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WHO BENEFITS FROM ENDING THE DOUBLE TAXATION OF DIVIDENDS?

EXECUTIVE SUMMARY

President Bush's proposal to end the double taxation of dividends has been criticized as a tax break for the rich because high income individuals receive the majority of taxable dividends. If dividend taxes were eliminated, these individuals would pay less in taxes; to many observers, this suggests that eliminating dividend taxes would benefit the wealthy and no one else.

Although this reasoning appears intuitive, it is fundamentally flawed. Decades of economic research have demonstrated that paying a tax is not the same as bearing the economic burden of a tax. Economists of all ideologies and political affiliations have long been careful to draw this distinction. Unfortunately, this insight is often forgotten in political debates over tax policy. This report 1) explains the distinction between paying a tax and bearing the burden of a tax, and 2) applies that insight to the current debate over dividend taxes. It finds:

- Paying a tax differs from bearing the burden of a tax because people change their behavior in response to taxes. This distinction can be demonstrated by two real world examples: 1) the tax exemption for municipal bond interest favors state and local governments much more than it favors the high income investors who appear to be receiving the exemption and 2) the 1990 luxury tax on yachts was ultimately borne by average workers rather than yacht purchasers.

- The distributional impacts of tax relief proposals are often judged by looking only at how tax payments are currently distributed across income levels. Such "static" analyses ignore the ways individuals and markets respond to taxes. "Dynamic" analyses account for these responses and, thereby, identify the true distributional burdens of existing taxes and the true benefits of tax relief.

- Capital markets are particularly sensitive to taxes. For that reason, policymakers should use dynamic analyses, not static analyses, when analyzing changes in the tax treatment of dividends or other forms of capital income.

- Dynamic analyses show that the economic burden of dividend taxes – and the economic benefit of eliminating them – is spread much more broadly through the economy than static tax payment analyses suggest. Lowering the tax burden on dividends will reduce the cost of capital for businesses, leading to higher stock prices, increased investment, and greater economic growth.

- Eliminating dividend taxes will increase stock prices significantly. This increase will benefit all stockholders, even those who hold stocks in tax-advantaged accounts (e.g., pensions, 401(k)s, and retirement accounts). Investors do not have to pay dividend taxes to benefit from their elimination.

- Eliminating dividend taxes will accelerate economic growth by increasing incentives to save and invest, strengthening our international competitiveness, and improving corporate governance. Increased investment and economic growth will boost wages and salaries for American workers, will lower prices for consumers, and will boost investment returns. Eliminating dividend taxes will therefore benefit all Americans.

WHO BENEFITS FROM ENDING THE DOUBLE TAXATION OF DIVIDENDS?

> *In my judgment, the elimination of the double taxation of dividends will be helpful to everybody. ... There is no question that this particular program will be, net, a benefit to virtually everyone in the economy over the long run, and that's one of the reasons I strongly support it.*
>
> Alan Greenspan[1]

Economists draw a distinction between who pays a tax and who actually bears the economic burden of that tax. Identifying who pays a tax is usually straightforward since that person is the one who writes a check to the government. Identifying who bears the burden of a tax is often much more complicated. Individuals and markets respond to taxes in ways that shift some or all the economic burden away from the individuals who pay the tax and onto other individuals. Distributional analyses that ignore these dynamic effects can be highly misleading.

This report explains the economic distinction between paying a tax and bearing the burden of a tax, illustrates this distinction with several real world examples, and applies this insight to current proposals to end the double taxation of dividends.[2] The key finding is that the benefits of ending the double taxation of dividends will be distributed much more broadly in the economy than critics have suggested.

PAYING A TAX ISN'T THE SAME AS BEARING THE TAX

To illustrate the difference between paying a tax and bearing the burden of a tax, it is useful to begin with a simple example. Suppose that flashlights currently sell at retail for $10 a piece. One day the federal government decides to collect a $2 tax from retailers for each flashlight they sell. Who bears the burden of this tax? The answer depends on how much retailers increase the price of flashlights and how much consumers reduce their purchases of flashlights.

Retailers May Increase Prices in Response to the Tax

Retailers bear the burden of the flashlight tax in a static accounting sense since they are responsible for writing the check to the government. This does not mean that they bear the economic burden of the tax. Retailers will likely increase the price of flashlights, shifting some of the tax burden to consumers. If retailers increase prices to $11 per flashlight, for example, they share the tax equally with consumers: retailers receive $1 less, after-tax, for each flashlight they sell, while consumers pay $1 more.

