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Pathway to Economic Growth and Tax Reform: Eliminating the Double Tax on Dividends

Daniel J. Mitchell, Ph.D., Norbert J. Michel, and David C. John

In a bold move, President Bush has proposed that the double taxation of dividends be eliminated. Under his plan, businesses would still pay tax on corporate income, but individual stockholders would no longer pay a second tax on that income when it is distributed as dividends.

All Americans will gain if the double tax on dividends is eliminated. Federal Reserve Board Chairman Alan Greenspan, who rarely has a kind word to say about tax relief proposals, testified recently that "This particular program will be of net benefit to virtually everybody in the economy over the long run, and that is one of the reasons I strongly support it."

Disadvantages of the Double Taxation of Dividends. Few tax policies are more self-destructive than the double taxation of corporate profit. Double taxation punishes an activity—investment—that is unambiguously good for the nation; encourages taxpayers to put today ahead of tomorrow; retards economic growth by lowering investment; promotes excessive debt; and, combined with other misguided tax policies, hinders America's competitiveness in the global economy.

With dividend income taxed at both the corporate and individual levels, the effective tax rate can easily exceed 60 percent (or even 70 percent for investors living in high-tax states). In addition to reducing the nation's stock of productive capital by causing some taxpayers to forgo investment and instead use the money for consumption, these punitive tax rates misallocate capital by leading taxpayers to shift their investment patterns in ways that are economically less efficient. The net effect is lower wages and slower growth.

Double taxation of dividends imposes a specific hardship on certain classes of taxpayers. The elderly receive almost half of all dividends, and the double tax imposes an average annual tax burden of $936 on nearly 10 million seniors. Many of these seniors rely on dividends for retirement income; yet, their efforts to create a more comfortable existence are undermined by the double tax.

Subjecting dividend income to an extra layer of tax creates a bias for borrowing since equity invest-

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ment is taxed twice while debt-financed investment is taxed once. This tax bias against equity is so significant that corporate managers have little choice but to over-utilize corporate debt. Companies incur large amounts of debt, making them vulnerable to an economic downturn during which revenues fall while interest costs do not.

Advantages of Eliminating the Double Taxation of Dividends. Under the President's proposal, the effective tax rate on dividend income will drop, in some cases by more than 50 percent, helping the economy grow faster. In addition, by removing a significant distortion in the tax code, ending the double taxation of dividends will create an environment in which decisions are more likely to be guided by economic considerations instead of tax-minimization goals. The main effects include:

- **Increasing investment.** According to the Council of Economic Advisers, "a dividend exclusion could also lower the economy-wide average effective tax rate on capital income by as much as one-quarter…and improve the overall incentive to save and invest."
- **More efficient use of capital.** A 1992 U.S. Treasury Department study found that, even in the absence of increased investment, eliminating double taxation would eventually raise economic output by about 0.5 percent of consumption—equal to about $36 billion each year.
- **Attracting global capital.** Nations with pro-growth policies attract money from investors in other nations. With about $2 trillion changing hands every day in global capital markets, this is an increasingly important reason to eliminate the double tax on corporate profits.

The President's proposal would enhance near-term economic growth by encouraging higher levels of corporate investment and capital accumulation, resulting in greater productivity increases and, therefore, higher wages for workers.

Ending the double taxation of dividends would boost U.S. competitiveness. Only three of the world's 30 developed nations—America, Switzerland, and Ireland—double tax corporate income. And since Switzerland and Ireland have lower corporate tax rates, this means that America has one of the most punitive and anti-growth dividend tax policies in the industrialized world.

Many economists have noted that eliminating this double tax is likely to boost the stock market by 10 percent or more, helping people recover much or even all of their recent losses. Moreover, a 1992 U.S. Treasury Department study estimates that the leverage ratio (the ratio of debts to assets) would fall by as much as 7 percent. This could mean fewer bankruptcies.

The tax code creates a perverse incentive for companies to hoard earnings. The President's plan would end this anti-dividend bias, giving companies an incentive to attract investors by offering dividends instead of promising capital gains. The Treasury Department has also found that state and local government tax revenue would climb by about $20 billion annually because of stronger economic growth.

Conclusion. President Bush's plan to eliminate the double tax on dividends, if implemented, will make the nation stronger and improve the living standards of all Americans. It will make the United States more competitive in the global economy and eliminate a bias against saving and investment, significantly improving the economy's performance.

Ending the double taxation of dividends is also an inherent and necessary component of fundamental tax reform. All proposals to create a simple and fair tax code—such as the flat tax—are based on the notion that income should be taxed only once. President Bush's proposal should therefore be seen as an important step toward a tax system based on sound economics and good tax policy.

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Pathway to Economic Growth and Tax Reform: Eliminating the Double Tax on Dividends

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In a bold move, President George W. Bush has proposed that the double taxation of dividends be eliminated. Under his plan, businesses would still pay tax on corporate income, but individual stockholders would no longer pay a second tax on that income when it is distributed as dividends.

The President is addressing a very serious problem. The Internal Revenue Code punishes investment by taxing dividend income twice. Discarding one of these layers of taxation will encourage more investment by reducing the tax bias against capital formation. This important reform could single-handedly increase the nation's supply of capital (e.g., machinery, tools, and equipment) by nearly 1 percent.[1] This will lead to more jobs and higher living standards.

Because of improved economic performance, all Americans will gain if the double tax on dividends is eliminated. Even Federal Reserve Board Chairman Alan Greenspan, who rarely has a kind word to say about tax relief proposals, testified recently that "elimination of the double taxation of dividends will be helpful to everybody." Greenspan specifically praised the President's proposal, stating, "This particular program will be of net benefit to virtually everybody in the economy over the long run, and that is one of the reasons I strongly support it."[2]

Ending the double taxation of dividends will increase economic growth and boost U.S. competitiveness. These are tangible benefits, but they should not overshadow the important goal of creating a simple and fair tax code. Taxing income only once is a key feature of all tax reform plans, and President Bush's dividend proposal is a necessary step toward fundamental tax reform.

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1. Council of Economic Advisers, "Eliminating the Double Tax on Corporate Income," January 7, 2003.
2. Alan Greenspan, testimony before U.S. House Committee on Financial Services, February 12, 2003.

DOUBLE TAXATION IS BAD FOR AMERICA

Few tax policies are more self-destructive than the double taxation of corporate profit. Double taxation punishes an activity—investment—that is unambiguously good for the nation. It encourages taxpayers to put today ahead of tomorrow. It retards economic growth by lowering investment and promotes excessive debt. Combined with other misguided tax policies, it hinders America's competitiveness in the global economy.

Bias Against Capital Formation. Taxes discourage the activity that is taxed. This is one of the reasons, for instance, that politicians impose so-called sin taxes. By this standard, investing in corporate equity must be a terrible transgression. With dividend income taxed at both the corporate and individual levels (see Chart 1), the effective tax rate can easily exceed 60 percent (or even 70 percent for investors living in high-tax states).

These punitive tax rates discourage investment, much as harsh sin taxes affect the consumption of targeted products. By so doing, they reduce the nation's stock of productive capital by causing some taxpayers to forgo investment and instead use the money for consumption. In addition, these high tax rates misallocate capital by leading taxpayers to shift their investment patterns in ways that are less economically efficient. The net effect of these decisions is lower wages and slower growth.

Burdening Taxpayers. Double taxation of dividends imposes a specific hardship on certain classes of taxpayers. The elderly receive almost half of all dividends, and the double tax imposes an average annual tax burden of $936 on nearly 10 million seniors.[3] Many of these seniors rely on dividends for retirement income, yet their efforts to create a more comfortable existence are undermined by the double tax.

