The Heritage Foundation
Executive Memorandum

No. 876

May 9, 2003

Senate Dividend Plan Fails to Deliver for the Economy

Daniel J. Mitchell, Ph.D.

Not all tax cuts are created equal. Some tax cut proposals will generate more growth by reducing tax rates on work, saving, investment, and entrepreneurship. However, others will have little or no impact on the economy because they merely transfer money from the pockets of one group of people to the pockets of another group. This is why some tax cuts—such as the Kennedy tax rate reductions in the 1960s and the Reagan tax rate reductions in the 1980s—yielded big rewards. This also explains why some tax cuts—such as the Ford tax rebate in the 1970s and the child credit today—have no effect on the economy's performance.

Three Proposals. This analysis also applies to specific issues, such as the taxation of dividends. Under current law, dividend income is taxed two times, once by the corporate income tax and a second time by the personal income tax. There are a number of proposals to address this double taxation, but not all of them will result in equally large benefits. Three major proposals are being considered in Washington.

1. President George W. Bush's proposal would eliminate the double tax on dividend income by sparing individual taxpayers from paying income tax on dividends that were already taxed at the corporate level. It also would eliminate the capital gains tax on re-invested corporate earnings.
2. The House Ways and Means Committee's proposal would reduce the double tax by lowering the tax rate on dividend income to 15 percent—a significant reduction. The 15 percent rate would also apply to capital gains, which is another form of double taxation in the tax code.
3. The Senate Finance Committee's proposal would allow people to protect the first $500 of dividends from double taxation. Above $500, a small percent of dividend income would be excluded from taxation, but even after a five-year phase-in, 81 percent of dividends above $500 would continue to be double taxed.

Produced by the
Thomas A. Roe Institute for
Economic Policy Studies

Published by
The Heritage Foundation
214 Massachusetts Ave., NE
Washington, D.C.
20002–4999
(202) 546-4400
http://www.heritage.org

This paper, in its entirety, can be found at: *www.heritage.org/research/taxes/em876.cfm*

By every possible measure, the President's plan is the best alternative and the Senate Finance Committee's plan is the worst. Indeed, because it would have so little beneficial impact—and therefore discredit the arguments for good tax policy—current law is probably preferable to the Senate plan. According to the following criteria of good tax policy, there is almost no reason to consider the Senate plan:

- **Improve incentives to invest more.** If something is taxed, less of it is produced. Double taxing something compounds the damage so that even less is produced. This is why the double tax on dividends has such an adverse impact on investment. The President's plan solves this problem. The House plan substantially reduces the double tax, but 81 percent of dividends would still be subject to double taxation under the Senate plan, ameliorated only slightly by the 10 percent to 20 percent exclusion. (In other words, 81 percent of dividends would still be double taxed under the Senate plan, and affected taxpayers would pay a second layer of tax equal to 80 percent of their marginal tax rate; i.e., a taxpayer in the 35 percent tax bracket would pay a 28 percent tax on dividend income.)
- **Improve incentives to use capital more efficiently.** The double tax on dividends creates incentives for investors and corporate managers to make decisions based on tax considerations instead of economic considerations. The President's plan largely solves this problem. The House plan substantially reduces this form of social engineering, but the Senate plan does almost nothing to reduce the tax code's backdoor industrial policy.
- **Improve corporate governance.** Current tax law contributed significantly to corporate scandals because both investors and corporate managers faced a perverse incentive to overstate projections of future earnings. The President's plan solves this problem by creating a level playing field for retained earnings (capital gains) and distributed earnings (dividends). The House plan also creates a level playing field, albeit with some double taxation of both dividends and capital gains. The Senate plan, however, will likely have no positive impact on corporate governance issues.
- **Improve international competitiveness.** The United States is one of only three nations to fully double tax dividends, and because the U.S. corporate tax rate is one of the highest in the world, the effective top tax rate on dividends in America is the second highest in the developed world. The President's proposal would dramatically improve America's ranking on this important measure. The House plan would generate a substantial improvement in the U.S. ranking, but the United States would see almost no improvement in its competitive position if the Senate plan were enacted.

Conclusion. Tax cuts could significantly improve the American economy, but only if lawmakers make wise decisions about which taxes to cut and how to cut them. Addressing the double tax on dividends is a big step in the right direction, but the economy will not reap major benefits unless the tax is reduced the right way.

—Daniel J. Mitchell, Ph.D., is McKenna Senior Fellow in Political Economy in the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation.