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Dividend Taxation and Corporate Governance

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Abstract

Dividends are about corporate governance. Shareholders want companies with cash flows exceeding their profitable investment opportunities to pay the residual free cash flow out as dividends. Without undermining traditional arguments, this casts dividend taxation in a new light. In 2003, the Bush administration cut, but did not eliminate individual dividend taxes. Cutting the tax deprives corporate managers of a justification for retaining earnings to build unprofitable corporate empires. Not eliminating it preserves an advantage for certain institutional investors, who can put pressure on underperforming managers. This balance is broadly appropriate in the United States – whose large companies are freestanding and widely held. Preserving the existing tax on intercorporate dividends, in place since the Roosevelt era, discourages the pyramidal corporate groups commonplace in other countries, and preserves America's exceptional large corporate sector of free standing widely held firms.

1. Introduction

Conventional wisdom holds that dividends should be taxed to redistribute income away from shareholders, whose incomes tend to be relatively high. However, recent work indicates that dividends have economic purposes beyond a simple return to capital. In particular, dividends are intricately related to corporate governance. Corporate governance considerations should therefore inform dividend tax policies.

The United States subjects dividends to *double taxation*. That is, it taxes dividends once as part of the payer's corporate income and again as part of the recipient's individual income. Until 2003, dividends were taxed at the same rates as ordinary corporate and individual income. This resulted in overall taxes on dividends much higher than those in most other countries. The *Job Growth and Taxpayer Relief Reconciliation Act* of 2003 (2003 Reform) cut the individual tax rate on dividend income to fifteen percent. Dividends paid are still taxed at the same rate as other corporate income. Nonetheless, the overall tax levy on dividends in the United States fell sharply.

Recent work shows that the primary economic purpose of dividends is to remove funds from companies that would otherwise invest them poorly. Dividends reflect good governance. Firms pay higher dividends in countries that provide stronger legal rights to shareholders. Traditional theories about dividends and dividend taxation remain valid, and are usefully recast in this light.

Taxing individuals' dividend income encourages firms to keep dividends low. Since evidence suggests that many American firms retain earnings for unprofitable empire building, lightening individual dividend taxes might well improve governance.

Taxing individuals' dividend income also makes stocks relatively unattractive to taxable individual investors and relatively attractive to tax-exempt institutional investors, like pension funds. Institutional investors can potentially overcome the collective action problems that permit governance problems to run unchecked in widely held corporations, where each individual shareholder rationally opts to free-ride on other shareholders' efforts to improve governance. Retaining a significant tax on individual dividend income preserves this advantage for tax exempt institutional investors.

Finally, the 2003 Reform leaves unchanged an exceptional feature of American dividend taxation - the tax on intercorporate dividends introduced in 1935 by the Roosevelt administration to break up pyramidal groups. A pyramidal group has an ultimate controlling shareholder, usually a wealthy family, who controls a first tier of listed firms, each of which controls yet more listed firms, each of which controls still more listed firms, and so on.

Most large listed companies outside the United States belong to pyramidal groups. Pyramids let tiny elites control the greater parts of the corporate sectors of certain developing economies. Though commonplace in the United States until the Roosevelt era, pyramids are now essentially unknown in that country.[1] Details of the demise of pyramidal groups in the United States are poorly understood, but it seems likely that intercorporate dividend taxes were important. The United States remains the only

[1] The only present day U.S. pyramid we have discovered is the Massachusetts firm Thermo Electron, which retains stakes in publicly traded high tech firms as an intermediate step to spinning them off. This results in a two-tiered pyramid much simpler than the structures typical elsewhere. We are grateful to Martin Feldstein for bringing Thermo Electron to our attention. According to La Porta *et al.* (2000), the only other country largely bereft of pyramidal groups is the United Kingdom. Franks *et al.* (2003) argue a 1968 mandatory takeover rule requiring that bids for 30% or more of a company be for 100% eliminated British pyramids.

country with a substantial stock market that taxes intercorporate dividends on control blocks, and is almost the only country without extensive pyramidal groups.

The 2003 Reforms are defensible as applying pressure on companies to disburse more cash to shareholders, while retaining a tax incentive for institutional investors to hold stock and a tax penalty on corporate groups. This preserves America's unique flavour of capitalism – its economy of freestanding firms – while applying balanced pressure for better corporate governance.