Shareholders, of course, bear the direct burden of double taxation. The most obvious burden is that their investment income is taxed twice. Adding insult to injury, double taxation also reduces their investment options. The share of companies paying dividends has dropped by 50 percent in the past 40 years—a decline that is almost surely due in part to the double tax. Investors seeking to balance their portfolios between "growth stocks" and "income stocks" must therefore pay a price premium for shares that still pay dividends—meaning that the rate of return on these stocks is lower. Dividend yields, for instance, have fallen from more than 4 percent in the 1980s to less than 2 percent today.[4]

Encouraging Debt. Subjecting dividend income to an extra layer of tax creates a bias for borrowing since equity investment is taxed twice while debt-financed investment is taxed once. This tax bias against equity is so significant that corporate managers have little choice but to over-utilize corporate debt. This may be their best choice, given the tax code's perversity, but it comes at a cost. Companies incur large amounts of debt, making them vulnerable to an economic downturn during which revenues fall while interest costs do not.

A neutral tax code would encourage companies to restructure their finances and improve their balance sheets, thereby reducing bankruptcies. It is impossible to know, of course, whether this policy would have prevented any of the recent high-profile bankruptcies. However, it is very safe to say that this reform, if enacted, would prompt a significant shift from debt to equity. This would reduce bankruptcies since the tax code would no longer encourage corporations to incur excessive debt.

Lowering Wage Growth. Workers are paid based on production, and there are only two ways to increase their output. One option is to work longer hours, but this is generally not desirable since it deprives workers of time with their families and other leisure activities. The other option is to increase productivity. If workers are able to increase their hourly output, they can simultaneously preserve their leisure time and become more valuable to their employers.

This is why investment is so important. Workers become more productive when they have better tools, equipment, and technology. Yet the double tax on dividends penalizes capital investment. As a result, this means less investment, which translates into lower wages for American workers.

3. E-mail to Daniel Mitchell from Office of Tax Policy, U.S. Department of the Treasury, February 27, 2003.
4. Council of Economic Advisers, "Eliminating the Double Tax on Corporate Income."

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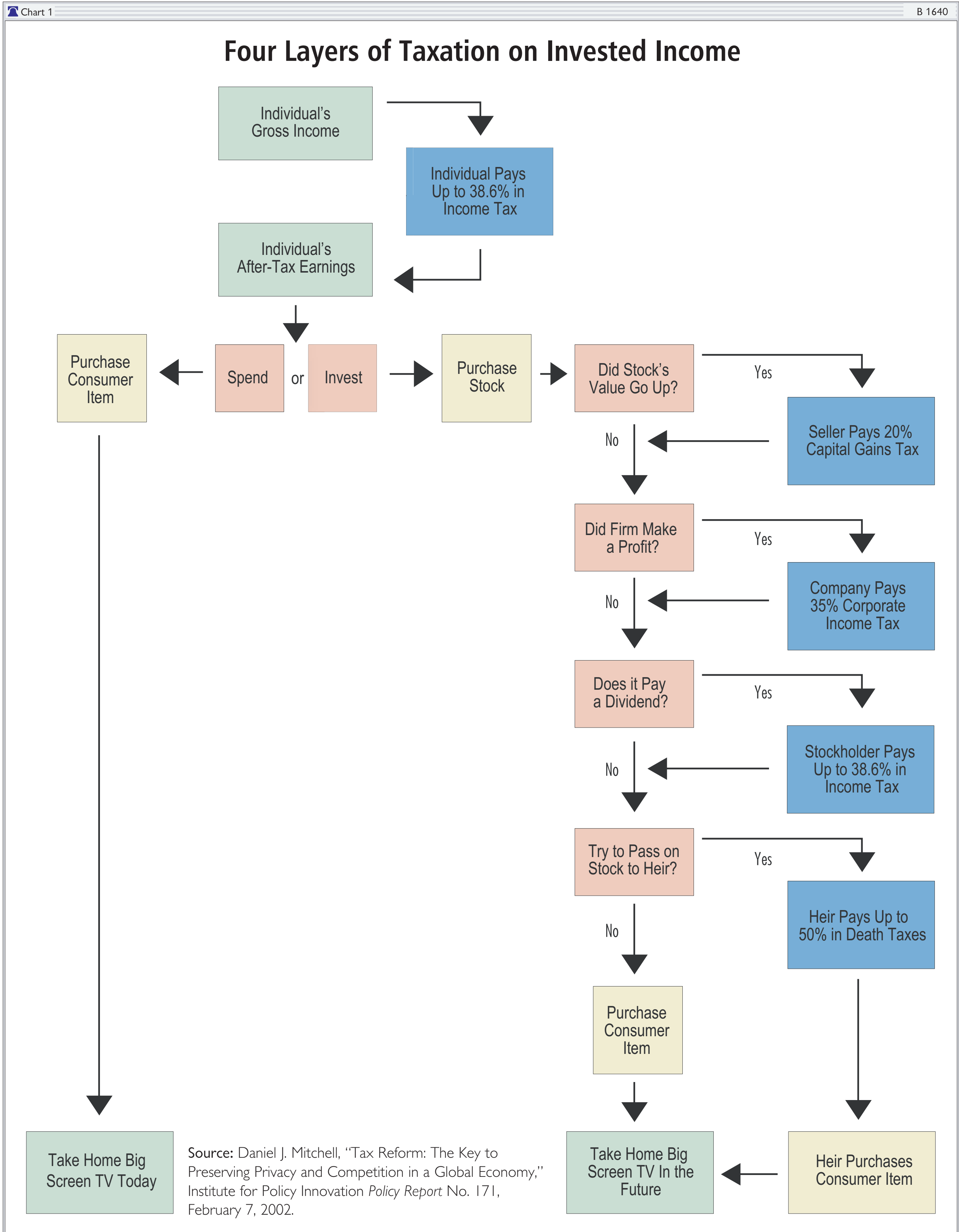


Source: Daniel J. Mitchell, "Tax Reform: The Key to Preserving Privacy and Competition in a Global Economy," Institute for Policy Innovation *Policy Report* No. 171, February 7, 2002.

WHAT IS A DIVIDEND?

Shareholders are the owners of a corporation, and the corporation exists to make a profit for those owners.[1] Shareholders put their money at risk when they invest money in a company, but they incur this risk because they expect to get a "return" on their investment. This return can be in the form of dividends—periodic payments from a company to its shareholders—or capital gains—an increase in share price generated by the expectation of higher income in the future.[2]

Simply put, paying dividends to a stockowner is profit sharing. By paying a dividend, a corporation passes a portion of its earnings to its owners. Paying a dividend is not required, and the proportion of corporations that choose to pay dividends has dropped over the past several decades. Forty years ago, almost 70 percent of corporations paid regular dividends, but today, that has dropped to only 35 percent of corporations. The rest retain their profits to finance growth or acquisitions or have no profits to share. Dividends are paid either in cash or in the form of more stock.

A record number of Americans have invested in stocks. In 2002:

- About 36 million households owned stock outside employer-sponsored retirement plans.
- About 21 million households held stock directly, primarily through brokerage accounts.
- Nearly 29 million households held stock indirectly through mutual funds.[3]

Cash Dividends

Cash dividends are usually paid quarterly as a certain amount per share. Most companies that pay cash dividends prefer either to pay a stable amount each quarter or to have dividends that regularly increase. Corporations will declare that a dividend will be paid to all shareholders who are recorded on the company books as of a certain date, known as the *record date*. The actual check is mailed on the *distribution date*.

Stock Dividends

An alternate form of dividend is paid in additional company stock. In most cases, the value of the stock becomes taxable income only when the stock is sold.

Preferred Stock

Preferred stock is really an alternate form of bond financing. Typically, this type of stock pays a regular cash dividend at a set amount, and the company often has the right at some point to re-purchase the stock or convert it into another type of asset. In most cases, preferred stock carries either no right to vote on corporate governance issues or only limited voting rights.

