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Tax Fairness: Does Double Taxation Unfairly Target Older Americans?

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Introduction

Mr. Chairman, and Members of the Committee, thank you for asking me to testify on the issue of double taxation and the potential economic effects of the President's tax proposal.

My name is Mark Crain. I am a professor of economics and Director of the Center for Study of Public Choice at George Mason University in Fairfax Virginia. I teach and conduct research on public finance, fiscal policy, government regulation, and political economy. I also currently serve as a Trustee of the Virginia Retirement System (VRS) and chair two VRS committees, the Optional Retirement Plan Committee, and the Corporate Governance Committee. My goal today is not to advocate for particular policies, but rather to analyze issues from an economic perspective.

I would like to highlight three analytical issues related to the President's proposal to exclude dividends from the federal income tax. First, I would like to highlight the economic distortions caused by double taxation of corporate dividends. Second, I would like to highlight the potential for improving corporate governance if dividends are excluded from taxation. Third, I would like to provide an analysis of the latest data showing that older workers and seniors are likely to benefit disproportionately from the President's proposal to exclude dividends from taxation. The first discussion that follows provides an assessment of the best evidence on the economic efficiencies that can be achieved by excluding dividends from federal income taxes.

The Impact of the Dividend Exclusion on Productivity and Living Standards

The President's proposal has two major features. The first is that dividends are excluded from federal income taxation. The second feature is that corporations have the option to create internal accounts that raise the tax basis for individual taxpayers and have the effect of reducing the taxable capital gain for shareholders.

To analyze the impact of these proposed policy changes, it is important to note that research on economic growth universally recognizes the fundamental role of well-functioning financial markets. The reason is straightforward: financial markets provide the mechanism whereby national savings are channeled into new investments in plants and equipment. The rate of investment, in turn, determines whether the available stock of capital per worker increases, decreases, or remains the same. The amount of capital per worker is a critical determinant of how much the nation produces, and how much the nation produces ultimately determines its standard of living.

The current system taxes corporate profits distributed to shareholders twice — once at the shareholder level and once at the corporate level. This policy of double taxation affects capital markets, and thereby limits living standards, in two ways. First, it lowers the incentive to save and invest simple because the return on investments are lower than they would be without double taxation. Second, for a given amount of savings, double taxation of dividends distorts incentives (in financial markets) to channel these funds into investment activities that would produce the highest return — that is, into those investment activities that would be the most productive and generate the highest living standards.

On the first point — the impact of double taxation on the amount of national savings and investment — the economic literature provides a mixture of theoretical predictions and results.[1] A cautious reading is that the elasticity of saving with respect to dividend taxation is small; that is, the impact on total savings and investment might not be substantial. However, on the second point — the impact of double taxation on the efficiency of capital markets — the theoretical analysis and empirical evidence is compelling. First, double taxation creates an incentive to invest in noncorporate rather than corporate businesses. Second, it creates an incentive to finance corporate investments with debt rather than new equity. And third, corporations have a distorted incentive to retain earnings or to structure distributions of corporate profits in a manner that avoids the double tax.

James Poterba and Lawrence Summers provide the most relevant empirical evidence on these issues in a series of studies.[2] Their analyses provide three important findings regarding the effects of a reduction in dividend taxation rates: an increase in dividend payouts, an increase in corporate spending on investments, and a reduction in firms' cost of capital. In other words, reducing or eliminating dividend taxation

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[1] The landmark study is Arnold C. Harberger, "The Incidence of the Corporate Income Tax," *Journal of Political Economy*, Vol. 70, June 1962. For a review of further developments, see Jane G. Gravelle, "The Corporate Income Tax: Economic and Policy Issues," *National Tax Journal*, Vol. 48, June 1995. Also see CRS Report for Congress The Taxation of Dividend Income: An Overview and Economic Analysis of the Issues October 7, 2002, Gregg A. Esenwein and Jane G. Gravelle.

[2] James Poterba and Lawrence Summers, "Dividend Taxes, Corporate Investment, and Q," Journal of Public Economics 22 (1983), 135-167. James Poterba and Lawrence Summers, "New Evidence that Taxes Affect the Valuation of Dividends," Journal of Finance, 39 (1984), 1397-1415; and James Poterba and Lawrence Summers, "The Economic Effects of Dividend Taxation," in Altman and Subrahmanyam, eds. Recent Advances in Corporate Finance, Irwin, 1986.

facilitates the incentive of corporations to raise equity capital, as opposed to debt-financed capital, and this gets channeled into the purchase of new plants and equipment.

