

## Dividends and Tax Policy in the Long Run: Discussion

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In “Dividends and Tax Policy in the Long Run,”<sup>2</sup> Professor Bank reviews the theoretical and empirical literature on dividend taxation, and challenges the conventional wisdom about the consequences of making the 2003 dividend tax cut<sup>3</sup> permanent. Two main conclusions emerge from Professor Bank’s analysis.<sup>4</sup> First, even if the rise in dividend payments observed since 2003 is indeed attributable to the lower tax rate on dividends, it does not necessarily follow that making this tax cut permanent will increase or prolong the higher dividend payments. Indeed, under the “new view” of dividend taxation,<sup>5</sup> firms may have responded to the tax cut by increasing dividends precisely *because* the tax cut was temporary; a permanent tax cut would, in contrast, have elicited no response. Second, efforts to influence corporate and managerial behavior through the tax system are at best fraught with difficulty, and may have counterproductive results.<sup>6</sup> In the following discussion, my aim is to amplify these conclusions, while raising some questions and qualifications. Then, I focus on a neglected element of the 2003 reform, namely its international dimension.

Professor Bank’s first policy conclusion relates to the argument that it is desirable to increase dividend payments,<sup>7</sup> for instance, in order to get free cash flow out of managers’ control. He points out that this aim could be achieved (even under the “new view”) by a policy of “permanent impermanence” where Congress always maintains some positive probability that the tax rate will increase in the future. While this would be difficult to achieve through the political

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<sup>2</sup> Steven A. Bank “Dividends and Tax Policy in the Long Run” 2007 *University of Illinois Law Review* 533 (2007).

<sup>3</sup> This was enacted as part of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA2003).

<sup>4</sup> Bank *supra* note 2, and much of the discussion below, is premised on the assumption that the 2003 dividend tax cut was indeed perceived by firms and investors as being temporary. There are some reasons to believe that this may not be true. For instance, once the tax cut is in place, it is possible to characterize those who oppose its extension as proposing a tax increase. On the other hand, the recent adoption of a “pay-as-you-go” (PAYGO) rule by Congress may work in the opposite direction. For an analysis of how budget rules may affect fiscal outcomes, see e.g. Dharmika Dharmapala “The Congressional Budget Process, Aggregate Spending, and Statutory Budget Rules” 90 *Journal of Public Economics* 119 (2006).

<sup>5</sup> The “new view” is reviewed extensively in Bank *supra* note 2.

<sup>6</sup> The intersection between the tax system and corporate governance is the subject of a growing literature – see e.g. Mihir A. Desai and Dharmika Dharmapala “Corporate Tax Avoidance and High-Powered Incentives” 79 *Journal of Financial Economics* 145 (2006).

<sup>7</sup> It should be stressed that Bank *supra* note 2 does not advocate the view that increasing dividend payments is necessarily desirable; however, this is one of the stated aims of many proponents of the dividend tax cut.

system, there exists a theoretical solution that is economically equivalent. This involves (credibly) enacting a dividend tax schedule in which the tax rate increases over time. To avoid the prospect that the rate may exceed 100% at some point in the future, the tax rate can be made contingent on the age of the firm.<sup>8</sup> For example, for the first 5 years after its incorporation, a firm's shareholders may face a 3% tax rate on its dividends, and a 10% rate for the next 5 years. Firms that are a century or more from their date of incorporation might face very high rates. The rate of increase of the dividend tax rate over the firm's life-cycle can be calibrated to achieve the desired incentive for managers to pay out dividends in the firm's earlier years. In addition, this rate of increase can be varied depending on how responsive firms are to tax incentives at different stages of their life-cycle.

The administrative difficulties of this type of scheme are obvious, as taxpayers would have to keep track of the age of each firm from which they receive dividends. However, proponents of using the tax system to induce higher dividend payout should not scoff too loudly. The policy they propose is (at least under the "new view") economically equivalent to the increasing-rate scheme, though more haphazard (given the difficulty of achieving just the right degree of political uncertainty) and entailing greater costs associated with uncertainty about future policy.