1. This is a simplification. Some corporations (for example, nonprofit corporations) are created to fulfill other goals. This paper—borrowing from conventional use—focuses on large, publicly traded, for-profit institutions.
2. If investors believe that a firm will not generate future income, or that it will generate less income than previously expected, shareholders will alter their behavior. Shareholders in the company will generally want to sell their holdings, while other investors will be less likely to add that particular stock to their portfolios. This combination will cause shares to decline in value. The opposite is also true. If a company's prospects improve, investors will generally want to own more stock, bidding up the value of the stock.
3. The White House, "The President's Jobs and Growth Plan: The Dividend Exclusion Is Not Complex," at *www.whitehouse.gov/infocus/economy/complexity.html*.

Just Part of the Problem. Imposing two layers of tax on dividends is a bad policy, but it is only one example of the tax code's bias against saving and investment. If investors die with "too much" wealth, accumulated dividend income is subject to the death tax. Most perverse of all, this income can also be hit by the capital gains tax. Stocks rise in value because of a market expectation of higher future income, and this increase in share price is subject to capital gains taxation. This means essentially that dividends can be taxed once before they even materialize.

These multiple layers of taxation are bad, but tax policies compound the damage by forcing companies to overstate profits. Depreciation, for instance, treats a portion of new investment as if it were taxable income. Foreign tax rules require companies to pay tax on income that was already taxed by a foreign country. And the alternative minimum tax compels businesses to pretend that some costs do not exist, artificially inflating taxable income.

Under existing law, cash dividends are taxable as ordinary income. Some companies offer dividend reinvestment plans, under which stockholders can automatically use their dividends to purchase more stock without paying brokerage fees. However, in this case, both the value of the dividends and any brokerage fees paid by the company count as taxable income.

BENEFITS OF REFORM

Boosting the Economy and Increasing Wages. The President's proposal will substantially reduce the tax burden on productive behavior. The effective tax rate on dividend income will drop—in some cases by more than 50 percent. This will help the economy grow faster, but higher national income is just one of the many benefits. Eliminating the double tax on dividends will also remove a significant distortion in the tax code, creating an environment in which decisions are more likely to be guided by economic considerations instead of tax-minimization goals.

There are several reasons why the economy will benefit if lawmakers shift to a tax code that taxes dividend income only once. These reasons include:

- **Increasing investment.** The effective tax rate on corporate investment could fall by as much as one-third, dropping from 32.2 percent to 21.7 percent. This translates into a lower tax burden on investment income. According to the Council of Economic Advisers (CEA), "By lowering the tax cost of corporate investment, a dividend exclusion could also lower the economy-wide average effective tax rate on capital income by as much as one-quarter (from 19.8 percent to 14.8 percent) and improve the overall incentive to save and invest."[5] The CEA also estimates that the cost of capital investments in equipment would be reduced by more than 10 percent and that the tax burden for equity investment in structures would be cut by more than one-third.[6]
- **More efficient use of capital.** Ending the double tax on dividends would create a level playing field, removing tax preferences for non-corporate investment and owner-occupied housing. In other words, capital would be allocated in ways that maximize growth instead of ways that minimize tax.[7] A 1992 U.S. Treasury Department study found that, even in the absence of increased investment, eliminating double taxation would eventually raise economic output in the United States by about 0.5 percent of consumption—equal to about $36 billion each year.[8]
- **Attracting global capital.** In a competitive world economy, nations with pro-growth policies attract money from investors in other nations. With about $2 trillion changing hands every day in global capital markets, this is an increasingly important reason to eliminate the double tax on corporate profits.

More investment and better investment are the benefits of dividend tax reform. Both would pro-

5. *Ibid.*
6. E-mail to Daniel Mitchell from Office of Economic Policy, U.S. Department of the Treasury, March 19, 2003.
7. Council of Economic Advisers, "Eliminating the Double Tax on Corporate Income."
8. U.S. Department of the Treasury, "Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once," January 1992, at *www.treasury.gov/offices/tax-policy/library/integration-paper/index.html#summary.*

mote higher wages in the long run. The proposal would also enhance near-term economic growth.[9] Eliminating double taxation would encourage higher levels of corporate investment and capital accumulation, resulting in greater productivity increases and, therefore, higher wages for workers.

Academic Evidence. Many economists have long argued that the double taxation of dividends reduces the after-tax return on capital in the nation's economy and thus discourages corporate investment.[10] This reduced corporate investment, such as purchases of new business equipment and machinery, weakens economic growth. Consequently, these economists would argue that eliminating this double taxation would spur corporate investment and improve the economy's long-term growth.

While empirical evidence does support such claims, economists have struggled with many issues surrounding the taxation of dividends. For example, given the tax-disadvantage of receiving dividends, economists have striven to explain why firms pay dividends at all. Furthermore, the lack of significant changes to U.S. dividend tax policy through most of the last century has made empirical studies problematic.

As a result, a large portion of the professional literature has focused on explaining why dividends are paid. Aside from the obvious reason—that investors want cash despite the tax burden—two of the more common theories found in the literature are the "free cash flow" and "signaling" hypotheses. On balance, a fair amount of empirical evidence supports each hypothesis.[11]

The free cash flow hypothesis states that shareholders want dividends because distributing this leftover cash prevents managers from having "too much" cash. Theoretically, having extra cash allows managers to fund projects that are not in the best interest of the shareholders. The signaling hypothesis states that managers are distributing cash to shareholders to "signal" that the firm has good long-term prospects. The idea is that a firm's ability to pay out cash on an ongoing basis represents a sound financial structure.

Empirical evidence for other aspects of dividend tax policy, such as which investors seek dividends and the economic effects of double taxation, is smaller in volume and less conclusive. Still, some empirical evidence does suggest that eliminating the double taxation of dividends would lower the cost of capital and, in turn, increase investment and economic growth. Since the United States is one of only three countries in the 30-member Organization for Economic Cooperation and Development (OECD) without some form of protection from the double taxation of dividends, much of the empirical evidence examines the experiences of other countries.

In 1987, New Zealand and Australia implemented a dividend "imputation credit" mechanism to eliminate the double tax on dividends.[12] This method, which has the effect of adding back the corporate layer of tax to the dividend received by the shareholder, was found to increase capital investment in both countries.[13] Furthermore, the imputation credit employed in Australia was found to offset the investment-dampening effects of a capital gains tax increase.[14]

9. Council of Economic Advisers, "Eliminating the Double Tax on Corporate Income."

10. For more on the economic effects of federal double taxation of dividends, see James M. Poterba, "Tax Policy and Corporate Saving," *Brookings Papers on Economic Activity* No. 2, 1987, pp. 455–515; Peter Birch Sorensen, "Changing Views of the Corporate Income Tax," *National Tax Journal*, Vol. 48, No. 2 (June 1995), pp. 279–294; and James M. Poterba and Lawrence H. Summers, "New Evidence That Taxes Affect the Valuation of Dividends," *Journal of Finance*, Vol. 39, No. 5 (December 1984), pp. 1397–1415.

11. These theories are not necessarily mutually exclusive. For the signaling hypothesis, see James A. Brickley, "Shareholder Wealth, Information Signaling and the Specially Designated Dividend: An Empirical Study," *Journal of Financial Economics*, Vol. 12 (1983), pp. 187–209. For the free cash flow hypothesis, see Larry Lang, R. Stulz, and R. Walkling, "A Test of the Free Cash Flow Hypothesis: The Case of Bidder Returns," *Journal of Financial Economics*, Vol. 29 (1991), pp. 315–335.

12. For a complete discussion of the imputation credit, as well as other methods for eliminating the double taxation of dividends, see Deborah Thomas and Keith Sellers, "Eliminate the Double Tax on Dividends," *Journal of Accountancy*, November 1994.

