Double Taxation Double Speak: Why Repealing Dividend Taxes Is Unfair

BY JOHN MILLER

Concerned that the most well off in our society might be suffering a bout of the post-holiday blues, the *Wall Street Journal*'s day-after-Christmas editorial urged the Bush Administration to end the "double taxation" of dividends—payments of corporate profits to stockholders. Nothing lifts the spirits of the wealthy like yet another tax give-away.

But for the editors of the *Journal*, making dividends tax exempt is not just psychotherapy for stock investors. It's a matter of economic justice and sound economic policy. (See excerpts.) In their hands, however, notions of a fair and effective policy response to today's stagnant economy become "double taxation" doublespeak. Let's try to set the record straight.

- **The equity argument [for ending the dividend tax] is that it is unfair to tax anything twice, even at the highest levels of income. Americans will favor repealing the double tax on dividends because it offends their sense of fair play.***

The "double taxation" of dividends is the heart of their argument. But there is nothing about double taxation that ought to offend Americans' sense of fair play. True enough, the government collects income taxes on dividends paid out of the profits of corporations that have already been taxed. But being taxed more than once on the same income is a fact of life for every taxpayer, not just dividends collectors. Most workers, for instance, pay Social Security payroll taxes and income taxes on their wages, and then sales taxes when they spend what remains of their paycheck.

Beyond that, the claim that dividends are "double" taxed is an exaggeration. To begin with, in the year 2000 more than half of corporate dividends went to tax-exempt pension funds, individual retirement accounts, and non-profit foundations or to individuals who owed no income tax. In addition, corporate *income* is hardly taxed the first time around. Relative to GDP, U.S. corporate income taxes are no more than half those of other wealthy industrial (OECD) countries. By our own historical standards, corporate income taxes have fallen from 4.1% of GDP in 1960 to just 1.7% of GDP in 2001. In addition, the average rate of taxation on corporate profits currently stands at 15%, far below the top corporate tax rate of 35%. Worse yet, in 1998, twenty-four highly profitable major corporations, including Pfizer, PepsiCo, MCI Worldcom, General Motors, and Texaco, paid no corporate income taxes—and received a tax rebate. Robert McIntyre, director of Citizens for Tax Justice, estimates that "barely more than half of corporate profits are subject to tax at any level."

More importantly when it comes to fairness, the issue is not *how often* we pay taxes, but *how much* we pay in taxes. By that standard, eliminating taxes on dividends would surely violate most people's sense of fair play. As even the *Wall Street Journal* allows, the beneficiaries would be those "at the highest levels of income." Some 42% of the benefits from repealing taxes on dividends would go to the richest 1% of taxpayers, and three-quarters of the tax benefits would go the richest 10%, reports the Tax Policy Center of the Urban Institute and the Brookings Institution. The top 1% of taxpayers, those with yearly incomes greater than $373,000, also benefited most from the economic growth of the last two decades. After adjusting for inflation, their real average before-tax income more than doubled (a 138% increase) from 1979 and 1997, according to the Congressional Budget Office, while their tax burden, much like that of large corporations, has declined. By 1997, the richest 1% of U.S. families paid out about 1/3 of their income in all federal taxes, far less than the 2/5 they paid in 1977. These figures will only get worse due to the 2001 Bush tax cut or the elimination of dividends taxation.

- **[Taxing dividends] creates huge distortions in both corporate and investor behavior… [O]n the corporate side, taxation creates incentives for companies to finance themselves via debt (interest on debt is tax deductible, dividend payouts are not). Increased debt can of course result in increased financial fragility for the company and risk for investors.**

The *Journal* editors argue that repealing the taxation of dividends might reduce corporations' reliance on debt financing. Interest payments are currently tax-exempt. By putting the taxation of interest payments and dividends on an equal footing, the government would take away the incentive for corporations to finance themselves through borrowing. But so too would several other changes in the tax code that would not result in a tax windfall for the super wealthy. For instance, to eliminate the tax bias in favor of "growth stocks" (which benefit investors by increasing in price), we could just remove the 20% cap on income taxes on capital gains (the sale of stocks and other assets). But the editors of the *Wall Street Journal* are loathe to consider any proposal that would boost government revenues and arrest the decline in the tax burden of the rich or large corporations.

*All quotations are from the editorial: "Ending Double Tax Trouble," *Wall Street Journal*, December 26, 2002.

■ **The tax penalty also prompts companies to retain earnings … rather than paying profits to investors. This can freeze capital—rather than allowing investors to reinvest cash in other businesses where rates of return might be higher, thus permitting capital to flow to more productive uses.**

Cutting taxes on dividends is surprisingly less than popular with corporate managers. Both Carter and Reagan administration proposals to reduce or eliminate the double taxation found little support among business elites. Joel Slemrod, a former Reagan administration White House aide and tax economist, told the *Wall Street Journal* that business executives dismissed the Reagan proposal to cut dividend taxes as "just for shareholders," saying that they preferred tax relief that comes directly to corporations. While the *Wall Street Journal* editorial touts dividend paying corporations as a good investment in today's bear market, some economists are not convinced. Economist Alan Auerbach argues, for instance, that with lower dividend taxes, investors would expect corporations to pay out more of their earnings in the form of dividends, reducing the cash available for new corporate investments.

Finally, repealing the tax on dividends is unlikely to provide the stimulus necessary to counteract today's economic stagnation. As Slemord's comments suggest, business investment is unlikely to pick up in response to cutting dividend taxes, especially in face of the overcapacity in today's economy. Even if shareholders do pour new money into stocks paying dividends, that will do little to spark new corporate investment. The vast majority of stock sales are not new issues, but resales of existing stock from one stock investor to another, which do not provide corporations with new funds for investment. During the 1990s stock boom, economists Robert Pollin, Dean Baker, and Marc Schaberg put the ratio of stock resales to new stock sales at 113.8 to 1.

If fairness and effectiveness are the issues, then a cut in the Social Security payroll taxes will do more to spread widely the benefit of cutting taxes and do far more to get the economy going again than eliminating dividend taxes. Today, three quarters of taxpayers pay more in payroll taxes than income taxes. In addition, we can count on those middle- and low-income households, many of them strapped for cash with the economic slowdown, to spend more of their income than the super-rich who would make out with the repeal of taxes on dividends.

A one-year payroll-tax holiday on the first $10,000 of wages would give workers a tax cut of up to $765, with much of the benefit going to middle- and low-income taxpayers. The AFL-CIO, the Business Roundtable, and the Economic Policy Institute all support proposals similar to this one. The Tax Policy Center estimates that 45.4% of the benefits of a Social Security payroll-tax holiday would go to the bottom 60%, as opposed to 4.7% of the benefits from repealing dividend taxation.

A payroll tax holiday would do as much to lift the spirits of most people as repealing dividends taxation would do to buck up the super-rich. It's the right thing to do. Don't let all the double taxation doublespeak make you doubt that for one minute. ■

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