Another possibility is that retailers would shift the entire tax onto consumers by raising prices to $12 per flashlight. In this case, consumers bear 100 percent of the tax burden even though retailers are the ones writing checks to the government. At the other extreme, it is also possible

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[1] Testimony before the House Financial Services Committee, February 12, 2003.

[2] Under current tax law, the profits that businesses earn are taxed twice: first as corporate profits and a second time as dividends or capital gains received by investors. The tax on corporate profits is 35 percent and the personal income tax on dividends is as much as 38.6 percent, so the combined tax rate on dividends can be more than 60 percent. President Bush has proposed ending double taxation by exempting dividends from personal income taxes.

BOX 1: PAYING A TAX IS NOT THE SAME AS BEARING A TAX

Example: Flashlights originally retail for $10; government levies a $2 tax on retailers.

Possible Outcomes	Retailers Absorb the Tax	Retailers & Customers Share the Tax	Retailers Pass on the Tax Entirely
Retail Price	$10	$11	$12
Taxes Paid			
Retailers	$2	$2	$2
Consumers	$0	$0	$0
Taxes Borne			
Retailers	$2	$1	$0
Consumers	$0	$1	$2

Lesson: There is no necessary relationship between paying a tax and bearing the tax burden. Tax burdens are determined by market forces, not by who writes the check to the government.

that retailers would absorb the entire tax and keep prices at $10 per flashlight. In this case – and this case only – the burden of the tax falls entirely on the retailers who write checks to the government. These possibilities are summarized in Box 1.

In practice, the price change – and, therefore, the sharing of the tax burden – depends on a host of market-specific factors such as the availability of alternative products, consumer preferences, and the cost structure of the business. These factors can differ substantially from case to case. The economic burden of taxes thus has no necessary relationship to the act of actually paying the taxes.[3] Distributional analyses of tax policy should focus on true economic burdens, not on the mere accounting of tax payments.

Consumers May Buy Fewer Flashlights Because of the Tax

The analysis of price changes tells us how retailers and consumers share the economic burden of paying taxes to the government. Taxes also create a second burden: reductions in output. To illustrate, suppose that the $2 tax raises the retail price of a flashlight by $1. Consumers will respond to this price increase by decreasing the number of flashlights that they purchase. Businesses, in turn, will produce fewer flashlights. This output reduction means that both consumers and retailers are worse off: consumers purchase fewer flashlights than they otherwise would want, and retailers have lower profits. The rest of the flashlight supply chain – manufacturers, distributors, and their employees – also bear some economic loss because of the output reduction.

[3] Such statements can be found in any reputable textbook on public finance. For example: "Because prices may change in response to the tax, knowledge of statutory incidence tells us essentially nothing about who is really paying the tax" (Rosen 1992, p. 275).

Because of output losses, the economic burden of taxes exceeds, sometimes substantially, the tax revenue collected by the government. This "excess burden" is the fundamental economic cost of taxation. The sharing of this burden depends on the same market-specific factors – the availability of alternative products, consumer preferences, costs, etc. – that determine the sharing of price changes.

TWO PRACTICAL EXAMPLES

The flashlight example illustrates the key issue in tax distribution: writing a check to the government may have nothing to do with bearing the burden of a tax. Price changes can shift the burden away from the taxpayer (e.g., when retailers pass taxes on to their customers), while quantity reductions due to taxes represent a significant economic burden that results in no tax revenue whatsoever.

Economists have applied this theory – and confirmed its relevance – for myriads of different markets and different taxes. Two of the clearest examples, with particular relevance to the current dividend tax debate, are the luxury tax on yachts and the tax exemption of interest on municipal bonds.

The Luxury Tax on Yachts

In 1990, Congress introduced a new federal sales tax on private boats costing more than $100,000 and various other products deemed to be luxuries. The government's intent was to raise additional revenue by levying a tax on the rich; after all, who else would purchase a private boat costing more than $100,000? Unfortunately, demand for such boats turned out to be very responsive to price changes – many potential boat buyers were unwilling to accept substantial price increases. At the same time, boat manufacturers were unable to absorb much of the tax. When they tried to raise prices, boat purchases declined, and manufacturers were forced to lay off a significant number of their workers.[4]

Because yacht sales fell, the tax on the rich became a tax on the average worker. When the broad economic impacts of the tax became apparent, Congress reversed course and eliminated the luxury tax on yachts and several other products.