13. See Ervin Black, Joseph Legoria, and Keith Sellers, "Capital Investment Effects of Dividend Imputation," *Journal of the American Taxation Association*, Vol. 22, No. 2 (Fall 2000), pp. 40–59.

HOW TAX CUTS HELP—OR DO NOT HELP—ECONOMIC GROWTH

The current tax policy debate is clouded by a poor understanding of how tax cuts affect economic performance. The following primer explains why some tax cuts work—and how—and why others do not.

FACT 1: Tax cuts help the economy by improving incentives to earn more income and create wealth. Lowering tax rates on productive behavior is the key to good tax policy. Taxes are a "price" imposed on different activities. When the "price" is prohibitive (i.e., high tax rates), it discourages the activity being taxed. Hence, lower tax rates on work, saving, and investment encourage additional economic growth. Some tax cuts, by contrast, may have no effect on growth. Giving all taxpayers $500, for instance, does not influence their incentives to earn more income or engage in productive behavior. As a result, this policy is incapable of increasing national income.

FACT 2: The change in tax rates matters, not the size of the tax cut. The public policy debate frequently focuses on the size of a tax package, but this can be very misleading. Providing a $500 annual "rebate" to every taxpayer in the country, for instance, would involve a significant reduction in tax revenue, but it would have no direct impact on economic growth. (It might have a positive indirect impact on growth if the revenue reduction slows the growth of federal spending.) A small reduction in the capital gains tax, by contrast, would encourage more investment and boost economic performance—even though the amount of tax relief would be tiny compared to the tax rebate. It is also possible to use tax policy to boost growth without lowering the overall tax burden. A revenue-neutral flat tax, for instance, would significantly increase gross domestic product even though taxpayers as a group would have no extra money in their pockets.

FACT 3: Good tax policy leads to a "revenue feedback" caused by better economic performance. One noteworthy feature of good tax policy is that the actual reduction in tax revenue is always smaller than suggested by static revenue-estimation models because lower tax rates encourage taxpayers to work more, save more, and invest more. As a result, national income increases, expanding the tax base. This does not mean that all "tax cuts pay for themselves." Only in select instances—and usually only in the long run—will a reduction in the tax rate generate a large enough increase in taxable income to offset the revenue loss associated with a lower tax rate.

FACT 4: Tax cuts do not help the economy by "giving people money to spend." Consumer spending is a symptom of a strong economy, not the cause of a strong economy. Nonetheless, some believe that boosting consumer spending is the key to growth. But this analysis looks at only part of the equation. Taxpayers keep more of their money when tax burdens are reduced, but the extra money does not materialize out of thin air. Instead, the government must borrow it from private credit markets (or, if there is a surplus, return less money to private credit markets). This means that any increase in private consumer spending caused by a tax cut is exactly offset by a reduction in private investment spending. There is no increase in total spending, no increase in national income, and no increase in economic growth.

FACT 5: Consumer spending is a consequence of growth, not a cause of growth. Some politicians talk about the need to encourage consumer spending as a means of spurring growth. This puts the cart before the horse. Consumers spend when they have disposable income, and faster growth is the only permanent way to increase consumption. Government has some ability to boost consumption at the expense of investment—thus altering the use of national income. As discussed above, however, this does not increase national income.

FACT 6: Good long-term tax policy is the best short-term "stimulus." Another common refrain is that good tax policy should be postponed in order to allow "stimulus." This argument is usually put forth by those who purportedly believe that consumer spending drives the economy. In the real world, the only tax policies that create short-run growth are the ones that also improve long-run growth. Some of those policies—such as tax cuts that attract capital from other nations—can have a pronounced immediate impact. Other policies, such as personal income tax rate reductions, may be equally desirable, but the economic benefits compound over time.

In a 1984 paper, James Poterba and Lawrence Summers tested several competing hypotheses regarding the economic effects of dividend taxation, using data from the United Kingdom.[15] Unlike the United States, the United Kingdom has experienced several dividend tax reforms since the 1950s, making empirical testing more straightforward. The authors found that the double taxation of dividends in the United Kingdom did lower corporate investment and worsen distortions in the capital markets.

One of the few recent U.S. tax reforms that lends itself to this type of empirical study is the Tax Reform Act of 1986 (TRA86). A 1991 paper by Serge Nadeau and Robert Strauss notes that TRA86 significantly reduced the tax advantage of retained earnings over dividends.[16] The authors' model estimated that this tax reform reduced the cost of equity capital by about 30 percent. A 1992 study found that TRA86 lowered the cost of capital and increased investment.[17] Recently, Heritage Foundation economists simulated the dividend tax reform bill introduced by Representative Christopher Cox (R–CA) and estimated that ending the double tax on dividends would lead to higher investment and economic growth.[18]

Making America More Competitive. Ending the double taxation of dividends would boost U.S. competitiveness. According to a Cato Institute survey, only three of the world's 30 developed nations—America, Switzerland, and Ireland—double tax corporate income. And since Switzerland and Ireland have lower corporate tax rates, this means that America has one of the most punitive and anti-growth dividend tax policies in the industrialized world. Indeed, only Japan has a higher top tax rate on dividends. (See Chart 2.)

This is an embarrassment—and it clearly puts America in a disadvantageous position. About one-fourth of our competitors do not impose any double taxation on dividends, and almost all of the rest provide at least partial protection from double taxation. According to the Council of Economic Advisers:

> all countries in the G-7 but the United States provide at least some relief from the double tax on dividends. Italy provides full relief.… Germany has a 50 percent dividend exclusion, and the United Kingdom has a preferential rate on dividends plus a system in which shareholders receive partial credit for taxes paid at the corporate level.[19]

By ending the double taxation of dividends, President Bush hopes to significantly improve America's ranking in this critical measure of global competition. Being next-to-last is not a smart policy in a competitive world economy. Because the United States also has a high corporate tax rate, eliminating the double tax will not put America in first place, but it would put America in the top tier of nations. This means more jobs for American workers and more capital for American companies.

Regrettably, the President's proposal does not eliminate the double tax on foreigners who invest in U.S. companies. Currently, nonresident aliens are subject to a 30 percent withholding (i.e., pre-paid) tax on dividends, and that second layer of tax will remain in effect. This discriminatory treatment is misguided. Ending the double taxation of dividends paid to foreigners will significantly increase the amount of foreign capital invested in the U.S. economy.

14. *Ibid*.