The primary criticism of the 2003 Reform, that it favours the rich, is probably valid. However, better corporate governance probably disproportionately benefits Middle America by enhancing job creation and promoting growth. This smells of *trickle down economics*, but may nonetheless be valid. While distributional concerns are well-founded, and ought to sway many economic debates, corporate governance considerations have a solid case for helping guide dividend taxation.

2. The Purpose of Dividends

The *Oxford English Dictionary* traces the financial definition of *dividend* to a 1690 edition of the *London Gazette*, which reports that "Sir Edward Dering, the Deputy-Governor of the Hudson's Bay Company presented to his Majesty a Dividend in Gold, upon His Stock in the said Company." This archetypical usage also highlights the economic purpose of dividends.

The North America fur trade promised vast wealth, but only after a huge capital expenditure on ships, forts, and trading posts. The outlay exceeded the resources of even the King. Consequently, Charles II signed a Charter in 1670 granting a fur trade

monopoly to eighteen investors led by his cousin, the inventor and Civil War general Rupert Palatyne, who formed *The Company of Adventurers Trading into Hudson's Bay*, a joint stock company.[2] The company's profits would be divided periodically among its owners, with each payment to be called a *dividend*.

In an age of horses and carriages, gathering the adventurers for every company decision was impractical, so the Charter mandated they elect a Governor, a Deputy Governor, and a seven member Committee to manage the company. This delegation, though expedient, left the company's managers, in part, spending other people's money. The other investors needed assurances that the company would be well governed and that their streams of dividends would be as great as possible. To assuage these governance concerns, the Charter granted a *Generall Asemblee* of the company's owners the right to dismiss the Governor, Deputy Governor, and Committee, granting each owner "for every hundred pounds by him subscribed or brought into the present Stock one vote."

The company paid its first dividend, fifty percent of book value, in 1685, and continued paying fat dividends through 1690. The price doubled at Jonathon's exchange, as investors salivated for further generous distributions. Meanwhile, six Committee members quietly sold all their shares and resigned. The six arranged that the "Dividend in Gold", cited by the Oxford English Dictionary, be paid to the King alone (dividends were not yet necessarily paid simultaneously to all shareholders), perhaps to buy official acquiescence of this deceit.

This stock manipulation by Committee insiders was but the faintest prelude to the governance scandals in other companies that followed. The South Seas Bubble of 1720 was a frenzy of speculation, stock manipulation, and fraud, in which Englishmen lost

[2] A superb history of the Hudson's Bay Company is Newman (2000)

fortunes in legions of bogus joint stock companies.[3] The Hudson's Bay Company, drained by the excessive dividends of 1685 to 1690, had paid no dividends for twenty-eight years, while new managers slowly rebuilt its balance sheet. It commenced paying a dividend of ten percent of book value in 1718, but remained on the sidelines through the South Seas bubble. Its stock rose with the market and then fell, but unlike the sham bubble companies, it survived because it had an ongoing source of income, and continued paying its ten percent dividend through the mania and subsequent panic.

The Company's dividends, with rare exceptions due to wars and other periods of historical interest, held steady at ten percent of book value for the next century and a half, until farming displaced the fur trade after the 1870s. The company evolved from a network of trading posts into a department store chain, and still pays steady dividends.

[Figure 1 about here]

This financial history lesson is useful because, by examining the economic circumstances surrounding early corporations, we gain insight into the purpose of institutions – in this case the practice of paying dividends. Three basic issues are apparent: dividends are an uncertain return to capital, dividends are intricately intertwined with corporate governance issues, and dividends are affected by the State's protection of investors' property rights.

[3] Balen (2003) is a highly readable account of the South Seas Bubble and its aftermath.

2.1 Dividends Are an Uncertain Return to Capital

As its etymology indicates, a dividend is a divvying up of a company's earnings among its owners – a return to capital. Modern finance theory values stocks as the *expected present value of future dividends*. The term *expected* underscores that dividends are uncertain. The board of directors, the modern descendent of the Hudson Bay Company's "Committee", can raise, cut or suspend the dividend by majority vote.

2.2 Dividends Are About Corporate Governance

This discretion, though essential for corporate survival in bad times, intricately ties dividends to corporate governance. When the Hudson's Bay Company was established in pre-industrial Britain, commerce and finance were considered filthy occupations, alongside prostitution and dung collection. Judges had little time for business disputes, reasoning that the judiciary had no interest in resolving quarrels among thieves. This made business dealings outside circles of kinship and close friendship unwise, for there was no legal remedy for ill faith. The investors in early joint stock companies genuinely were "adventurers", for they journeyed beyond the known institutional world. A Royal Charter from Charles II gave shareholders confidence in the venture, but ultimately did not prevent insiders from abusing other shareholders.