The Tax Exemption for Municipal Bonds

The luxury tax illustrates how a tax aimed at the rich may ultimately be borne by average Americans. The tax exemption for municipal bonds illustrates the same idea, but in reverse: the tax exemption appears to be a tax break for high income, high tax bracket individuals but turns out to benefit state and local governments and, thereby, average Americans.

Under current tax law, interest payments from most municipal bonds are exempt from federal taxes. This exemption is most valuable for individuals in the highest tax brackets, so most of these bonds are held by high income, high tax bracket investors. Indeed, ownership of tax-

[4] See Joint Economic Committee (1992, p. 159 ff) for further details on the luxury tax.

exempt municipal bonds may be even more skewed toward high income earners than is ownership of dividend paying stocks.[5]

A static analysis – one that focuses solely on who pays taxes to the government – would suggest that the tax exemption is a major boon for rich investors. After all, those investors get to earn tax-free interest on the bonds. The flaw in this reasoning is the fact that the interest rate that investors receive on tax-exempt debt is much lower than they could receive on comparable investments. Investors compete among themselves to get the best after-tax returns on their investments. This competition passes much of the benefit of tax exemption back to state and local governments in the form of lower interest rates, making it cheaper and easier to finance schools, roads, and other local projects.

Demonstrating this dynamic requires little effort beyond surfing to a financial web site and doing some simple arithmetic. At this writing, a leading web site reports that the average two-year municipal bond of highest quality yields 1.13 percent (i.e., an investor purchasing $10,000 of two-year municipal bonds would receive interest payments of $113 per year). At the same time, the average two-year Treasury yields 1.59 percent.

U.S. Treasuries are widely considered to be the safest investments in the world, yet they pay substantially more interest than do municipal bonds. Why? Because interest on municipal bonds is exempt from federal taxes.

At these interest rates, more than 80 percent of the benefit of the tax exemption goes to the municipalities that issue tax-exempt bonds; less than 20 percent goes to investors. To see this, consider what would happen if municipal bonds did not receive a tax exemption. In that case, their debt would have to pay at least as much interest as is currently paid on comparable Treasuries. To make things simple (if somewhat unrealistic, given the higher risk of municipal bonds) suppose that absent the tax exemption, municipal bonds would also pay 1.59 percent in annual interest.

Suppose further that the average investor in municipal bonds invests $10,000 and that he faces a marginal tax rate of 35 percent, the highest rate under the President's economic proposal. At a 1.59 percent interest rate, the investor would receive $159 in interest per year from either a two-year Treasury or a taxable two-year municipal bond. With a tax rate of 35 percent, the investor would pay taxes of $56 and receive an after-tax return of $103 (see Box 2).

Now consider what happens if, as in reality, the municipal bond is tax-exempt. The federal government receives no tax revenue from the bond interest, so it loses $56 in revenue each year. The municipality sees its borrowing cost fall from 1.59 percent to 1.13 percent, so it realizes a benefit of $46 (= $159 - $113) on each $10,000 in debt. The investor sees his after-tax return increase from $103, the amount he could earn on taxable bonds, to $113, and so he realizes a benefit of $10 per year.

[5] Feenberg and Poterba (1991).

BOX 2: THE DISTRIBUTIONAL IMPACTS OF EXEMPTING INTEREST FROM FEDERAL TAXES

Example: Suppose an investor purchases $10,000 of bonds; the investor is in the 35% tax bracket.

	Taxable	Tax-Exempt
The Perspective of the Local Government		
Bonds Sold	$10,000	$10,000
Interest Rate	x 1.59%	x 1.13%
Annual Interest Payments	$159	$113

The tax exemption benefits the local government: interest costs are lower by $46 (= $159 - $113).

The Perspective of the Federal Government		
Interest Payments	$159	$113
Tax Rate on Interest	x 35%	x 0%
Federal Tax Revenue	$56	$0

The tax exemption costs the federal government: tax receipts are lower by $56.

