Kramer's Corner

The Double Taxation Deficit: How to Put Trillions Back into the Pockets of Americans

PHOTOS

Click image to enlarge

RELATED INFORMATION

Kramer's Corner Archive

Show Navigation

This Week's Show
Last Week's Show
Terry Keenan's Bio
mailto:cash@foxnews.com

Cashin' In Home

COMING UP ON FNC

The O'Reilly Factor
Wed. 8 pm / 11 pm ET

Should taxpayer money fund public schools for gays? O'Reilly weighs in.

FNC Schedule

Friday, October 18, 2002
By Hilary Kramer

FOX NEWS

***DISCLAIMER*: THE FOLLOWING "The Double Taxation Deficit: How to Put Trillions Back into the Pockets of Americans" CONTAINS STRONG OPINIONS WHICH ARE NOT A REFLECTION OF THE OPINIONS OF FOX NEWS AND SHOULD NOT BE RELIED UPON AS INVESTMENT ADVICE WHEN MAKING PERSONAL INVESTMENT DECISIONS. IT IS FOX NEWS' POLICY THAT CONTRIBUTORS DISCLOSE POSITIONS THEY HOLD IN STOCKS THEY DISCUSS, THOUGH POSITIONS MAY CHANGE. READERS OF "The Double Taxation Deficit: How to Put Trillions Back into the Pockets of Americans" MUST TAKE RESPONSIBILITY FOR THEIR OWN INVESTMENT DECISIONS.**

Corporate mismanagement and accounting fraud have done great damage to the stock market and to the United States economy in the past year. Although justice is being served as crooked CEOs and accountants are starting to get what they deserve, investors and the American people as a whole should not be made to suffer further, as corporate corruption is compounded by mismanagement of the political economy. Indeed, one of the ongoing “scandals” of our time is how Washington has managed to escape blame for creating many of the moral hazards that have clouded the minds of corporate chiefs -- and the balance sheets of so many companies. At a time of uncertainty, the time is now for clear thinking about the economic future, as well as the past.

Investors and the American people have lost more than $8 trillion of wealth from the stock market meltdown. The Dow Jones Industrial Average now sits close to 3,500 points below its high of 11,723 reached on January 14, 2000. To get a gauge of the tremendous loss of wealth, consider as a hypothetical scenario: what would have happened if the bull market of 1982 to 2000 had continued through to today? From 1982 to 2000, the Dow Jones Industrial Average began at 777 and rose at a historical rate of 16.1 percent per year. If this rate had continued, we would today -- thirty-three months later -- have a Dow in the range of 15,500.

Does this immense loss in wealth merit our attention? If so, then, we owe it to ourselves to think about tax policy. We must think about the DTD -- the Double Taxation Deficit -- that has robbed our economy of trillions of dollars in lost dividends, output, and wages.

So, what are we to do? After the corporate crooks have been led away in handcuffs, American must face up to the fact that tax policy in Washington has also contributed to the problem by creating perverse incentives and morally hazardous temptations for corporate executives to manipulate earnings. In particular, we need to look at the bigger picture and abolish one of the biggest sources of economic distortion and disincentive of all: the double taxation of dividends.

The double taxation of dividends works this way: Today, on average, there is a 35 percent tax on corporate income and then stockholders also pay regular income taxes on dividends received at their individual tax rates. So, dividends are taxed once as part of corporate earnings, and again as the personal income of the investor who receives the dividend. This means the effective rate on corporate profits is as much as 60 percent. If private investment capital is the lifeblood of our economy, and tangible returns on that capital represent the reward investors reap for taking risk, we must end the perverse incentive for corporations to avoid “dividending income” to common shareholders. In other words, we must stop the hemorrhaging.

Why must the double taxation of dividends be abolished? Why should income be taxed only once and then be left alone? Because it would be a swift and effective way to attack our economy’s problems and help bring us out of the bear market. As noted above, trillions of dollars are at stake. Consider these facts:

• Dividend taxation distorts the attractiveness of different sectors in the market: With a higher effective tax rate on dividends of 60 percent relative to the maximum 20 percent on capital gains, most investors are naturally inclined to purchase risky growth stocks in order to generate a higher rate of after tax return. Who wants to buy and hold real companies that pay out real profits to their shareholders when it means huge tax payments? So this is why so many corporations have stopped paying dividends -- even when the cash is plentiful and available for distribution. In fact, in 1987, 85 percent of the companies in the S&P 500 paid a dividend and today that number has dropped to 70.2 percent. Additionally, of the companies that do pay a dividend, nearly all decide to declare a smaller dividend to shareholders than they could afford to distribute. Steve Galbraith, chief economist at Morgan Stanley comments on the status and implications of the decrease in dividend payouts. He says, “The dividend payout ratio on the S&P 500 today is 15 percentage points below long term averages. Putting an average payout ratio on current earnings would actually result in among the highest dividend yields versus government bonds in about 30 years.” Now, if that were the case, imagine the investors that would swarm into the equity markets. Even the bond bulls would change direction.