In the post-bubble economy, investors shunned equity, fearing deceit and thievery in even the soundest of joint stock companies. In response, the Governor and Committee quickly concluded that continual stable dividends were imperative. Continuity reassured investors that the company had a real ongoing business, unlike the bubble companies of

1720. Stability countered memories of how insiders used unsustainable dividend hikes to manipulate the company's own shares in 1690.

Thus, although boards *can* raise, cut, or skip dividends as they like, they seldom do so. Lintner (1956) discovered that companies pay steady or steadily rising dividends, even if this necessitates occasional borrowing to cover temporary cash shortfalls.[4] More recently, Jaganathan *et al.* (1999), Guay and Harford (2000), Lie (2000), and others show dividends to be proportional to the permanent component of corporate income.[5] Dividends are a stable continuing stream of payments that reflect the long-term financial health of the firm.

All of this further resonates with a corporate governance role for dividends, as in Easterbrook (1984). Jensen (1986) argues that well-governed mature firms, whose operations generate more income than is needed to finance profitable investment opportunities, should pay out their leftover income, or *free cash flow*, as dividends.[6] But, corporate insiders – managers or controlling families – might either retain free cash flow to pay for private benefits, like empire building, or strategically release free cash flow to manipulate the stock price.

Jensen (1986) calls the first sort of problem a *free cash flow agency problem* – corporate insiders fail to disburse free cash flow, and thus fail to act as faithful agents of public shareholders. A large body of empirical work, surveyed by Shleifer and Vishny

[4] More precisely, Lintner (1956) finds that dividends are a weighed average of past dividends and a long run target dividend payout level.
[5] See also DeAngelo *et al.* (2000).
[6] Jensen also considers higher debt and higher corresponding interest payments as ways of insuring that free-cash flow is paid out to investors. Unforeseen calamities can easily trigger bankruptcies in highly levered firms. Skipping or cutting the dividend triggers a lesser corporate crisis.

(1997), Denis and McConnell (2003), and others suggests that free cash flow agency problems are economically important in the United States and elsewhere.

Reflecting on the second sort of problem, Bhattacharya (1979) and others propose that dividends are *signals* – a language through which corporate insiders communicate with shareholders. Financial reports are useful ways of making companies transparent, and therefore less perilous investments. But, as the first shareholders of the Hudson's Bay Company learned, a long history of steady cash dividends is more inimitable proof of enduring financial health then even explicit certification by the King.

Since dividend hikes raise share prices and dividend cuts lower them, a signalling role for dividends seems plausible. However, *pure signaling models*, which assume that all firms are well governed, fail to explain why firms typically only begin paying dividends when they are a decade or two old. For example, Microsoft, founded in 1976 and listed in1986, paid its first dividend in 2003. But young firms ought to be hardest for investors to value, and so ought to need signalling the most.

This conundrum is resolved if dividends mainly signal insiders' willingness to disburse free cash flow. Young firms typically need all their earnings to finance profitable growth opportunities, and so are unlikely to have free cash flow agency problems. But mature firms, whose cash flows often surpass their profitable investment needs, can be vulnerable to such problems and so need to pay dividends. Lang and Litzenberger (1989) find that dividend hikes raise share prices the most in firms with ample cash flows and few profitable investment opportunities. Thus, dividends seem to be signals about corporate governance.

However, a more direct link between dividends and corporate governance also seems plausible. Desai *et al.* (2002) examine dividends foreign subsidiaries pay to their US parents. Signaling is an unlikely explanation of variation in these dividends because only dividends by unlisted subsidiaries are used. Although these dividends trigger a tax liability for the parent, they nonetheless resemble the dividends paid by freestanding firms – they are steady or steadily rising. Desai *et al.* (2002) conclude that these "dividend policies are largely driven by the need to control managers of foreign affiliates. Parent firms are more willing to incur tax penalties … when their foreign affiliates are partially owned, located far from the United States, or in jurisdictions in which property rights are weak."

This reasoning highlights the parent company's property rights over its investment in the subsidiary. The head office insists on higher dividends from subsidiaries where its property rights are weaker. The State, as guarantor of property rights, thus figures directly in corporate dividend policy.