The Perspective of the Investor		
Interest Received	$159	$113
Taxes Paid	- $56	- $0
After-Tax Return	$103	$113

The tax exemption benefits the investor: after-tax returns are higher by $10 (= $113 - $103).

Lesson: Tax breaks on interest primarily benefit local governments who need financing, not the investors who provide that capital.

The tax exemption primarily benefits municipalities: 82 percent (= 46/56) of the tax savings accrue to state and local governments, while only 18 percent (= 10/56) of the benefits accrue to investors.[6] Benefits to state and local governments are passed on to their citizens through a combination of lower taxes and increased government services.

This analysis is "dynamic" because it considers how taxes influence the interest rates paid by municipal bonds. Just as flashlight retailers could pass on a significant portion of that tax to consumers, investors pass on to local governments the benefit of their tax exemption.[7]

To illustrate the importance of such dynamic analysis, it is useful to compare these results to the calculations that would comprise a "static" analysis that ignores capital market responses.

[6] This particular result reflects market conditions on a particular day for a particular group of bonds. Impacts vary over time and across bonds depending on a host of factors, not least of which is ongoing debate about tax policy. Nevertheless, several decades of academic research have confirmed this general pattern: municipal tax exemption primarily benefits municipalities who issue debt; benefits to investors are much smaller. Fortune (1992), for example, finds that municipalities received at least three-quarters of the benefit of the tax exemption in 1990.

[7] This analysis is partially dynamic because it considers the dynamics of price changes (the change in interest rates) but not the dynamics of quantity changes. Measuring the distributional impacts of quantity changes would require information about the types of projects that municipalities are able to finance with tax-exempt debt, but wouldn't finance otherwise, and the beneficiaries of those projects. It would also require additional information about how such projects influence federal revenues.

BOX 3: WHY STATIC ANALYSES ARE FLAWED

This box repeats parts of the previous analysis, but makes the static (and faulty) assumption that interest rates are unaffected by taxes. Changes from the dynamic analysis are *italicized*.

	Taxable	Tax-Exempt
The Perspective of the Investor		
Bonds Purchased	$10,000	$10,000
Interest Rate	x *1.13%*	x 1.13%
Interest Received	*$113*	$113
Tax Rate on Interest	x 35%	x 0%
Taxes Paid	*$40*	$0
After-Tax Return	*$73* (= *$113* - *$40*)	$113 (= $113 - $0)

The static analysis makes it appear that investors receive a $40 benefit (= $113 - $73) from the tax exemption; in reality, the benefit is about $10, as shown in the dynamic analysis.

The Perspective of the Local Government		
Bonds Sold	$10,000	$10,000
Interest Rate	x *1.13%*	x 1.13%
Annual Interest Payments	*$113*	$113

The static analysis makes it appear that local governments receive no benefit from the tax exemption; in reality, they receive a benefit of about $46, as shown in the dynamic analysis.

Lesson: The static analysis ignores how interest rates respond to taxes. As a result, it misses a key dynamic: competition in capital markets forces investors to pass much of the benefit of the tax exemption on to local governments as lower interest rates. Static analyses thus provide a completely misleading assessment of the impacts of exempting interest from federal taxes.

In a static framework (see Box 3), the analysis would begin by assuming that investors in municipal bonds earn $113 in interest for each $10,000 of bonds that they own, regardless of whether that interest is taxed or not. If this interest were taxable, the investor would pay $40 in taxes (= $113 x 35%). The static analysis thus concludes that the tax exemption provides a $40 benefit to the investor and no benefit to local governments (since there is no change in interest payments).

These calculations illustrate how far static analyses can deviate from economic reality. Under the obviously flawed (and often concealed) assumption that individuals and markets do not respond to taxes, the static analysis finds that the tax exemption provides significant benefits to high income investors and identifies no benefits for state and local governments. The dynamic analysis, in contrast, identifies the fundamental economics associated with the tax exemption: high income investors do receive some benefit, but the vast majority of the benefit flows to those who need financing – the state and local governments – not those who provide the capital.

THE BENEFITS OF ELIMINATING DIVIDEND TAXES

The municipal bond example illustrates a fundamental truth about taxes on capital: capital markets distribute the burden of taxes (and the benefit of tax breaks) depending on market conditions, not on the accounting issue of who writes checks to the government. Because of competition among different types of investment, the vast majority of the tax benefits go to governments who need financing, not the investors who provide that capital. In other words, the tax exemption makes it cheaper and easier to finance roads, schools, and other local projects; it is not a give-away to the rich.

