan Goolsbee, an economist at the University of Chicago, “numerous firms that were on the margin of retaining earnings for capital gains or paying them out as dividends are going to lean towards paying them out as dividends.” This change may increase the number of people looking to invest in those firms. “We’re going to see a smaller, but still somewhat noticeable, shift in the composition of portfolios towards dividend-paying stocks,” says Goolsbee.

Paying investors dividends may lead to more efficient capital markets, as investors move money between companies and put it to its most profitable use. “By encouraging more dividend payout ... dividend recipients can buy stock in other companies or buy bonds issued by other companies, and move that capital around,” says Martin Feldstein, president of the National Bureau of Economic Research and an economist at Harvard University.

The price of capital should also decrease. The bill “will lead to a reduction in the cost of capital for those corporations that are ... planning to pay dividends over the next few years, and that would increase investment somewhat,” says Joel Slemrod, an economist at the University of Michigan.

The new tax change also reduces the appeal of debt to equity. Firms can deduct their interest payments on debts, but the payout of dividends is taxed, making equity less appealing. The new law reduces that gap. “The law as it was before the change encouraged companies to have more debt and to take the extra risks that go with higher leverage,” says Feldstein. “And by reducing the burden on returns to equity the new tax law reduces the incentive to take that extra risk by using more debt.”

Indeed, a few large corporations announced changes in their dividend policy after the tax change. Citigroup Inc. announced a 75 percent increase in dividend payouts, from \$0.80 to \$1.40 per share. Citigroup Chairman and CEO Sanford Weill cited the tax law as a main reason for the change. “The recent change in the tax law levels the playing field between dividends and share repurchases as a means to return capital to shareholders,” he said. Numerous other firms, including Walgreen Co., Procter & Gamble Co., and The Goldman Sachs Group Inc., also have increased their dividend payout.

This bill should increase asset values, says Alan Auerbach, an economist at the University of California at Berkeley. Lower- and middle-income people may be helped indirectly by this, but “the [main] impact is really going to be at higher income levels where people are actually holding these assets directly in taxable accounts rather than tax-sheltered savings.”

Feldstein says that the lower rates may also encourage people to put additional money into investments. “To the extent that [lower- and middle-income households] have 401(k) or IRA income, it may actually encourage them to hold equities directly, rather than in the form of 401(k)s or IRAs,

because the tax burden has been reduced so much.”

The biggest argument against this latest round of tax cuts was that it would reduce government revenues. “Even if these tax cuts do make the economy stronger, I think it’s very unlikely that it will increase the tax base so much to offset these tax cuts,” Slemrod says. Feldstein agrees, but says the effects will not be “as large as the so-called ‘static analysis’ used by the government suggests.”

Advocates of limited government often view tax cuts as a useful way to restrain government spending, since they typically reduce revenue growth. Feldstein, for instance, notes that future governments may have to respond “by taking a harder look at some of the spending and tax subsidies that we have in the tax law today.” Auerbach agrees. But he is less sanguine about that possibility. “If you do assume [the tax cuts] are permanent, then there are pretty enormous costs in the decades to come, and we’re already in a situation where we don’t have enough money to pay for Social Security and Medicare.”

Unfortunately, economics does not provide any easy answers to this debate. It merely illuminates the multiple viewpoints people can take. **RF**

From Six Brackets to Two

Single Filers' Income	Joint Filers' Income	Old Dividend Rate* (%)	New Dividend Rate (%)
\$7,000	\$14,000	10.0	5.0
\$28,400	\$56,800	15.0	5.0
\$68,800	\$114,650	27.0	15.0
\$143,500	\$174,711	30.0	15.0
\$311,950	\$311,950	35.0	15.0
>\$311,950	>\$311,950	38.6	15.0

*Dividends were taxed at the same rate as income prior to the recent change.

SOURCE: Internal Revenue Service