2.3 Dividends, the State, and Corporate Governance

The role of the King in the early history of the Hudson's Bay Company underscores the complicated interest the State has in dividends. The King was also a shareholder, and the outside investors wrongly assumed that Royal wrath would deter thievery by insiders and assure good governance. Nonetheless, modern corporate finance still links corporate dividends to government policies.

First, dividend taxation makes the state an implicit partner in dividend payments to shareholders. But this need not give the modern State a common interest with public

shareholders. Just as the King received other payments from the Hudson's Bay Company, the State receives other streams of revenue from modern companies.

Second, the State provides public shareholders with property rights to protect them from corporate insiders. In the United States, small shareholders can sue insiders, demand emergency shareholder meetings, and invoke other legal remedies. La Porta *et al.* (1998) show that many other countries, even with otherwise highly developed legal systems, do not provide similar protection.

[Figure 2 about here]

La Porta *et al.* (2000) compare average dividend payout ratios in countries with *strong* or *weak* shareholder rights, measuring this by counting legal safeguards against insider malfeasance. They find higher dividends where shareholder rights are stronger. They also find a bigger difference between high and low growth firms' dividends in countries with stronger shareholder rights. Reasoning that high growth firms have better investment opportunities, they argue that strong shareholder rights promote higher dividends in firms with higher free cash flow. These results suggest that insiders in firms with few growth opportunities pay high dividends where shareholders can force them to. Again, this supports a corporate governance explanation for dividends along the lines of Jensen (1986).

3. Dividend Taxes

The previous section showed dividends to be an outcome of shareholders' ability to induce good governance. This section considers how this view of dividends lets taxes enter the picture. But first, we review the different ways governments tax dividends.

One option is to tax dividends at the corporate level only. For example, Argentina taxes corporate income, including dividends paid out, at 35%, but levies no individual tax on dividend received on the grounds that the firm has already paid taxes on this income.

A second option is to tax dividends at the individual level only by levying no corporate income tax, or exempting dividends paid from corporate taxation, but taxing individuals' dividend income fully. To our knowledge, no country does this.

This may be because a corporate income tax provides an auditing service for the public, as well as a source of government revenues. The US Corporate Excise Tax of 1909, the ancestor of today's corporate income tax, was justified in these terms.[7] Reacting to corporate scandals (and to undermine his political enemies), President Taft made the disclosure of corporate tax returns a key part of the bill, arguing

> "If now, by a perfectly legitimate and effective system of taxation, we are incidentally able to possess the Government and the stockholders and the public of the knowledge of the real business transactions and the gains and profits of every corporation in the country, we have made a long step toward that supervisory control of corporations which may prevent a further abuse of power."[8]

Business leaders were furious, but the press was divided. The *Wall Street Journal* wrote

> "Inside graft is today the thing that is doing probably as much as anything else to bring injury to honest investment and ruin to corporate morals. Much of the protest against the proposed measure has its root in rottenness rather than righteousness."[5]

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[7] A corporate excise tax is a tax on corporate revenue, rather than income or profits.
[8] See Thorndike (2002).

Although Congress restricted public access to corporate tax returns two years later, their disclosure remained an issue for several decades. At present, the income and tax figures in US annual reports reflect *Generally Accepted Accounting Principles*, and often differ greatly from taxable income and taxes paid. US corporate tax returns are available to neither shareholders nor the public. Nonetheless, the corporate income tax is a window into the corporate sector for governments. Still, this argument does not prevent governments from levying a corporate income tax only on retained income. The unpopularity of this approach requires further study.

A third option is taxing dividends fully at both the corporate and individual levels. The United States applied this so-called *classical system* prior to the 2003 Reforms.

A fourth option is a tax credit nullifying individual dividend taxes. Mexico effectively applies such a system by levying a 43% corporate income tax (a 33% statutory rate + a 10% profit sharing levy). Individual recipients pay a 33% tax on dividend income, but this is fully offset by a tax credit. Hence, the effective tax on corporate cash passed out as dividends is the 43% corporate tax rate, with individual dividend income essentially exempt from taxes.

