United States Senate
Democratic Policy Committee Hearing

"Is the Bush Economic 'Stimulus' Plan Effective, Fair, and Fiscally Responsible?"

Chris Edwards
Director of Fiscal Policy, Cato Institute

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Mr. Chairman and members of the Committee, thank you for inviting me to testify today on proposals regarding dividend taxation being considered by Congress.

President Bush has proposed reducing taxes on corporate earnings distributed as dividends. Dividend tax cuts would boost the stock market, lessen the tax code bias against savings, and reduce incentives for firms to take on too much debt and to excessively retain earnings.

Earnings distributed as dividends may face both the 35 percent corporate income tax and the individual income tax, which has a top rate of 38.6 percent. This double taxation leads to federal marginal tax rates of up to 60 percent.[1] By contrast, interest is deductible to the corporation and thus only taxable at the individual level.

The Bush administration's plan to fully exclude dividends from tax at the individual level would save taxpayers a projected $364 billion over the next ten years.[2]

U.S. Has the Second Highest Dividend Tax Rate in the OECD

Nearly all major nations allow full or partial relief of dividend double taxation, and thus have lower top dividend tax rates than does the United States. Indeed, the latest data shows that the United States has the second highest dividend tax rate in the 30-nation Organization for Economic Cooperation and Development (see Figure 1).[3] The OECD data includes corporate and individual taxes imposed by both national and subnational governments.

[1] Calculated as 35% + 38.6%*(1–35%).

[2] Council of Economic Advisors, "Eliminating the Double Tax on Corporate Income," January 7, 2003.

[3] Data is from the OECD Tax Database emailed to author from OECD–Paris, January 13, 2003. See also Isabelle Journard, "Tax Systems in European Union Countries," Working Paper no. 301, OECD, June 29, 2001.

Problems Caused by High Dividend Taxes

High dividend tax rates reduce economic growth by creating numerous distortions. First, high dividend taxes add to the income tax code's general bias against savings and investment. Second, high dividend taxes cause corporations to rely too much on debt rather than equity financing because interest is deductible against the corporate income tax but dividends are not. Highly indebted firms are more vulnerable to bankruptcy in economic downturns. Third, high dividend taxes reduce the incentive to pay out dividends in favor of retained earnings. That may cause corporate executives to invest in wasteful or unprofitable projects. Fourth, high tax rates on dividends and other types of capital income greatly increase the wasteful efforts of financial engineers to design ways of avoiding taxes.[4]

Methods of Relieving Double Taxation

Table 1 shows that 27 of 30 OECD countries have adopted one or more ways of reducing or eliminating dividend double taxation.[5] Only Ireland, Switzerland, and the United States do not relieve double taxation. However, Ireland's corporate tax rate is just 12.5 percent compared to the U.S. federal rate of 35 percent.

Individual rate reduction. Numerous countries set the tax rate on dividends lower than the ordinary top rate on wages, including Austria, Belgium, Italy, Korea, the Netherlands, Poland, and Portugal. Some countries, such as Finland, Norway, and Sweden, have "dual income tax systems" that impose high rates on wage income but lower flat rates on all forms of capital income. (The second column in Table 1 shows the maximum individual tax rate on dividends if it is lower than the ordinary top rate).

Individual exclusion. Two countries, Germany and Luxembourg, provide a 50 percent dividend exclusion to individuals (e.g. if $1,000 in dividends is received, only $500 is taxed). Greece fully exempts domestic dividends from individual taxation.

Individual credit. Numerous countries provide individuals a dividend tax credit to fully or partially offset the corporate income tax paid on the earnings.[6] Countries offering partial credits include Canada, France, and the U.K. Countries providing credits that fully offset double taxation include Australia, Finland, Italy, Mexico, and New Zealand. Norway provides a full dividend credit and has a flat individual rate of 28 percent on all

[4] William Gentry and R. Glenn Hubbard, "Fundamental Tax Reform and Corporate Financial Policy," National Bureau of Economic Research Working Paper 6433, February 1998.

[5] Table 1 was complied by the author based on Ernst & Young, "The Global Executive 2002," October 2001; Paul van den Noord and Christopher Heady, "Surveillance of Tax Policies," Working Paper no. 303, OECD, July 17, 2001; and various other sources. Credits, exemptions, and lower rates are often only available for domestic investments.

[6] Often called the "dividend imputation" method.

capital income, with the result that it has the lowest combined dividend tax rate in the OECD (see Figure 1).

Corporate deduction. Dividends can be given parallel treatment to interest by allowing corporations to deduct dividends at the corporate level. The Czech Republic and Iceland allow a partial dividend deduction.

Conclusion

There is a global trend toward lower tax rates on all forms of capital income, including corporate income taxes and individual taxes on dividends and capital gains.[7] Policymakers in many countries are recognizing that high capital income taxes distort savings and investment decisions and reduce economic growth. In this country, Congress should begin reforming the tax code in line with global trends and reduce the high tax rates that are currently placed on dividends.

Thank you for holding these important hearings, and I look forward to working with the Committee on these issues.

[7] See Chris Edwards and Veronique de Rugy, "International Tax Competition, A 21st Century Restraint on Government," Cato Institute Policy Analysis no. 431, April 12, 2002.

Note: Data is for 2001 and 2002 for a resident in the top tax bracket.
Source: OECD Tax Database. Email to author from OECD–Paris January 13, 2003
Note: Data is for domestic investment. Foreign investment may face different rules.
Sources: Author based on 2001 and 2002 data from Ernst & Young and OECD.