A more fundamental objection is that it may not be desirable to use the tax system to induce larger dividend payments, even if this were feasible. The agency cost argument for increasing dividend payments is premised on the notion that managers will use free cash flow to invest in negative-value projects. However, there are many mechanisms that have emerged to ameliorate agency problems (such as the market for corporate control, and stock-based incentive compensation for managers).<sup>9</sup> Agency costs may also (or primarily) take forms other than over-investment, such as the consumption of leisure by managers, excessive managerial compensation, or the failure by managers to invest in positive-value projects that are too difficult

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<sup>8</sup> This is analogous in some respects to the "generalized cash flow tax" proposed by Alan J. Auerbach and David F. Bradford "Generalized Cash Flow Taxation" 88 *Journal of Public Economics* 957 (2004). There, the aim is to replicate the economic consequences of an income tax (namely, the burden on the risk-free return and the associated intertemporal distortion of consumption) using tax rates on individuals' cash flows that are contingent on the taxpayer's age (and that increase over time).

<sup>9</sup> For a discussion of how the tax system interacts with these mechanisms, see Mihir A. Desai and Dhammika Dharmapala "Taxation and Corporate Governance: An Economic Framework" working paper.

or risky from their point of view.<sup>10</sup> If agency costs are not significant, or if they take forms other than negative-value investments, then tax policies that seek to elicit higher dividend payments may inefficiently distort firms' investment decisions without achieving any significant reduction in agency costs.

To illustrate this last point, consider a stylized example with two periods. At time 0, a firm generates \$1 of earnings and decides whether to retain these funds and invest them, or to pay out the funds as dividends to its shareholders. Retained earnings are assumed to be the only source of funds for investment, so this example is framed within the "new view." Let  $i$  be the rate of return on investment projects available to the firm, and  $r$  be the after-tax rate of return available (outside the firm) to shareholders. At time 1, the returns are realized, and the firm (which has no more investment opportunities) pays out all its earnings to its shareholders. In the absence of taxes, a value-maximizing firm will invest at time 0 only if  $i > r$  (the economically efficient benchmark for investment decisions).

Suppose that shareholders face a dividend tax at rate  $t_d > 0$  (in both periods), and assume there is no corporate tax.<sup>11</sup> If the firm retains the dollar at time 0 and invests it, then its investment will have grown in value to  $(1 + i)$  at time 1; when this amount is paid out at time 1, the dividend tax will be triggered, leaving shareholders with  $(1 + i)(1 - t_d)$ . If the firm were instead to pay out the dollar at time 0, then shareholders would receive an after-tax payout of  $(1 - t_d)$ , which they would invest (outside the firm) at the after-tax rate  $r$ , leaving them with  $(1 + r)(1 - t_d)$  at time 1. This example illustrates the central "new view" intuition – a value-maximizing firm would retain funds and use them to invest at time 0 if and only if  $i > r$  (just as if there were no dividend tax).

Consider instead a system in which the dividend tax is zero at time 0, and is expected to be  $t_d > 0$  at time 1. This assumption reflects (in stylized) form the temporary dividend tax cut enacted in 2003 (or the hypothetical increasing-rate system discussed above). Then, if the firm retains the dollar at time 0 and invests it, shareholders will end up with  $(1 + i)(1 - t_d)$  at time 1, as above. However, if the firm pays out the dollar at time 0, then shareholders receive \$1 (and pay

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<sup>10</sup> For example, Marianne Bertrand and Sendhil Mullainathan "Enjoying the Quiet Life? Corporate Governance and Managerial Preferences" 111 *Journal of Political Economy* 1043 (2003) find evidence that managers pursue a "quiet life" (rather than over-investment) when subject to less monitoring by shareholders.