The same dynamic forces will be unleashed by ending the double taxation of dividends. Lowering the tax burden on investing will reduce the cost of capital for businesses, thereby boosting stock prices and increasing investment. Benefits will flow not only to investors who currently receive taxable dividends, but to all stockholders and to the businesses that need to raise capital. Those businesses will then pass on the benefits to their employees, customers, and investors.

Eliminating Dividend Taxes Will Lower the Cost of Capital

Many businesses raise capital by selling stock. To get investors to purchase their stock, businesses must offer them a sufficiently high rate of return on their investment. This required rate of return is the cost of capital for the business.

The cost of capital depends on a host of factors, including the other investment options that investors have, the risk of investing in the business, and the taxes investors have to pay on their investment returns. If taxes on capital income decline, the cost of capital goes down, and businesses find it cheaper and easier to raise capital.

To illustrate, suppose that investors in a particular business demand an after-tax return of 6.5 percent per year; for simplicity, assume that this return will be achieved entirely through dividends. If dividends were tax-exempt, the cost of capital for the business would be 6.5 percent. In other words, for every $100 of capital that the business raises, it would have to provide investors with dividends of $6.50 per year.

If, as in reality, dividends are taxed, the cost of capital is substantially higher. In order to provide an after-tax return of 6.5 percent, the business must provide a dividend yield of 10 percent. In other words, for every $100 of capital that the business raises, it would have to provide investors with dividends of $10 per year. At a 35 percent tax rate, $3.50 of those

BOX 4: TAXES INCREASE THE COST OF CAPITAL

Suppose that investors demand a 6.5% after-tax return and all returns are paid as dividends:

If Dividends are Tax-Exempt	
Investors' Required After-Tax Return	6.5%
Additional Return to Cover Taxes	+0.0%
Cost of Capital for the Business	6.5%
If Dividends are Taxed at 35%	
Investors' Required After-Tax Return	6.5%
Additional Return to Cover Taxes	+3.5%
Cost of Capital for the Business	10.0%

Lesson: Taxes increase the cost of capital.

dividends would go to the government, leaving $6.50 for the investor. The after-tax return would thus meet the 6.5 percent requirement. These calculations are summarized in Box 4.

Taxes thus raise the cost of capital. Eliminating dividend taxes would lower the cost of capital for businesses in the same manner that the tax exemption for municipal bonds lowers the cost of capital (i.e., interest rates) for state and local governments.[8]

Eliminating Dividend Taxes Will Increase Stock Prices

By lowering the cost of capital, eliminating dividend taxes will provide an immediate boost to stock prices. Taxable investors will find stocks – both those that currently pay dividends and those that may pay dividends in the future – to be more attractive, so they will shift resources into stocks and bid up their prices.

To illustrate, suppose that the company in the example pays $10 per share in dividends every year and that investors demand an after-tax return of 6.5 percent. As demonstrated in Box 4, under current tax law the company has to provide a 10 percent pre-tax return in order to provide investors with a 6.5 percent return after-tax. As illustrated in Box 5, the stock will provide a 10 percent return if the stock price is $100 per share. At that price, the dividend yield is 10 percent (= $10 / $100), and the after-tax rate of return is 6.5 percent (= $6.50 / $100).

If dividend taxes were eliminated, the stock's value would increase to as much as $154 per share – a gain of more than 50 percent. At this stock price, the $10 dividend (tax-free) would provide investor's with an after-tax rate of return of 6.5 percent (6.5% = 10 / 154).

BOX 5: A LOWER COST OF CAPITAL BOOSTS STOCK PRICES

If Dividends are Taxed at 35%	
Annual Dividend	$10
Cost of Capital	÷10.0%
Implied Stock Price	$100
If Dividends are Tax-Exempt	
Annual Dividend	$10
Cost of Capital	÷ 6.5%
Implied Stock Price	$154

Lesson: If the cost of capital declines, stock prices increase.