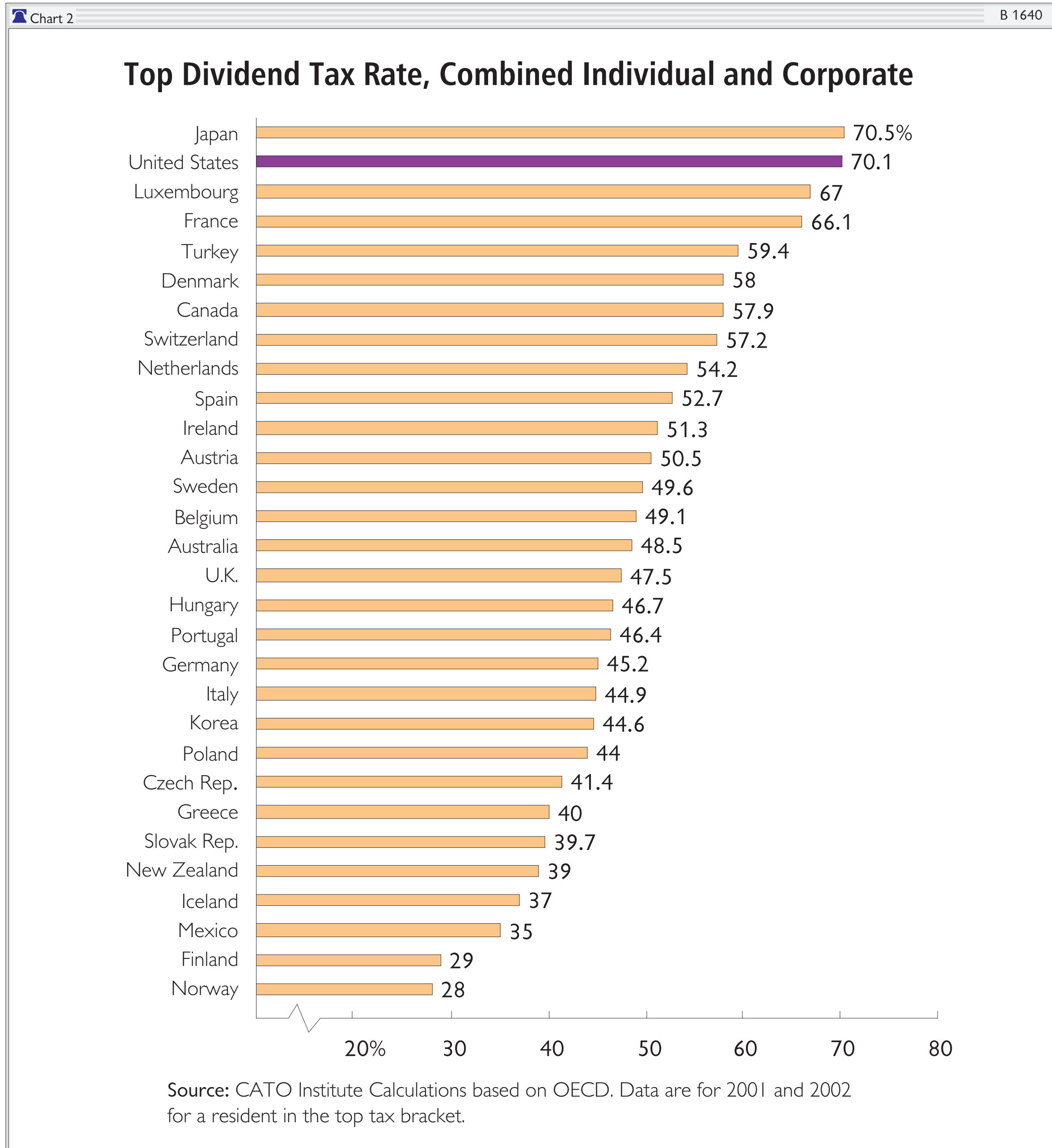
15. See James Poterba and Lawrence Summers, "The Economic Effects of Dividend Taxation," National Bureau of Economic Research, *NBER Working Paper* No. 1353, May 1984.

16. See Serge Nadeau and Robert Strauss, "Tax Policies and the Real and Financial Decisions of the Firm: The Effects of the Tax Reform Act of 1986," *Public Finance Quarterly*, Vol. 19, No. 3 (July 1991), pp. 251–292.

17. See Jason Cummins and Kevin Hassett, "The Effects of Taxation on Investment: New Evidence from Firm Level Panel Data," *National Tax Journal*, Vol. 45, No. 3 (1992), pp. 243–251.

18. See Norbert J. Michel, Alfredo Goyburu, and Ralph Rector, Ph.D., "The Economic and Fiscal Effects of Ending the Federal Double Taxation of Dividends," Heritage Foundation Center for Data Analysis Working Paper, February 3, 2003, at *www.heritage.org/research/taxes/cda_workingpaper.cfm*.

19. Council of Economic Advisers, "Eliminating the Double Tax on Corporate Income."



Source: CATO Institute Calculations based on OECD. Data are for 2001 and 2002 for a resident in the top tax bracket.

Building Wealth and Boosting Retirement Income. Repealing the dividend tax would help investors at any income level to build wealth and improve their retirement income. While it would especially help those who directly invest in stocks that pay regular dividends, the predicted overall rise in the stock market would even assist those who put their funds in a tax-advantaged 401(k) or similar retirement plan.

Experts estimate that simply passing President Bush's proposed repeal of the double tax on stock dividends could lift the entire stock market by as much as 10 percent.[20] This would replace about 45 percent of the average stock portfolio loss in 2002. However, the legislation would have an even greater effect simply because it would encourage more companies to pay regular dividends—and

20. Grace Toto, "Monthly Statistical Review," *Securities Industry Association Report*, Vol. 4, No. 1 (January 31, 2003).

investing in stocks that pay dividends can be a good strategy for building a retirement nest egg.

Today, dividends are somewhat out of fashion, but historically, they have played a key role in the valuation of a stock. Currently, only about 35 percent of publicly traded companies pay dividends, while over 70 percent paid regular dividends in 1960.[21] As recently as 1982, about 60 percent of companies listed on the New York Stock Exchange, NASDAQ, and American Stock Exchange paid dividends. Today, that proportion is less than 40 percent.[22] Larger companies are more likely to pay dividends than smaller ones.

Similarly, dividend yields have dropped. In 2002, the average dividend yield at the year-end value of S&P 500 stock was 1.83 percent. Since 1936, the average dividend yield for that index has been 4 percent. At the market low in October 2002, the yield was 2.02 percent. At the low point of the 1974 bear market, the dividend yield was 5.77 percent, and the market low for the 1982 bear market was a dividend yield of 6.62 percent.

This decline in both the number of companies that pay dividends and the reduced dividend yield has forced investors to rely on market appreciation for most of their profits. Dividends accounted for about 16 percent of average annual returns on the S&P 500 during the 1990s; over the past 75 years, they accounted for an average of 43 percent of the market's total returns.[23] Clearly, encouraging more companies to pay dividends would reduce the risk of equity investments while also providing a stable source of retirement income.

Investing in companies that pay dividends can be profitable. Some experts contend that companies that pay dividends actually outperform those that do not pay dividends. In 1996, James O'Shaughnessy pointed out in his book *What Works on Wall Street* that investing in carefully selected large capitalization stocks that pay dividends can actually result in higher profits than the average return for large capital stocks.[24]

Recently, Motley Fool, an on-line investment adviser, tested this premise by selecting nine dividend-paying stocks with annual yields greater than 4.5 percent. They excluded utilities, bank stocks, and real estate investment trusts. Motley Fool's staff invested $1,000 in each of nine dividend-paying stocks on June 13, 2001, and held them until December 4, 2002. During that time, the S&P 500 stock index lost about a quarter of its value. However, the nine stocks lost an average of only 8.5 percent, while paying dividends equal to 7.4 percent of the purchase price, and were worth a total of $8,907.94 at the end of the experiment.[25]

Before retirement, an investor can use dividends to accumulate a company's stock through a "dividend reinvestment plan" (DRIP). Under this plan, an investor allows the company to take the dividends that would have been paid and use them to buy additional shares of the company's stock. Over the years, these plans act like compound interest as dividends from shares purchased through the DRIP allow the purchase of even greater amounts of the company's stock. In almost all cases, the investor also avoids paying any brokerage fees for the transaction.