<sup>11</sup> A corporate tax would create an additional distortion to investment, but would not affect the basic conclusions.

no dividend tax), which grows to  $(1 + r)$  at time 1. Therefore, under such a tax regime, a value-maximizing firm would retain funds and use them to invest at time 0 if and only if:

$$i > \frac{r + t_d}{1 - t_d} \quad (1)$$

Clearly, the minimum rate of return required for an investment within the firm now exceeds  $r$ . If managers have a propensity to over-invest, then this tax regime can potentially counteract that tendency by creating a tax incentive to pay out funds to shareholders. However, if agency costs take forms other than overinvestment, then this tax system may inefficiently induce firms to forego investment opportunities in order to pay dividends. For instance, if managers tend to under-invest, this problem may well be exacerbated by a temporary dividend tax cut.

Finally, while there has been extensive discussion of many aspects of the 2003 tax reform's treatment of dividends, the international dimension has been relatively neglected. In general terms, the 2003 reform can be viewed as an exercise in partial corporate tax integration. Integration has been widely supported by economists and tax scholars as a means of reducing distortions to firms' payout and financing decisions.<sup>12</sup> However, its international ramifications may potentially introduce other distortions, notably in investors' global portfolio allocation decisions. Investors can diversify part of the risk associated with holding domestic equity by investing in foreign equity (which typically is subject to risks that are not perfectly correlated with those in the domestic economy). For reasons that are not completely understood by scholars, investors appear to invest in foreign assets to a lesser extent than might be predicted based on standard economic theories; this is known as the "home bias" in investment.

Efforts to integrate corporate and shareholder taxes may in some circumstances exacerbate the "home bias." For instance, consider a country that offers domestic shareholders imputation credits for corporate taxes paid by domestic corporations. Such schemes typically do not compensate domestic shareholders for corporate taxes paid to foreign governments by foreign corporations in which they own shares.<sup>13</sup> Thus, the integration scheme creates a tax incentive to invest in domestic rather than foreign corporations, potentially causing under-diversification among investors.

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<sup>12</sup> See e.g. R. Glenn Hubbard "Corporate Tax Integration: A View from the Treasury Department" 7 *Journal of Economic Perspectives* 115 (1993).

<sup>13</sup> See e.g. Michael J. Graetz and Itai Grinberg "Taxing International Portfolio Income" 56 *Tax Law Review* 563 (2003).

The 2003 reform achieves partial integration through an alternative mechanism, which amounts to the partial exclusion of dividends from shareholders' income. However, because this exclusion does not apply to all foreign dividends, its impact on diversification may well be similar to that of the imputation system described above. The lower rate for dividends enacted in 2003 applies to dividends paid by domestic corporations and by "qualified" foreign corporations. Dividends paid by foreign corporations can qualify for the reduced rate under any of three tests.<sup>14</sup> First, corporations resident in a US possession (such as Puerto Rico) automatically qualify. Second, corporations resident in a country with which the United States has a tax treaty that satisfies certain information-exchange requirements also qualify.<sup>15</sup> Finally, corporations whose shares are traded in the United States are also eligible for the favorable dividend tax treatment. To the extent that these categories exclude some foreign corporations whose shares are valuable to US investors from the standpoint of risk diversification, the 2003 tax reform may distort the international portfolio allocation decisions of US investors. This effect may well be significant, in the light of emerging evidence of the sensitivity of foreign portfolio investment to taxes.<sup>16</sup>

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<sup>14</sup> See Hale E. Sheppard and Scott A. Harty "Tax Treatment of Foreign Dividends under JGTRRA: Ambiguities and Opportunities" 15 *Journal of International Taxation* 20 (October 2004) for a more extensive discussion.

<sup>15</sup> The countries with which the United States has treaties meeting these requirements are listed in IRS Notice 2003-69 ("United States Income Tax Treaties That Meet the Requirements of Section 1(h)(11)(C)(i)(II)").

<sup>16</sup> See Mihir A. Desai and Dhammika Dharmapala "Taxes, Institutions, and Foreign Diversification Opportunities" National Bureau of Economic Research Working Paper #13132, 2007.