

The Dividend Bounce

By **Burton G. Malkiel**

The firestorm of criticism that greeted President Bush's proposal to eliminate the income taxes individuals pay on dividends was fierce—and predictable. Critics have attacked the plan for favoring the wealthy without any beneficial effect on economic activity. But the complaints obscure many real advantages.

The president's proposal would have important long-term benefits. It will eliminate the tax-induced incentives that make corporations adopt overly leveraged capital structures and contribute to a misallocation of corporate resources. It will boost stock prices, improve credit equity, and strengthen corporate governance. The proposal is worthwhile because it will both stimulate the economy and have important effects on long-run efficiency.

Dangerous Buildup

The present system has had two undesirable effects. First, it has encouraged a dangerous buildup of debt at the expense of equity financing. Because interest is tax deductible to businesses, the cost of debt financing is made artificially low relative to equity financing, and firms are encouraged to adopt a leveraged capital structure.

High debt levels make the economy less stable. Any protracted weakness in economic activity can turn a heavy debt burden into a killing one. High debt levels have been associated with many of the large bankruptcies during the recent two years. While interest rates today are at 40-year lows, risk spreads in the corporate bond market are at 40-year highs.

Second, the tax system has encouraged a dramatic change in corporate dividend behavior. To the extent that stocks are held outside of tax-advantaged retirement plans, dividends are taxed at regular income-tax rates while capital gains are taxed at much lower rates if realized. More important, the tax on unrealized capital gains is deferred and can be eliminated completely if stocks are bequeathed to one's heirs. Small wonder that stockholders in companies like Cisco recently voted 10 to one against the company paying cash dividends.

The bias against dividends has also been influenced by employee stock-option programs. The optionee does not receive credit for divi-

dends paid but does benefit if funds are used to buy back shares creating capital gains. Fewer companies today pay dividends and those that do so have been increasing their dividends far more slowly. Dividend payout ratios—the proportion of earnings paid out in dividends—have fallen from close to 60% in the 1960s to just over 30% today. The percentage of large nonfinancial firms paying dividends has fallen from over 80% in the early 1960s to just over 50% today.

This shift has created distortions: The unfavorable treatment of dividends encourages a misallocation of capital by favoring retained earnings over cash payouts. If corporate earnings are retained, they are taxed only once. Thus, the tax laws incentivize corporate managements to retain earnings. Particularly during the ebullient markets of the late 1990s, managers reinvested earnings in acquisitions with questionable payoffs. It is, I suspect, not accidental that most of the major recent corporate

Ending double taxation would mean a powerful rally.

scandals, and some of the most glaring instances of misallocation of resources, occurred in companies that paid no dividends. The payment of dividends imposes a discipline on management to insure that corporate resources are spent only on projects that can pass an external market test.

By eliminating the personal income tax on dividends, the tax system will become more even-handed in the treatment of debt and equity. While debt financing will retain the advantage of allowing interest to be deducted from corporate taxes, interest received will continue to be fully taxable when held outside of tax-advantaged retirement plans. Dividend payments will come after the payment of corporate taxes but the recipients will not be taxed. Assuming an average marginal corporate and individual tax rate of, say, 35%, both debt and equity would be treated in roughly an equivalent fashion.

No one can be completely certain of all the factors that have determined stock market prices over recent periods. Markets sometimes take trips to the loony bin in both directions. It may well be that the period of overexuberance that ended in March of 2000 has been followed by an overreaction of pessimism in recent months

with worries about a soft economy and a variety of geopolitical risks. But at least one factor in the stock market's woes has been the decline in dividend payouts—a situation which tax-relief will change.

In an environment where reported earnings are viewed with some degree of skepticism, cash dividends will provide a very strong signal to investors of true financial strength and of the credibility of earnings reports. Even John Chambers of Cisco has made clear that Cisco would reconsider its “no dividend” policy if the tax law were changed.

Other advantages would follow as well. Firms would be encouraged to compensate managers with stock grants rather than options and the interests of shareholders and managers could be brought even closer together. Managers would be required to hold the stock so that they would benefit only if their actions were in the long-run interests of the corporation and its shareholders.

The encouragement of larger dividend payments would signal that managers were willing to let shareholders participate in decisions regarding corporate investment. It would also give shareholders a degree of confidence in the future distribution of cash flows. As Morgan Stanley strategist Steven Galbraith has noted, share buybacks are like dating, while dividends are like the commitment of marriage. If firms increased their payout ratios closer to historical levels, the dividend yield for the market as a whole would appear especially attractive relative to government bond yields.

Lifting Uncertainty

My guess is that eliminating the double taxation of dividends would lead to a powerful rally in stock prices and would do much to lift the penumbra of uncertainty that has bedeviled both consumers and corporate managers. The U.S. is one of the few countries in the world where dividends are taxed at both the corporate and the individual level. Treating debt and equity in an equivalent fashion will eliminate a major distortion in the tax code.

In the longer run, the effect on corporations and the economy will be unambiguously beneficial.

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