In the past, retirees who could afford to have any investments often owned utility stocks because of their regular cash dividends. Today, companies in the utility, financial, and material sectors, along with larger energy companies, are most likely to offer higher dividend yields, according to Sam Stovall, chief investment strategist for Standard and Poor's.[26] At the same time, looking only at yields, which are usually expressed as a percentage of the average price of the stock in question, can be misleading. If a stock price is falling sharply and the

21. Christopher Farrell, "The Uncertain Yield of Untaxed Dividends," *Business Week*, January 9, 2003, at *www.businessweek.com/bwdaily/dnflash/jan2003/nf2003019_5598.htm* (March 19, 2003).
22. Deborah Adamson, "Dividend Tax Cut: Stock Market Savior," at *www.cbs.marketwatch.com* (January 10, 2003).
23. Farrell, "The Uncertain Yield of Untaxed Dividends."
24. James P. O'Shaughnessy, *What Works on Wall Street: A Guide to the Best-Performing Investment Strategies of All Time* (New York: McGraw–Hill, 1998), p. 151.
25. Zeke Ashton, "Beating the Market with Dividends," at *www.fool.com/specials/2003/03010700sp.htm* (March 19, 2003).
26. CBS MarketWatch, January 6, 2003.

dividend remains the same, the yield will seem very large. For that reason, marginal stocks with dividends may look like a real value even though the company is clearly in trouble—and could suspend payment of its dividend.[27] Investors should consider both the dividend yield and the underlying financial condition of the company before investing.

Regardless of income level, an investor will benefit from the repeal of the double tax on dividends. Those who invest through 401(k) or similar retirement plans, because of the overall rise in the market resulting from passage of the tax change, will see their portfolios increase by about 10 percent. Those who invest through other plans will receive the direct benefit of tax-exempt dividends. In addition, more companies will choose to pay dividends regularly. Investment in the stocks of sound, well-managed dividend payers will reduce investors' exposure to market risk and increase their ability to build wealth for their retirements and other purposes.

Boosting Stock Values. The 84 million Americans who own equities have suffered steep losses over the past few years. The Dow Jones Industrial Average fell 7.1 percent from December 2000 to December 2001 and another 16.8 percent from December 2001 to December 2002. During these two years, the Dow dropped just over 22 percent.[28] One good way to reverse this trend would be to eliminate the double tax on dividends.

Many economists have noted that eliminating this double tax is likely to boost the stock market, helping people recover much or even all of their recent losses—even if the stockholders, such as holders of individual retirement accounts (IRAs), do not currently pay taxes on dividends. This means that Americans who assume they will have to delay their retirement because of their shrinking IRAs or pension funds could see their retirement plans become real again. The following is a sample of what these economists are saying:

- Lynn Reaser, an economist with Banc of America Capital Management, predicts that eliminating the double tax on dividends could boost the stock market by as much as 10 percent.[29]
- White House economist R. Glenn Hubbard estimates that repealing the double tax could increase equity values by up to 20 percent.[30]
- The Joint Economic Committee reviewed the evidence and found that stock prices would increase between 6 percent and 13 percent.[31]
- Dr. John Rutledge estimates that the S&P 900 would rise in value by 8.5 percent and that investors would enjoy an increase of almost $800 billion in their net worth.[32]

Some observers focus on the all-important psychology of Wall Street. "A cut in dividend taxes…could help to lift some of the gloom on Wall Street," says Greg Valliere at Schwab Washington Research. "It would be quite positive, quite quickly for the stock market."[33] A 10 percent increase in stock values due to the dividend tax repeal would enable the average stockholder to recoup 45 percent of the typical portfolio decline during 2002. A 20 percent recovery in values would mean that the average portfolio would recover 75 percent of the 2002 loss and just over 57 percent of the losses from the past two years.[34]

In other words, eliminating the double taxation of dividends is one of the most positive and imme-

27. For instance, Allegheny Energy paid dividends equal to 22 percent of its stock price in the fourth quarter of 2002. The company had severe cash flow problems and suspended its dividend shortly thereafter. See Adamson, "Dividend Tax Cut: Stock Market Savior."
28. Toto, "Monthly Statistical Review."
29. "Can a Dividend Tax Cut Juice Growth?" January 3, 2003, at *www.businessweek.com:/print/bwdaily/dnflash/jan2003/nf2003013_6478.htm?pi*.
30. Toto, "Monthly Statistical Review."
31. Donald B. Marron, "Who Benefits from Ending the Double Taxation of Dividends?" *Economic Policy Research*, Joint Economic Committee, February 2003.
32. John Rutledge, "How the 0% Dividend Tax Cut Will Work," Rutledge Investment Strategies, January 4, 2003.
33. Mary Thompson, "Dividend Tax Cut Would Bolster Wall Street," January 6, 2003, at *moneycentral.msn.com/content/CNBCTV/Articles/TVReports/P37293.asp*.

diate actions that Congress and the President could take to restore investor confidence and portfolio value.

Improving Corporate Governance. The Bush proposal will mean faster growth, stronger retirement, more competitiveness, and higher stock prices, but the plan promises several other benefits. One of those benefits is a better set of incentives for proper company management and wiser investment strategy. There has been much publicity about the recent spate of high-profile corporate bankruptcies. In many of these cases, company executives made poor decisions—some of which crossed the line into illegal and/or immoral choices—that have been properly criticized. But what was not adequately discussed is how double taxation actually promotes bad business behavior.

Many corporate critics, for instance, have denounced companies for taking on too much debt while failing to acknowledge the role of the tax code. Under current tax law, companies are encouraged to use debt, not equity, to finance investments because dividends are taxed twice and interest on corporate bonds is taxed only once. If the Bush plan is approved, this bias disappears and companies will have a strong incentive to strengthen their balance sheets. The 1992 U.S. Treasury Department study, for instance, estimates that the leverage ratio (the ratio of debts to assets) would fall by as much as 7 percent.[35] This would mean fewer bankruptcies.

Another common complaint is that companies overstate earnings. This certainly is a valid criticism, but it is also appropriate to investigate how the tax code encourages this behavior by creating a perverse incentive for companies to hoard earnings. The double tax on the earnings kept by companies (capital gains) is lower than the double tax on the earnings they distribute to investors (dividends). The President's plan would end this anti-dividend bias, giving companies an incentive to attract investors by offering dividends instead of promising capital gains.

The other side of this coin is that eliminating the double tax on dividends will have a positive impact on investor attitudes. Because of the heavier tax on dividends (distributed earnings), investors are more likely to seek stocks that pay capital gains. If this anti-dividend bias disappears, companies will be more likely to attract investors by offering periodic payments (dividends) instead of promising capital gains. This will improve corporate governance, since firms no longer will feel as much pressure to boost share prices by making unwarranted claims about future revenue. Investors will then be more likely to judge companies by the dividends paid to shareholders.[36]

This does not mean that dividend reform will stop all companies from overstating revenues and understating costs. Some companies will still incur too much debt even if the double tax is eliminated and debt and equity are treated equally. Corporate executives, like people in other walks of life, are far from perfect. However, eliminating the double tax will end the perverse incentive to incur excessive debt and/or give overly optimistic (or even dishonest) projections of future revenue streams.

34. These estimates assume that the typical portfolio is invested 50 percent in a diversified mix of equities, 30 percent in AAA-rated corporate bonds, and 20 percent in short-term securities. The return used for the corporate bond portion of this portfolio was the Moody's AAA corporate bond annual return of 5.99 percent as of February 13, 2003. The return used for the short-term securities portion was the rate of 4 percent on a 10-year U.S. Treasury security as of December 2002. The above estimates assume that the corporate bond and Treasury returns will remain unchanged from these levels. These estimates are for illustration only and should not be used to make investment decisions.

35. Council of Economic Advisers, "Eliminating the Double Tax on Corporate Income."

36. Increasing the capital gains tax could also eliminate the bias between distributed earnings and retained earnings, but this approach would exacerbate the bias between income that is consumed and income that is saved and invested. In other words, the only way to improve corporate governance and boost the economy is to eliminate both the capital gains tax and the double tax on dividends.

IS THERE A BETTER WAY TO ELIMINATE DOUBLE TAXATION?

If taxing income more than once hinders economic growth, the obvious answer is to eliminate double taxation. But there are three ways to achieve this goal. The President's approach—eliminating the second layer of tax at the individual level—is the preferred method, but the other approaches are theoretically similar and would generate the same economic benefits.