Furthermore, increased dividend payouts of income also increases the liquidity of capital so it can seek higher productivity sectors. That is, eliminating the dividend tax will change the incentive for firms to retain earnings and increase payouts to shareholders, and shareholders can invest this capital in other, higher return opportunities.[3]

Finally, critics argue that excluding dividends would only affect a small subset of equity holders because most assets are held in tax-deferred plans (IRAs, 401(k)s, annuities, and other pension plans). That is, the benefit of tax-free dividends does not benefit all investors. This understanding is incorrect. The elimination of double taxation will improve the efficiency with which capital markets channel funds into the most productive investment opportunities, thereby increasing potential returns for all shareholders. This improved efficiency and increases in shareholder returns comes in part from changes in what might broadly be labeled corporate governance practices.

Potential Consequences for Corporate Governance

As noted above, the evidence indicates that the exclusion of dividends from federal taxation will increase dividend payouts. Dividends now represent 30% of corporate earnings, down from 60% 40 years ago. Aside from the obvious gain to shareholders in the form of income, dividend payments provide an added advantage: a relatively low cost way for shareholders to monitoring the performance of corporate management. When dividend taxes are eliminated and dividend payments become the norm, shareholders will find it cheaper to monitor management, and do more of it.

Under the current double taxation system, managers have added incentive to retain corporate profits for acquisitions and stock buybacks to raise stock prices and benefit option holders. This represents capital that is locked-in and unavailable to shareholders to invest in other, higher return options. In effect, as noted above, the tax induced incentive to retain earnings drives a wedge between managerial interests and the ability of shareholders to seek higher investment returns in the broad capital market.

Finally, because the President's plan for dividend tax relief goes only to shareholders of corporations that paid taxes, firms will need to provide an accounting of the percentage of profits not taxable as dividends (or as "deemed dividends"). This accounting information will provide valuable information with which investors can assess a company's true profitability. That is, the President's plan will generate information and increase transparency about corporate performance.

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[3] Poterba and Summer (1986) state this effect succinctly. Under double taxation, "manager's ask will this investment project raise share values by as much as it reduces the after-tax dividend income of shareholders? And they undertake some investment projects that do not raise the firm's value by the project's full cost."

Older Workers and Seniors Benefit Disproportionately from Dividend Tax Exclusion

The high levels of capital accumulation after a lifetime of work are the untold story by the mainstream press and critics of any proposal to reduce tax burdens on capital. Median and mean net worth generally peaks in the 55-64 age group. This pattern largely reflects life-cycle income, savings, and asset accumulation behavior. For example, younger families invest in their education and build a household while gaining work experience in lower income entry-level and early mid-level employment opportunities. This lowers their propensity to save and accumulate financial assets. However, as they move out of their early work years, they can expect to increase their net worth as a result of increased income and savings.

Ninety-three percent of American families held financial assets in 2001, according to the recently released Federal Reserve Survey of Consumer Finance.[4] Financial holdings include funds in checking accounts, certificates of deposit, savings bonds, corporate and government bonds, stocks, mutual funds, retirement accounts, life insurance, and other assets.

Table I shows that a disaggregated analysis further indicates that fifty-two percent of all families have stock holdings directly, in mutual funds, retirement accounts, and other managed assets.

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[4] This testimony presents an analysis of data on the real and financial wealth of U.S. families in 1992, 1995, 1998, and 2001. The data are from the tri-annual Survey of Consumer Finance (SCF) collected by the Federal Reserve Bank. The SCF provides data on the income, assets, and demographic characteristics of large representative samples of the non-institutionalized population of the United States. These are the most recent data on family wealth released by the Federal Reserve Bank.

TABLE I
FAMILIES HAVING STOCK HOLDINGS, DIRECT OR INDIRECT: 1992, 1995, 1998, 2001

Age of Head	1992	1995	1998	2001
<35	28.4%	36.6%	40.8%	48.9%
35–44	42.4%	46.4%	56.7%	59.5%
45–54	46.4%	48.9%	58.6%	59.2%
55–64	45.3%	40.0%	55.9%	57.1%
65–74	30.2%	34.4%	42.7%	39.2%
>75	25.7%	27.9%	29.4%	34.2%
All Families	36.7%	40.4%	48.9%	51.9%

Source: Ana M. Aizcorbe, Arthur B. Kennickell, and Kevin B. Moore. Federal Reserve Bulletin, January 2003. "*Recent Changes in U.S. Family Finances: Evidence from the 1998 and 2001 Survey of Consumer Finances*"

Family stock ownership rates are higher among families headed by persons age 35 and older. Families with heads age 35–64 have stock ownership rates of almost 60 percent; compared to just under 50 percent for families with a head of household under age 35. This is consistent with expectations of life-cycle income and wealth accumulation behavior.

