# JOINT ECONOMIC COMMITTEE

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ECONOMIC POLICY RESEARCH

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# Dividend Tax Relief and Capped Exclusions

Several forms of tax relief for dividend income have been proposed in recent months. A full dividend exclusion, such as that proposed by the president, would end the double taxation of corporate earnings paid as dividends.[1] Under the president's plan, earnings could be taxed when earned by a company or when paid to shareholders as dividends – but not on both occasions.

One variation on the president's proposal would exempt some fixed fraction of an individual's dividend income from personal income taxation instead of excluding the full amount. For example, a 50 percent exclusion would exempt from individual income taxation half of any person's otherwise taxable dividend income. A similar proposal would reduce the individual income tax rate on dividend income instead of fully eliminating that tax. For example, the tax rate on dividend income could be lowered to the current tax rate on long term capital gains.

Each of these approaches would reduce the tax rate on all taxable dividends. A different approach to dividend tax relief would lower taxes on only some taxable dividends. For example, a capped exclusion would eliminate individual taxes on dividends only up to a certain cap, such as $500 per person. Any dividends above that cap would continue to be taxed at both the corporate and individual levels. In other words, some shares of stock would be taxed differently based on who owns them.

**Many pro-growth and corporate governance benefits of dividend tax relief would be lost under a capped dividend exclusion.**

While such a capped exclusion may at a glance seem similar to the other approaches described above, this proposal would actually result in very different outcomes. In particular, many pro-growth and corporate governance benefits of dividend tax relief would be lost.

### Reducing dividend tax rates promotes efficiency and economic growth

Both a dividend exclusion that applies to all taxable dividends[2] and a reduction in the dividend tax rate would lower the effective tax rate on corporate earnings. This reduction would change managerial behavioral and deliver a number of economic benefits:

- *Better corporate governance and more efficient resource use.* Paying dividends rather than retaining earnings would become a more attractive proposition for companies; this change would promote a more efficient allocation of capital and give shareholders, rather than executives, a greater degree of control over how a company's resources are used.

- *Higher stock prices and healthier balance sheets.* Investing in equity would become more attractive to investors, boosting stock prices for short-term stimulus and making it easier for companies to finance new investment by issuing new shares of stock rather than by issuing debt. This change would mean less debt financing and healthier corporate balance sheets, reducing the risk of bankruptcy during hard economic times.

- *More growth-enhancing investment.* As the cost of financing new investments through the sale of new shares became more lucrative, companies would increase investment in capital such as equipment and buildings. This investment expansion would promote economic growth and increase real wages and incomes for all workers.

- *Improved international competitiveness.* Due to high U.S. corporate tax rates and the double taxation of dividends, the effective top tax rate on dividends in America is the second highest in the developed world.[3] Reducing the tax burden on dividends through a non-capped exclusion or reduction in the dividend tax rate would improve the attractiveness of investment in U.S. companies relative to foreign companies.

**Capped dividend exclusions don't change corporate behavior**

These positive effects of dividend tax relief would fail to materialize if that tax relief takes the form of a small capped exclusion. To understand why, one must consider the corporate manager's predicament. From the manager's perspective, each share of the company's stock represents a vote, with each shareholder-owner allowed to make one vote for each stock share owned. That manager makes decisions for the company based on how most shares are affected, crafting policies that would, in essence, receive the largest number of "votes."

Now consider a manager's decision-making process in the case of a dividend exclusion with a $500 cap. The problem with a fixed dollar cap on the amount of dividends excludable from individual tax is that individuals with dividend income in excess of the $500 cap may hold many or most of the shares of company stock that are subject to dividend taxes. Dividend income from the shares held by these individuals would continue to be subject to full double taxation. The more shares that are held by individuals subject to full double taxation, the more "votes" there will be for the status quo. Corporate managers are therefore much less likely to change their behavior in response to a capped exclusion than they would be if double taxation were fully ended.

**Because it does little to lower the effective tax rate on dividends, a capped exclusion would not lead to increased investment or higher dividend payments.**

With a capped dividend exclusion, managers will make decisions about dividend payments, investment, and investment financing in largely the same way as they did prior to the exclusion, since most of the shares held by taxable investors would continue to be fully taxed twice, at both the corporate and individual levels. That is, the total effective tax rate on corporate earnings, as well as managerial behavior, would remain largely unchanged.

The idea that caps don't affect economic behavior in important ways is widely accepted by economists. For example, the Congressional Research Service states:

> "There are proposals to provide a dividend exclusion that is capped at a certain level, such as the $400 exclusion that was provided historically. While this provision would be much less costly [than a full exclusion], it would provide little or no behavioral response and thus do little to increase investment in corporate equity. The capped exclusion therefore would have little effect on efficiency or the stock market, the main reasons for providing benefits, and would essentially be a windfall benefit for holders of dividends."[4]

**Caps lack "bang for the buck"**

A capped approach to dividends is questionable on economic policy grounds, particularly given the existence of attractive alternate proposals. While a capped exclusion could offer incentives for low- and middle-income households to save, concerns about personal saving adequacy would be better addressed through policy such as a relaxation of current restrictions on Individual Retirement Accounts. IRAs provide broader and stronger savings incentives by exempting from taxation not only dividend income but also interest and capital gains. And while a capped dividend exclusion might simplify income tax filing for some individuals with small amounts of dividend income, a full dividend exclusion would do the same thing and much more.

A capped dividend exclusion won't promote better corporate governance or enhance short- or long-term economic growth prospects. In terms of economy-wide benefits, a full or partial exclusion (e.g. 50 percent), or a reduction in the tax rate on dividend income, offers "bang for the buck" that a capped approach simply does not.

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[1] Under a full exclusion, taxpayers would not be required to include any "excludable" dividends in the computation of taxable income on their individual income tax returns. The president's plan specifies as excludable dividends those on which corporate income taxes have been paid.

[2] A proportional exclusion, such as a 50 percent exclusion, would apply to all taxable dividends.

[3] Edwards, Chris. "Dividend Taxation: U.S. Has the Second Highest Rate," The Cato Institute (January 17, 2003).

[4] Esenwein, Gregg A. and Jane G. Gravelle. "The Taxation of Dividend Income: An Overview and Analysis of the Economic Issues," Congressional Research Service (January 9, 2003).

## Recent Publications of the Joint Economic Committee

**Published in the past month:**

- "Dividend Tax Relief and Capped Exclusions," May 13, 2003. Explains how many pro-growth and corporate governance benefits of dividend tax relief would be lost under a capped dividend exclusion.

- "How the Top Individual Income Tax Rate Affects Small Businesses," May 6, 2003. Explains how reducing the top individual income tax rate of 38.6% to 35% would help small businesses and economic growth.

- "Recent Economic Developments: Mixed Economic Signals Continue," April 29, 2003. Reviews key economic indicators released during the month of April.

- "Economic Update: Economy Grew 1.6% in 1st Quarter of 2003," April 25, 2003. Takes a brief look at what's behind the latest GDP estimate.

- "Medicare Beneficiaries' Links to Drug Coverage," April 10, 2003. Provides new data from the Centers for Medicare and Medicaid (CMS) about existing coverage of prescription drugs among Medicare beneficiaries.

**Other JEC publications include:**

- "10 Facts About Oil Prices," April 1, 2003.

- "Understanding the Size of the Economic Growth Package," March 12, 2003.

- "Who Benefits from Ending Double Taxation of Dividends?," February, 2003.

- "The President's Budget and the Federal Debt," February 11, 2003.

Copies of the above publications and other information can be found on-line at the committee's website at jec.senate.gov.