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Obama's Dividend Tax Proposal Means More Debt, More Instability

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The President has proposed raising the tax on dividend income from 15 to 20 percent while his allies in Congress have created a procedural path whereby the income tax rate on dividends could again reach 39.6 percent. At the same time, it has been suggested by some that the deduction for business interest expense is a subsidy, implying that it should be curtailed or eliminated. Raising the tax on dividends and curtailing the deduction for business interest expense are related in that they would both profoundly influence the capital structures of business. They are also both wrongheaded and harmful.

The President's proposal, in particular, poses special dangers that policy makers should be more sensitive about. Raising the tax on dividends would of course reduce equity values while raising the cost of equity finance and thus reducing the level of investment and wage growth. However, raising the cost of equity finance would also further bias business capital structures in favor of debt over equity. Having seen what too much debt can do to housing markets, major financial institutions, financial markets broadly, and entire countries, tax proposals inducing companies to take on more debt must be avoided.

Debt as a Tool in the Big Picture. Most tools can be used to good purposes or bad. A hammer can drive a nail, or it can swell a thumb. The Internet can spread information in the blink of an eye to the four corners of the globe, or it can be used to numb the brains of teenagers playing games. Recently, two American scientists used a new tool called synthetic biology to create an artificial genome—a living creature with no ancestor—ushering in a technology that may allow scientists to design bacterium that thrive digesting oil spills, for example, or to create new biological weapons.

Debt is likewise capable of producing both good outcomes and bad. It allows those with savings to invest on well-defined terms and expectations for earnings while providing those seeing opportunity to finance their efforts quickly and typically at modest cost the chance to do so. The ability to lend and borrow through capital markets has greatly and directly improved the quality of life for many while raising the economy's ability to grow. But, as has been demonstrated repeatedly in recent years, debt in the wrong hands and in excessive amounts can be as destructive as it is constructive.

The housing boom and bust in the U.S. and elsewhere around the world was fed by excessive debt. The collapse or near-collapse of Bear Stearns, Lehman Brothers, and the other major Wall Street financial houses was due in part to their excessive leverage—too much debt. Greece today is in a sovereign debt crisis because it has taken on too much debt in financing government operations. In this behavior

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the rest of Europe and the U.S. appear to lag by only a few years and may soon face their own debt crises.

Debt is a vital tool for businesses. Businesses finance inventory through debt. They may finance the purchase of new plant and equipment in whole or in part through debt. Businesses seek out opportunities to use the nation's resources better, sometimes by buying other businesses, sometimes by selling their own parts. Debt is a critical component of these merger and acquisition transactions.

Too much debt, however, will put a business at greater risk of failure. Knowing how much debt is too much is a matter for markets to sort through after considering the businesses' near-term and long-term prospects. Avoiding policies that create artificial incentives for households and businesses to take on too much debt is the proper province of policymakers. Unfortunately, Congress and the President seem bent on reinstituting just such a policy by raising the tax on dividends.

A business will typically finance itself through some combination of debt and equity. The exact mix will depend on many factors, but a key factor is cost—cost to the business and ultimately cost in terms of the after-tax return to the business's owners. Under current tax law, interest expense is fully deductible to the business, and interest earned is taxable to the saver at their normal income tax rates, while dividends are not deductible and dividends earned are taxed at 15 percent. The President has suggested raising this tax rate to 20 percent, and there is a very real threat that Congress will allow the income tax rate on dividends to jump to 39.6 percent.

Some have recently argued that allowing a deduction for interest expense subsidizes debt for the business borrower, which in turn suggests that this deduction creates an incentive for businesses to take on too much debt and too little equity. While such an incentive in favor of debt does exist, the cause is the double taxation of dividend income, not the interest deduction. Criticizing the interest deduction on this basis evidences a fundamental misunderstanding of income tax while limiting or repealing the deduction would do significant harm to prospects for job and wage growth.

Interest and the Income Tax. The income tax issue is relatively straightforward. As a matter of simple income tax principles, if interest income is taxed, then tax neutrality is preserved (subject to differences in tax rates) when interest expense is deductible. Neutrality is preserved when symmetry in tax treatment is preserved. In general, interest income is taxable to the recipient (unless the recipient is a tax-exempt organization). Therefore, interest expense incurred by a business ought to be tax deductible.

This principle applies not just to interest expense incurred by businesses but also to interest expense incurred by individuals. The home mortgage deduction, for example, is perfectly appropriate under basic income tax principles because interest income received by the lender is taxed.[1] Likewise, other interest expense incurred by individuals and families such as interest on car loans and credit cards ought to be deductible, though it is not under current law.

It is reasonable to wonder why interest expense ought to be deductible under an income tax while it is not deductible under some other superior tax systems such as the venerable flat tax. Again, the explanation is simple: An income tax base includes all financial flows, including interest income and expense. Note that if the interest recipient and the interest payor face the same tax rate, then no net tax is collected by including interest in the tax base—the tax value of the deduction is equal to the tax paid on the income. In the flat tax and similar taxes, financial flows are generally excluded from the tax base at no loss of revenue. Thus, for example, lenders do not pay tax on interest they earn on business loans and home mortgages, so borrowers receive no deduction.

Interest, Dividends, and Growth. As noted above, interest and dividends are treated differently in the income tax code. Interest is generally treated

1. There is a federal level tax expenditure associated with owner-occupied housing that arises because the implicit rent earned by the owner escapes tax. Limiting the home mortgage deduction as a proxy to capture this tax expenditure is extraordinarily clumsy and uneven.

neutrally, while dividends are not treated neutrally because they are not deductible at the business level but are taxable at 15 percent (the current individual level). This differential treatment means that, everything else being equal, businesses face an important tax bias toward debt, raising the likelihood of failure and economic instability in good times but especially in times of trouble.

There is a right way and a wrong way to address this bias and a third to make it far worse. Unfortunately, the President and like-minded policymakers in the Congress prefer the third way. The wrong way to address the bias toward debt is to raise the tax cost of debt toward that of equity. While this policy would normalize the tax incentives between debt and equity, it would also further increase the hurdle rate businesses use to decide whether to make an investment.[2] Raising the hurdle rate would permanently reduce the stock of capital employed in the economy, reducing the level of output, productivity growth, and wages. In tax policy, as in life, two wrongs rarely make a right.

The right way to reduce the bias in favor of debt is to eliminate the double taxation of corporate income. This could be done most simply by repealing the corporate income tax. Then dividends would be subject to normal income tax rates, and neutrality between debt and equity would follow. Alternatively, one could eliminate the tax on dividends entirely, establishing a new basic symmetry: Interest would be taxable and deductible while dividends would be non-taxable and non-deductible. This solution would also establish neutrality between debt and equity and would do so in a way that reduces the hurdle rate on investment, permanently increasing the nation's stock of productivity capital, output, and wages.

Targeting American Workers. The third way proposed by the President—raising the tax rate on dividends—would exacerbate the bias in favor of debt. In light of the repeated recent financial crises, the folly of this policy should be obvious. It makes no sense to encourage businesses to take on more debt than they would under normal, prudent business practices. The President's proposal would lead to even greater instability in the economy as more businesses would be at risk of failure.

In addition to increasing economic instability, the President's proposal would raise the hurdle rate on new investment, reducing the stock of capital employed in the economy. It may appear to some that proposing to raise taxes on dividends is a way to "soak the rich," but the real targets of this proposal are American workers, who over time would forego in wages far more than the hike in dividend tax rates would collect.

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2. The hurdle rate is the minimum after-tax return required to make the investment. The technical terms are the cost of capital or the service price of capital.