In the real world, the increase in stock prices will not be quite so dramatic. Stock price gains will be mitigated because many companies reinvest their earnings rather than paying them out as dividends and because many stocks are held in tax-exempt accounts – pensions, 401(k)s, endowments, etc. These factors weaken the link between dividend taxes and stock prices, but do not eliminate it. A substantial body of economic research has documented that dividend taxes do raise the cost of capital and, thereby, lower stock prices.[9]

[8] The numerical example is extreme in several ways: it assumes that all returns come in the form of dividends and it assumes that the relevant investors are all in the 35 percent tax bracket. In reality, some returns will likely come in the form of capital gains and some of the relevant investors will be in lower tax brackets. The quantitative impact of eliminating dividend taxes will thus be smaller than the 35 percent in this example. The qualitative story remains the same, however. Dividend taxes are built into investors' required rate of return. If dividend taxes are eliminated, the cost of capital will decline significantly.

[9] Gentry, Kemsley, and Mayer (2003) survey this literature and provide new evidence that dividend taxes lower stock prices. Harris, Hubbard, and Kemsley (1999) demonstrate that this effect occurs stock markets around the world.

Financial economists have estimated that eliminating dividend taxes would increase stock prices substantially; recent estimates range from six to thirteen percent.[10] The increase would be most pronounced for stocks that already have high dividend payouts, but would also occur for stocks that are likely to introduce dividends in the future. Financial markets are well aware of the dividend tax debate, so some of this gain has already been built in to stock prices. Stock prices will rise further if Congress agrees to eliminate dividend taxes and, conversely, will fall if Congress leaves dividend taxes untouched.

The key distributional issue here is that rising stock prices benefit all stock investors, not just those who receive taxable dividends. Investors in 401(k)s, IRAs, and pension plans benefit in exactly the same way as investors who own taxable stocks and mutual funds. Recent surveys demonstrate how widely this benefit will be distributed. According to the Investment Company Institute and the Securities Industry Association, about half of U.S. households owned stock in 2002; these 53 million households comprise more than 84 million individual investors.[11] All of these investors will benefit from the elimination of dividend taxes.

Eliminating Dividend Taxes Will Increase Investment

As noted earlier, the economic analysis of taxes distinguishes between price and quantity responses. The price effect of eliminating dividend taxes is to lower the cost of capital. As demonstrated, the lower cost of capital immediately translates into higher stock prices.

The quantity effect of eliminating dividend taxes is that a lower cost of capital encourages greater investment. Some projects and companies that would not be profitable investments under existing dividend taxes would become profitable with the lower cost of capital.

To illustrate, suppose that the investor in our example has the opportunity to invest in a new company (see Box 6). For every $100 that the investor puts in, the company will pay back $8 in dividends each year. Under the current tax system, this investment would not be acceptable to the investor: the $8 dividend would be accompanied by a $2.80 tax liability. The net

BOX 6: A LOWER COST OF CAPITAL BOOSTS INVESTMENT

An investor can invest $100 in a new company that will provide an 8% return paid as dividends. The investor requires an after-tax return of 6.5%.

If Dividends are Taxed at 35%

Annual Dividend	$8.00
Taxes at 35 percent rate	- $2.80
After-Tax Return	$5.20
After-Tax Rate of Return	5.2%

The investor will not fund this company; the after-tax return is less than his 6.5% requirement.

If Dividends are Tax-Exempt

Annual Dividend	$8.00
Taxes	- $0.00
After-Tax Return	$8.00
After-Tax Rate of Return	8.0%

The investor will fund this company; the after-tax return exceeds his 6.5% requirement.

Lesson: A lower cost of capital boosts investment.

[10] See, for example, "Can a Dividend Tax Cut Juice Growth", *BusinessWeek*, Jan. 3, 2003; "Whole-Enchilada Tax Plan a Winner for All", *Detroit Free Press*, Jan. 8, 2003; "Dividend Tax Cut Could Shift the Investing Landscape", *MSN Moneycentral*, Dec. 13, 2002.

[11] Investment Company Institute and Securities Industry Association (2002).

return to the investor is thus $5.20, so the after-tax return is only 5.2 percent, well below the investor's required rate of return of 6.5 percent. Under current tax law, the investor would not be willing to invest in this new company.

If dividend taxes were eliminated, however, the investor would be willing to back this new venture. The dividend would then be worth a full $8 after-tax, and the investor would realize a rate of return of 8 percent – $8 for every $100 invested – well above his required rate of return.