1. **The individual side.** This is the approach sought by the Bush Administration. Dividend income would be subject to the corporate income tax, but individual taxpayers would no longer have to pay a second layer of tax on this income. Excluding all dividends from the personal income tax is the simplest way to achieve this goal. The President's proposal largely utilizes this method but, regrettably, is not quite this straightforward because of concerns that existing tax credits might allow some dividend income to escape tax at the corporate level.

2. **The corporate side.** Allowing companies to deduct dividend payments is another way to end double taxation of dividends. Firms would subtract dividend payments from taxable income, effectively ending the tax at the corporate level. Individual taxpayers, however, would continue to pay tax on that income. It is worth noting that the tax code uses this method to protect bondholders from double taxation. (Companies currently can deduct interest payments.)

3. **The combination method.** Finally, lawmakers could eliminate the double tax by mixing the previous two options. Simply stated, dividend income would still be taxed at both the corporate and individual levels, but at lower rates. The easiest way to implement this policy is to allow companies to deduct 50 percent of dividend payments and to require individuals to pay tax on 50 percent of their dividend payments (much as individuals are allowed to exclude a portion of their capital gains from taxation).

While all three options achieve the same goal, the President's approach has certain advantages: Three are good economic policy, and two address political concerns. From the standpoint of economic policy, eliminating the tax at the individual level:

- **Would be consistent with fundamental tax reform.** All tax reform plans are based on the commonsense notion that economic activity should be taxed only once (and presumably at the lowest possible rate). The most prominent of the tax reform proposals is the flat tax, and dividend income is taxed at the business level under this approach. President Bush's plan therefore is an important step toward fundamental tax reform.
- **Would be simple to implement.** Major companies often have more than one million shareholders. If dividend income is to be taxed only once, it is administratively much easier to collect the tax using one tax return—the corporation's—instead of requiring the Internal Revenue Service (IRS) to track millions of shareholders.
- **Would enhance individual privacy.** Taxing dividend income at the corporate level theoretically means that individuals would no longer have to tell the government about their private financial investments.[37] The President's plan does not achieve this important goal, but it is a substantial step in the right direction.

From a political standpoint, eliminating the tax at the individual level represents:

- **A smaller tax cut.** Thanks to individual retirement accounts and investments by nonprofit institutions, a significant portion of dividend income already is shielded from double taxation. As a result, fixing double taxation at the individual level requires a smaller tax cut than would be required if the double tax was eliminated at the corporate level. This is important because politicians generally are reluctant to

37. For more information on this topic, see Daniel J. Mitchell, "Tax Reform: The Key to Preserving Privacy and Competition in a Global Economy," Institute for Policy Innovation, *Policy Report* No. 171, February 7, 2002.

reduce the amount of money flowing to Washington.

- **Less demagoguery.** Class-warfare ideologues criticize the President for "giving a tax cut to his rich friends," but this demagoguery is modest compared to what would have happened if the Administration had tried to end the double tax at the corporate level. Critics would have accused the President of favoritism to corporations at a time when high-profile corporate governance scandals have created an impression that big business is either venal or incompetent.

RESPONDING TO MYTHS

President Bush's tax reform plan—particularly the proposed elimination of the double taxation of dividends—was instantly criticized for benefiting "the wealthy" and lacking "economic stimulus." According to Senator Joseph Lieberman (D–CT), "President Bush hasn't proposed a stimulus plan, instead, he has put forward an irresponsible, ineffective, ideologically driven wish list."[38]

These arguments, however, are firmly grounded in myth, not reality. Specifically:

MYTH 1: Dividend tax relief benefits only "the wealthy."

REALITY: The benefits from eliminating the double taxation of dividends come from at least two sources: economic growth and stock price increases. Roughly 84 million Americans now own equities, either directly or in tax-deferred retirement plans. While it is true that people with stocks in retirement plans will not receive direct tax relief, to say they will not benefit is misleading.

People who own equities through retirement plans own the same equities that other investors own directly. In other words, a share of Microsoft stock owned in an IRA is the same as a share of Microsoft owned directly. Therefore, any increase in the stock price resulting from dividend tax reform accrues to individuals owning the stock both directly and through retirement plans. Additionally, IRS data show that 70 percent of dividend-receiving taxpayers earn less than $55,000 in wage income.[39] Nevertheless, improving overall economic growth is still the most important reason to eliminate the double taxation of dividends.

The double taxation of dividends freezes capital and unnecessarily reduces the return on capital, making it more costly for corporate managers to invest. As a result, managers invest in fewer projects that, in turn, result in fewer jobs. Eliminating this double taxation will lead to increased investment, greater productivity, higher output, more jobs, and more money in people's pockets.

MYTH 2: State and local governments will be hurt if dividends are taxed only once.

REALITY: There are two issues for state and local governments. First, lawmakers from these governments fear that they will have a harder time borrowing money because municipal bonds, which are not subject to double taxation, will no longer be as attractive to investors if dividends are taxed only once. Second, these politicians fear that state and local tax revenues will decline because federal taxable income (which often is the starting point for state and local tax returns) will be smaller.

Both of these concerns are misplaced. Repealing the dividend tax should not affect the market for tax-exempt bonds. Investors buy bonds and stocks for different reasons. While bonds have a market price that is based on the relation of their coupon interest rate to the prevailing interest rate at the time they are bought and sold as modified by the investment rating of their issuer (which measures the risk that the bond will not be repaid), this valuation is very different from that of a stock. According to Mary Miller, Assistant Director of T. Rowe Price's Fixed Income Division,

> Investors often buy bonds to reduce the overall risk of their portfolio. It's then a question of whether to buy taxable or tax-exempt bonds. We entered the year [2003]

38. See Dana Milbank, "Bush Proposes $674 Billion Stimulus Plan," *Washingtonpost.com*, January 7, 2003, *www.washington-post.com/ac2/wp-dyn/A22200-2003Jan7*.
39. See Norbert J. Michel, "Who Really Benefits from Dividend Tax Relief?" Heritage Foundation *Center for Data Analysis Report* No. 03–02, January 7, 2003 at *www.heritage.org/research/taxes/cda03-02.cfm*.

> with tax-exempt bonds attractively priced compared to taxable bonds. We don't think tax-exempt bonds will be substantially affected by this proposal.[40]

The Council of Economic Advisers reached the same conclusion:

> Municipal bond yields are based on the fundamental economic factors of inflation and risk. The proposed Bush tax cut does not change the treatment of tax-exempts. Therefore, it will not impact yields in any material way.[41]

State and local lawmakers are also misguided to worry about potential revenue loss. Assuming states take no action, it is true that the 100 percent dividend exclusion will reduce state revenues by about $4 billion per year, but this looks at only one-half of the equation. If the economy grows faster—which is a certainty if the double tax on dividends is repealed—the reduction in revenues caused by removing dividends from the tax base is more than offset by higher state revenues due to the greater growth resulting from the package.

According to the Council of Economic Advisers, each 1 percent increase in gross domestic product (GDP) boosts income tax and sales tax revenue for state governments by slightly more than 1 percent—roughly $6 billion per year. Since the CEA projects that the President's tax package will increase GDP growth by 0.4 percent in 2003 and 1.1 percent in 2004, this means that state income and sales tax revenue will increase by more than $6 billion.[42] The Treasury Department conducted a wider analysis, looking at the impact of the dividend tax on all forms of tax revenue, including both state and local government, and found that receipts would climb by about $20 billion annually.

In other words, a stronger national economy will increase the tax base for states and result in higher tax collections. The CEA even presented two real-world examples of this phenomenon:

1. In 1982 when GDP growth turned negative (–1.6 percent), state and local governments had deficits of $2.3 billion, compared with surpluses of $7.5 billion in the previous year.
2. In 1998, GDP grew at a rate of 4.8 percent, and state and local governments had surpluses of $40.7 billion, with revenues increasing by 6.2 percent from the previous year.

MYTH 3: Repealing the double tax on stock dividends would result in lower investments in retirement plans such as 401(k) plans.

REALITY: Current law allows workers to protect their savings from the double taxation on interest by using 401(k) accounts or IRAs. This has led some in the industry to fear that these accounts would become less attractive if the double tax on dividends is eliminated. A study by T. Rowe Price, a fund management company, shows that this should not be the case.[43] The study shows that even after the repeal of the dividend tax, a worker would accumulate more in either a 401(k) retirement plan or a Roth IRA[44] than they would by investing the same amount of money in a plan that did not have tax-neutral features.

The study assumed that $1,000 in gross income was invested for 20 years in an account that would

40. T. Rowe Price, "T. Rowe Price's Views on the President's Tax Proposals," at *www.troweprice.com/common/index3/0,3011,lnp%3D10045%26cg%3D1350%26pgid%3D8816,00.html* (March 19, 2003).
41. Brian S. Wesbury and Maria A. Forres, "Monday Morning Outlook: Week of January 27, 2003," Griffin, Kubik, Stephens & Thompson, Inc.
42. Council of Economic Advisers, "The Effect of the President's Growth Package on State and Local Finances," January 8, 2003.
43. Karen Damato, "Retirement Contributions Shouldn't Stop," *The Wall Street Journal*, January 14, 2003, p. C1. Experts at T. Rowe Price were also kind enough to share their calculations with the authors.
44. A 401(k) plan allows workers to invest pre-tax dollars while paying ordinary income taxes on withdrawals after retirement. On the other hand, contributions to a Roth IRA are made in after-tax dollars upon which income taxes have already been paid, but withdrawals after retirement are completely tax-free.

pay 8.5 percent annually, including 2.5 percentage points in dividend income. Funds invested in the 401(k) plan were made in pre-tax dollars upon which no taxes had been paid. On the other hand, investments in the Roth IRA and non-tax–advantaged plan were made after income taxes were paid on the $1,000, which reduced the initial amount being invested to $694 in each case.

After 20 years, the $1,000 invested in the 401(k) plan was worth $4,661, with $1,459 in taxes owed upon withdrawal for an after-tax value of $3,232. Meanwhile, the $694 in after-tax income that was invested in the Roth IRA was also valued at $3,232, upon which no taxes were owed. The amount available from both tax-advantaged accounts was almost 20 percent more than from the taxable account even if the double tax on dividends is assumed to have been repealed. In that case, the $694 in after-tax income grew to $2,757, which after paying income taxes of $145 leaves $2,612, or $620 less than was available from the tax-advantaged accounts.[45]

Thus, even though repealing the dividend tax increases the total amount available from investing $1,000 of gross income by 16 percent, that return is still significantly lower than it would be from investing the same amount in a tax-advantaged 401(k) plan or Roth IRA. There is no reason to assume that changing the dividend tax would reduce the amount invested in either 401(k) plans or Roth IRAs. This is especially true if the employer matched all or part of an employee's contributions to the 401(k) plan. On the other hand, the holders of those tax-advantaged accounts would also benefit from the predicted 10 percent increase in overall stock values that would result from the dividend tax repeal in addition to the value of any dividends from companies that had not previously paid them.

MYTH 4: Corporations and "the rich" pay too little in taxes.

REALITY: First, *corporations* do not pay taxes; *people* pay taxes. Whether they are wealthy investors or hourly wage earners, individuals bear the burden of corporate taxes—some directly, some indirectly. For example, when corporate taxes are levied, less money is left to pay shareholders and workers, and more money is needed to pay taxes. Corporate taxes, therefore, translate into higher prices, lower wages, and lower returns on investment.

Additionally, an entire industry now exists specifically to help corporate managers lower these taxes. Spending money solely to lower the tax burden and to comply with the onerous tax code, as well as to pay the taxes themselves, means that resources are wasted and that workers, consumers, and investors keep less.

This same misguided reasoning is used when critics complain that "the rich" get away with paying too little in taxes. First, calling someone wealthy is subjective. IRS data show that, as of 2000, tax returns with adjusted gross income (AGI) of $92,144 are in the top 10 percent of all income totals.[46] However, this AGI total alone obscures a great deal of information. For example, a single person living in a Houston suburb and earning $92,144 is probably better off than a family of four living on Long Island and earning $92,144.

Even if it is agreed that those taxpayers in the top 10 percent are "the rich," the same data show that this group pays just under 70 percent of all income taxes. In fact, the top 1 percent pays nearly 40 percent of all income taxes despite earning about 20 percent of all income.[47] Regardless of a person's income level, having more money to save, invest, and spend benefits all of society. Punishing success by taking more of every dollar earned away from individuals hurts everyone.

For example, an aspiring young professional with $28,000 in taxable income has a top marginal tax rate of 15 percent, which means that the worker keeps $85 of the last $100 earned.[48] If this person gets a raise and ends up with a taxable income of $29,000, this individual would now move into the

45. With the double tax on dividends still in place, the return from the $694 of after-tax income invested in a non-tax–advantaged account is only $2,251 after taxes of $133 on investment gains, or $361 less than if the dividend tax was repealed.

46. These tables are available from the Joint Economic Committee at *www.house.gov/jec/press/2002/irs2.pdf*.

47. See David Hoffman, "Who Pays the Federal Individual Income Tax?" Tax Foundation *Special Report* No. 118, November 2002.

27 percent bracket and keep only $73 of the last $100 earned, a difference of $12.

Since the 27 percent tax bracket starts at taxable income of $28,400, this reduction in take-home pay applies to the last $600 earned, a difference of $72. Looked at differently, this individual is working for no wages for about five hours.[49] Since the marginal rates continue to rise with income, this situation worsens as more money is earned. Not only does this rate structure discourage work, but it also encourages behavior to lower taxable income, meaning the government ends up with less despite raising tax rates.

This example applies to a broad spectrum of American workers. A 1992 U.S. Treasury Department report found a great deal of income mobility in the U.S. The study divided people into five equal groups (quintiles) classified by income. The results showed that that between 1978 and 1988, about 86 percent of those in the bottom quintile moved to a higher quintile, and 35 percent of those in the top quintile moved to a lower quintile.[50] More recent studies have found similar results, which means that anyone, regardless of current income, could soon find himself or herself among "the rich."[51]

CONCLUSION

President Bush's plan to eliminate the double tax on dividends is a bold and visionary step. His proposal will make our nation stronger and improve the living standards of all Americans. It will make the United States more competitive in the global economy and eliminate a bias against saving and investment. This will mean a significant improvement in the economy's performance.

Ending the double taxation of dividends also is an inherent and necessary component of fundamental tax reform. All proposals to create a simple and fair tax code—such as the flat tax—are based on the notion that income should be taxed only once. President Bush's proposal should therefore be seen as an important step toward a tax system based on sound economics and good tax policy.

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48. This example considers only federal income taxes and uses CCH projections for the 2003 federal income tax brackets (Schedule X: Single Individuals). See CCH, Inc., *2003 Master Tax Guide* (Chicago, Ill.: CCH Inc., 2002), p. 25.
49. Assuming a 50-week year and 40-hour workweek, this individual would earn about $14.5 per hour. The individual would have to work almost five hours to earn $72.
50. See "Income Mobility and the U.S. Economy: Open Society or Caste System?" Joint Economic Committee, U.S. House of Representatives, January 1992.
51. See D. Mark Wilson, "Income Mobility and the Fallacy of Class-Warfare Arguments Against Tax Relief," Heritage Foundation *Backgrounder* No. 1418, March 8, 2001, at *www.heritage.org/research/taxes/bg1418.cfm*.