• Investors have too much incentive to speculate on volatile and risky stocks: Investors, especially during the bubble years of the late 1990's, sought out hype stocks that might pop--that is, company's whose stock prices would rise quickly. By investing in these high flyers, an investor could make a quick and profitable return. The incentive to make this "killing" was clearly motivated by the benefit of a 20 percent capital gains tax. So, holding a stock for only 52 weeks meant a tax of only 20 percent while anything less than 52 weeks translated into a tax that couldn't be any higher than an investor's income tax rate. Compare this approach to investing to the traditional and more conservative way to make money in the markets: seek out companies which have a tradition of paying dividends to their shareholders -- of sending a portion of their profits to their owners -- those who have purchased company stock. These companies tend to be old and established, with a long record of reliable though unexciting performance.

• Many profitable companies are hording their cash: It is one thing for a company not to pay a dividend in order to fund growth, but the problem is that companies that could be paying a dividend to their loyal shareholders are, instead, hoarding cash. Why? Because their own shareholders don't demand the dividend because they favor the expectation that the earnings will be used to lift the share price instead of paying-out a dividend. So, there sits Microsoft with $31 billion of cash and short term assets in its piggy-bank. This might be the best use of Microsoft's money, but it may also be a legal tax shelter that is not necessarily desirable to its shareholders, or the economy. Additionally, there are many companies that actually do pay a dividend, but at a rate way below where they should be distributing.

• Current Tax Policy Hurts Investors and Corporate Responsibility: Traditionally, stocks were valued based upon expected future dividends. In their book, *Dow 36,000: The New Strategy for Profiting From the Coming Rise in the Stock Market,* James K. Glassman and Kevin A. Hassett explain how dividend yields were once an important driver for the value of a stock. As they argue, "Dividends and dividend growth…are essential" to their optimistic scenario. But any positive scenario can be derailed by an anti-growth governmental system. The tax-rate-caused dividend drought of the past few decades means that investors must value stocks based on a corporation's earnings statement, which can be manipulated, as demonstrated by the recent corporate accounting scandals. But, as dividends can only be paid out of retained earnings that actually exist, eliminating the dividend will help to promote honest accounting practices and renewed confidence among investors. Then we will avoid much of the fraudulent financial reporting that has emerged as a major culprit in bringing down corporations. For example, WorldCom reported more than $7.1 billion in earnings that never really existed.

• Corporate executive's interests are misaligned with shareholders: Many corporate executives are paid a large percentage of their compensation through stock options—the right to by company stock in the future at today's price. Stock options were intended to provide incentives to executives to try to create a profitable and valuable company. But, stock options can also encourage executives to make the company seem more successful through accounting tricks and gimmicks. Instead of long-term growth, some "bad" executives are tempted to make a quick buck by cashing in their overvalued stocks as fast as possible before the shareholders and Wall Street analysts can decipher the real state of the company.

• Investors will go back into the stock market: Individual investors have been badly hurt by the meanest bear market since 1929-1932. With investors distrustful of the propaganda-promise spewed by the telecom and dot-com bubbles, a tax-free dividend or real cash would signal real profits and real promise and real incentive to investors to jump back into equities. This time, however, the incentive will be investment in companies that make money instead of promises. Steve Galbraith of Morgan Stanley writes on this point:

"In addition to unscrupulous management, what do most stock frauds share in common? No Dividends…But dividends require cash in order to be paid, cuts in dividends require board approval, and dividends have historically contributed around 40 percent of total investment returns. In short, dividends can serve as a wonderful governor in a world prone to emotional excesses."

The bottom line is that companies tend to spend their money making capital expenditures that hurt rather than grow the bottom line. Dividends would prevent the tendency towards excessive acquisitions and expenditures.