Of course, the new company might be able to drive a better bargain and get a better price for its stock (i.e., the stock price would rise). In the end, however, the company and the investor would be able to agree on a price that allows the venture to go forward. By lowering the cost of capital, eliminating dividend taxes makes it easier to finance new investment.

ELIMINATING DIVIDEND TAXES WILL ACCELERATE ECONOMIC GROWTH

Eliminating dividend taxes thus has three direct effects: it lowers the cost of capital for businesses, boosts stocks prices, and encourages new investment. In the short-run, higher stock prices will help to support consumer spending and the lower cost of capital will encourage business investment. Eliminating dividend taxes will thus provide a boost to the economic recovery and benefit Americans of all incomes.

In the longer run, eliminating dividend taxes would promote economic growth in several ways:

- First, as noted, it would encourage greater investment. Investment expands the capital stock so workers will have more factories and equipment with which to produce goods and services. The expanding capital stock creates greater productivity and faster long-run growth. As productivity rises, employers are willing to pay more to attract needed workers. Eliminating dividend taxes will thus boost wages and job prospects throughout the economy.

- Second, eliminating the double taxation of dividends would improve corporate performance. The current tax system encourages businesses to rely excessively on debt, leading to unnecessary bankruptcy risk when economic conditions change. The current tax system also penalizes the payment of dividends and, thereby, limits the degree to which shareholders can use dividends to monitor corporate performance. As we have learned, relying on accounting statements of earnings – which may be unrelated to the cash generating ability of a company – can lead to investment mistakes.

- Finally, eliminating personal taxes on dividends would improve the international competitiveness of the U.S. economy. Almost all other developed countries have reduced or eliminated the double taxation of dividends. In fact, the United States has the second highest combined tax rate on dividends – corporate plus personal – among the 30 members of the OECD.[12] Eliminating dividend taxes in the United States would make America a more desirable location for international investment.

[12] Edwards (2003).

By boosting economic growth in these ways, eliminating dividend taxes will naturally result in higher incomes, new jobs, and lower prices, providing important benefits to all Americans.

Recent studies of the dividend tax proposal suggest that these dynamic benefits are significant. A study prepared for the Business Roundtable (2003), for example, finds that the dividend tax cut would add a trillion dollars to cumulative GDP over the next decade and that employment would be higher by an average of 600,000 jobs each year over that period. Analyzing a slightly different dividend tax proposal, the Heritage Foundation finds that employment would be higher by an average of 300,000 jobs each year over the next decade, and that economic output, personal incomes, and overall investment would all expand significantly.[13]

Dividend tax relief thus provides significant economic benefits throughout the economy.

CONCLUSION

Static analyses of eliminating the double taxation of dividends emphasize that most taxable dividends currently go to individuals with high incomes.[14] Many observers conclude from these analyses that the benefits of dividend tax relief will disproportionately favor the rich. Although this reasoning appears to be intuitive, it is fundamentally flawed. As documented in this report, eliminating the double taxation of dividends will benefit essentially all Americans, in their roles as stockholders, workers, and consumers.

The fundamental flaw in static analyses is the assumption that tax changes can be analyzed without considering how people and markets will respond.[15] Static analyses may be useful when analyzing taxes that induce small responses, but they can be wildly inaccurate when market responses are significant. Capital markets are particularly sensitive to tax changes; as a result, policymakers should be particularly skeptical of static analyses of changes in the tax treatment of dividends or other forms of capital income.

Eliminating dividend taxes is likely to generate much broader benefits than static analyses would suggest. Increases in stock prices, for example, will benefit all stockholders, not just those who receive taxable dividends. Increased investment and faster economic growth will provide workers with more employment opportunities and higher wages, while consumers will enjoy lower prices. Recipients of taxable dividends will receive significant benefits from eliminating dividend taxes, but so will all participants in the U.S. economy.

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[13] Michel et al. (2003).

[14] See, for example, Urban-Brookings Tax Policy Center (2003).

[15] Another flaw in static analyses, beyond the scope of the current report, is their focus on tax payments in a single year. This "snapshot" approach conceals the important role that income mobility plays in distributing income tax burdens across individuals across time. The most recent *Economic Report of the President* (2003, pp. 196 ff.) discusses how tax fairness should be analyzed in terms of lifetime income.

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