A fourth option is a credit offsetting corporate taxes, often called an *imputation credit* because individuals get a credit for taxes the corporation is imputed to have paid. Australia levies a 37% tax on corporate income, including dividends paid, and a 47.7% individual income tax on dividends received. But individuals get a tax credit that precisely offsets the corporate taxes already paid on their dividends. Individuals end up paying the difference between the 47.7% individual rate and the 37% corporate rate on

dividend income. The total (corporate plus individual) effective tax on dividends equals the individual income tax rate.

A sixth option is a partial imputation credit. Canada taxes corporate income at 47.6% and individual income taxes at 46.4%.[9] But dividend recipients claim a tax credit that partially offsets the corporate taxes paid on their dividends, reducing the effective individual tax rate on dividends to 31.3%.

A seventh option is an offsetting rate reduction in individual taxes. For example, Italy taxes corporate income, including dividends paid, at 34%, and individual income at 56.8%, save that dividend income is taxed at only 12.5%. This reduced rate reflects corporate taxes already paid, but is actually more generous than a full imputation credit.[10]

Finally, an eight option is a smaller rate reduction at the individual level that still leaves dividends taxed overall at a higher rate than the general individual income tax rate. This is the system the US now uses: It levies a 41.5% tax on corporate income, including dividends paid, and collects a 47.9% individual income tax on most forms of individual income.[11] However, it levies a tax of only 15% on dividend income, in recognition of the taxes on this stream of money already paid by the corporation. The effective overall tax on dividends works out to 50.275%.[12]

[9] Federal plus Ontario rates.
[10] To see this, consider € 100 of corporate income subject to a 34% corporate tax permitting a dividend of € 66. A 12.5% individual tax collects another € 8.25, so the total tax on € 100 of corporate income paid out as dividends amounts to € 42.25, implying an overall tax rate of 42.25% – less than the 56.8% individual tax rate which would apply were Italy to adopt a full imputation credit system.
[11] Federal plus California rates.
[12] To see this, apply the 41.5% corporate rate to $100 of corporate income to get $58.5 that can be paid out as dividends. Applying the 15% individual rate to this generates $8.875 in further tax revenue. The total tax on $100 of corporate income paid out as dividends amounts to $50.275 – a 50.275% tax rate.

Different countries apply different systems at different points in time. Figure 3 illustrates the range of overall dividend taxation systems used in 2003 by a large cross section of countries.

[Figure 3 about here]

3.1 Dividend Taxes and the Return to Capital

The traditional dividend taxation literature, see e.g. Auerbach (2002), largely turns on dividends being part of the return on capital. The issues that arise are the effects of dividend taxes on share prices, risk-taking, investment decisions, financing decisions, and payout decisions.[13]

Share prices ought to be depressed by corporate taxes, for these reduce the dividends a company can pay, and share prices are the present values of expected future dividends. Certainly, dividend payouts are negatively correlated with dividend tax rates historically, for Brittain (1966) finds a negative correlation between personal tax rates and dividends between 1920 to 1960 in the United States. However, Miller (1977) argues that tax exempt investors, such as pension funds, charitable foundations, and individuals with 401(k) plans, might be the marginal owners of dividend paying stocks. If this were so, individual dividend taxes might not depress share prices.

Elton and Gruber (1973, 2003) resolve this by examining share price changes on *ex dividend dates*. Shareholders who own a stock before the ex date are entitled to its

[13] Dividend taxes may also affect corporate borrowing. However, a meaningful treatment of such *capital structure* considerations requires more space that is available for this article. We therefore assume away such issues. Fortunately, the major questions regarding dividend taxation are not fundamentally affected by this simplification.

impending dividend. Shareholders who buy the stock on or after that date are not. Unsurprisingly, the share price falls sharply on the ex date. More importantly, it falls by the after-tax value of the impending dividend, not its full nominal value.

This shows that the active investors, who price stocks, value dividends net of individual taxes. Since stock prices are the present values of expected future dividends, depressed valuation of dividends implies a correspondingly depressed share price. Both corporate and individual dividend taxes appear to depress share prices relative to what they would be absent taxes, all else equal and general equilibrium considerations aside.

Another traditional literature focuses on how taxes affect investors' tolerance of risk. Tobin (1958) and others argue that taxes on the return to capital scale down the risk in financial assets' returns, along with their expected return. Taxes clearly scale back investors returns in good periods, but loss carryover provisions and other effects also temper negative returns. This argument has not been prominent since Feldstein (1969) exposed the critical importance of a risk free asset to the argument and the unrealism of such an assumption in a period of high and uncertain inflation. With the advent of Treasury Inflation-Indexed Securities (TIPS) in the United States and similar securities elsewhere, this assumption is now perhaps less objectionable.