• Seniors are disadvantaged: As the Congressional Budget Office notes, "Senior citizens are more likely to invest in stocks that pay out their income in the form of dividends." It is also important to note that very often dividends -- with the exception of social security -- make up a greater percentage of senior citizens' income than capital gains, wages, and other income, especially for the lowest income senior citizens. Accordingly, eliminating the double taxation of dividends will significantly help seniors who depend on dividends for income during their retirement. Seniors could turn to dividend yielding stocks as an alternative and complement to bonds and certificates of deposit.

• The tax system causes companies to over-leverage their balance sheets: Since interest costs, but not dividend payments, are deductible, executives have been influenced to issue debt to raise capital. The effect of this leveraging has consequences. For example, a company with excessive debt can end up with a lowered credit rating which then scares off potential investors and can become a downward self-fulfilling prophecy. At the worst end of the spectrum, companies can end up like WorldCom, Global Crossing, and even Enron. Why? Because these companies tapped into the bond market to finance their imaginary future instead of tapping into the equity markets where they would have to answer to the questions of actual owners who would be buying into companies based on the expectation of real profits in the immediate future -- not twenty years out.

• The double taxation of dividends restricts economic growth: The double taxation of dividends has reduced the standard of living for all Americans, especially the very people that wealth redistribution was intended to aid -- by reducing economic growth. Eliminating the double taxation of dividends will free up new capital needed to make investments in technology, which increases labor productivity, and subsequently raises the incomes of workers and reduces the price of goods for consumers. More investment means more jobs and more jobs means more thriving tax payers out there.

Most countries in the world today do not have a double taxation on dividends. The American Council for Capital Formation, in a recent study, determined that 62.5 percent of all industrialized nations provide complete or partial offsets to the double taxation of dividends on the corporate level. Also, an additional 25 percent of those countries gave shareholders a break of some sort on the taxation of the dividends they receive.

Interestingly, Americans once received a break on dividend income. In 1954, there was a $100 exemption per couple that grew to $400 in 1980 (approximately $1000 in 2002 prices). The 1986 Tax Reform Act repealed the exemption and no further legislation was passed.

President Bush, responding to the difficulties of the market and the economy, hosted an economic forum on August 13, 2002 at Baylor University in Texas to “foster discussion of new ideas for economic growth.” One of the headline topics was the detrimental effect of the double taxation of dividends on our market and economy. Certainly, there are supporters of the repeal in the current administration. In fact, according to the *Wall Street Journal*, Glenn Hubbard, Chairman of the Council of Economic Advisors, co-researched and produced a 1992 study that concluded, “Cutting dividend taxes would make it cheaper for companies to raise money by issuing shares and also make the firms more stable”. To be sure, the loss in tax revenue to the Treasury was estimated to be $13 billion annually. That may sound like a lot, but it was less than 0.2 percent of GDP back then. Moreover, even the smallest increase in economic growth resulting from the elimination of double taxation would put even more money back in the Treasury. In fact, the study suggested that in the final “net-net” calculation, there would be an ultimate increase in tax receipts of $40 billion back to the government.

Federal Reserve Chairman Alan Greenspan is a proponent of eliminating the double taxation. In July 2002, Greenspan suggested that the double taxation of dividends was to blame for corporate America’s single-minded focus on earnings and the rash of accounting scandals, since lower taxes on capital gains make those more preferable to investors. Mr. Greenspan urged policies to re-emphasize dividends; during times when dividend payments were higher, he said, “One of the problems that we did not have… is earnings manipulation”.

On September 3, 2002, Congressman Christopher Cox, R-Calif., introduced a bill to repeal the double taxation of dividends. This bill, called “The Investor Protection, Market Stabilization, and Tax Fairness Restoration Act” has stalled for now and this critical and economy-saving measure has been lost in Washington as the November elections have held up any steps forward on this bill. In fact, there has been vehement opposition to this proposal as the liberal democrats believe that a dividend tax cut would represent a $50 billion loss in tax revenue and that it would reduce funds for the middle class. Senate Majority Leader Tom Daschle said:

"I would simply ask the question: How much deeper in debt, how many more Social Security dollars do we jeopardize with further proposals like this one?"

Senator Daschle should be applauded for his concern for senior citizens and for keeping the federal budget in balance. But, the challenge for investors worried about the DTD -- the Double Taxation Deficit -- is to help Senator Daschle and others understand that the best way to expand the pie is to stop slicing away 60 percent of it.

EMAIL THIS ARTICLE PRINTER FRIENDLY BECOME A FOX FAN

BACK TO HOME BACK TO TOP