Families headed by persons age 65 and older have significantly increased their stock ownership rates over the past 10 years. This group has increased their stock holdings by 30 percent over the past decade. As might be expected in a life-cycle analysis, seniors tend to shift their stock holdings to less dynamic investment instruments.

Though families headed by a person age 65 and older have somewhat lower stock ownership rates than the overall rate, Table II shows the median value of their holdings is significantly higher than younger Americans. For families with stocks, the average median value of stock holdings headed by persons age 65-74 is $150,000; over age 74 is $120,000. Younger families again have a lower median value of stock holdings, ranging from $7,000 for under age 35 to $81,000 for ages 55-64. Again, this squares with the pattern anticipated by a life cycle income and asset accumulation model.

TABLE II
MEDIAN VALUE AMONG FAMILIES HAVING STOCK HOLDINGS, DIRECT OR INDIRECT: 1992, 1995, 1998, 2001

Age of Head	**1992**	**1995**	**1998**	**2001**
<35	$4,300	$5,900	$7,600	7,000
35–44	$9,300	$11,600	$21,800	$27,500
45–54	$18,600	$30,000	$41,400	$50,000
55–64	$30,900	$35,800	$51,200	$81,200
65–74	$19,800	$39,300	$61,000	$150,000
>75	$30,900	$23,100	$65,300	$120,000
All Families	$13,000	$16,900	$27,200	$34,300

Source: Ana M. Aizcorbe, Arthur B. Kennickell, and Kevin B. Moore. Federal Reserve Bulletin, January 2003. "*Recent Changes in U.S. Family Finances: Evidence from the 1998 and 2001 Survey of Consumer Finances*"

Another way to analyze the data is to look at the extraordinary improvement by cohort as they have moved into new age classifications. Every age group had extraordinary increases in their median value of stock holdings over the past ten years ranging from 337 percent to 438 percent increases. Table III shows an analysis of stock holdings by age over a decade. It shows that the share of those with stock holdings declined by about 14 percent for persons entering what is commonly considered retirement at age 65. At the same time, the share of families with stock holdings headed by persons age 35-64 increased significantly. The share of families holding stock headed by persons born between the years 1947-1956 increased 40 percent. During the same time period, the share of families holding stock headed by persons born between the years 1937-1946 increased 23 percent. Again, these data are consistent with the income and asset accumulation life-cycle perspective. It is worth emphasizing that in 2001, nearly forty percent of senior citizens had stock holdings, and that the median value of these stock holdings was $150,000.

TABLE III
COHORT ANALYSIS OF STOCK HOLDINGS AND MEDIAN VALUE: 1992-2001

Year of Birth	Percent of Families Having Stock Holdings, Direct or Indirect			Median Value Among Families with Holdings		
	1992	2001	Percent Change	1992	2001	Percent Change
1947-1956	42.4%	59.2%	*+40%*	$9,300	$50,000	*+438%*
1937-1946	46.4%	57.1%	*+23%*	$18,600	$81,200	*+337%*
1927-1936	45.3%	39.2%	*-14%*	$30,900	$150,000	*+385%*

Source: Ana M. Aizcorbe, Arthur B. Kennickell, and Kevin B. Moore. Federal Reserve Bulletin, January 2003. "*Recent Changes in U.S. Family Finances: Evidence from the 1998 and 2001 Survey of Consumer Finances*"

Conclusion

The President's proposal to exclude dividends from the federal income tax will eliminate a number of distortions that limit the ability of capital markets to operate efficiently. The benefits from this plan derive from market-based incentives to channel savings into investments that yield the highest returns, and through the ease with which shareholders may monitor corporate performance. The gains in the form of increased returns on equity investments will benefit older workers and seniors disproportionately simply because it is this age group that tends to hold a large share of equity wealth. Of course, this benefit will redound to future generations as they age. Finally, improvements in capital markets will expand productivity and increase living standards, a benefit that will be shared broadly across all age groups.

Views expressed in this testimony are solely those of the author. George Mason University and the Center for Study of Public Choice do not take positions on public policy issues.