How dividend taxes affect investment, financing, and payout decisions remains subject to debate.

Consider a new firm soliciting funds from prospective shareholders. Dividend taxes reduce shareholders' return on their investment, rendering financially viable only companies with investment opportunities able to produce pre-tax cash flows big enough to give shareholders an acceptable return net of all taxes. Obviously, many companies

and projects viable with new equity financing in the absence of dividend taxes become unviable in their presence.

This view of dividend taxation, which holds that individual and corporate dividend taxes raise companies' costs of capital and so reduce corporate investment, all else equal, is implicit in Feldstein (1970), formalized by Black (1979) and empirically verified by Poterba and Summers (1985). Public finance scholars sometimes call it the *old view of dividend taxation*. The *old view* is relevant for firms whose marginal source of financing is issuing new shares to investors – new firms or firms requiring equity financing for expansions.

This view also implies that corporations that issue shares ought not to pay dividends. Retaining earnings lets the company build value without triggering individual dividend taxes for shareholders. Shareholders prefer this if individual capital gains taxes are lower than individual dividend taxes. In contrast, a firm exposes shareholders to unnecessary dividend taxes if it pays dividends with one hand while issuing shares with the other to solicit the funds back.

A second view of dividend taxation starts with an established firm that will issue no more stock, and whose marginal source of financing is retained earnings. In deciding whether to pay out earnings as dividends or retain them to finance new investments, management considers what would be best for shareholders. If the money is paid out as dividends, individual dividend taxes are due on the disbursement. If it is retained and invested, this generates future earnings, which permit future dividends, which elicit future individual dividend tax bills. Since reinvesting earnings only delays dividend taxes, the

company's cost of capital, investment decisions, and payout decision ought not to be affected by the individual dividend tax rate if it remains constant.[14]

This view of dividend taxation, which holds that individual dividend taxes do not affect corporate costs of capital, investment decisions, or payout policies, proposed in King (1977) and formalized by Auerbach (1979) and Bradford (1981). Public finance scholars sometimes call it the *new view of dividend taxation*. The *new view* is most relevant to firms with no plans to issue new shares – that is, old firms.

A few qualifications are in order. First, investment in new capital assets generates depreciation deductions. Retaining funds for investment thus cuts corporate tax bills, but paying the same money out as dividends does not. This means only the individual dividend tax rate is irrelevant in the *new view*. Second, the *new view* assumes a constant and certain dividend tax rate over time. In fact, governments frequently change individual dividend taxes, undermining the irrelevance argument.

Debate continues in the public finance literature as to which view is more realistic, theoretically consistent, and empirically supported.[15] At present, empirical support exists for both, perhaps suggesting a degree of heterogeneity across firms. The *old view* applies where new share issues are in the cards; the *new view* applies where companies finance new investments out of cash flow from past investments. This suggests a corresponding heterogeneity in the impact of dividend taxation. High

[14] Consider \$100 of corporate earnings paid out as dividends. The after tax income of the shareholder is \$100 $(1-T_P)$ where T_P is the individual. If the \$100 is retained and invested in a project that produces \$100$(1+r)$ the subsequent year, and this is then paid out as dividends, the shareholder gets \$100$(1+r)(1-T_P)$. But the present value of this is \$100 $(1-T_P)$. The company should only retain funds for reinvestment if it can obtain a return higher than the shareholder's discount rate. But this is precisely what the firm should do in the absence of any individual tax on dividend income.
[15] See Auerbach (2002) for a technical description of this literature.

dividend taxes raise hurdle rates for new capital investment projects and depress dividend payouts in firms that issue new shares, but not in firms that grow using retained earnings.

Still, neither view is fully consistent with the actual disbursement options open to companies. In particular, companies can buy back their own shares to raise the price of the remaining ones, thereby increasing shareholder wealth without triggering individual dividend taxes. This short-circuits much of the discussion above, but companies do not seem to use share repurchases in this way in practice. Empirical work shows that companies use repurchases in lieu of extraordinary dividends, but not ordinary dividends.[16] This behaviour by dividend paying firms is not fully understood, but is consistent with ordinary dividends tracking the permanent component of corporate income and extraordinary dividends, and repurchases, disbursing abnormal income.

Black calls firms' continued willingness to pay dividends despite this tax burden *the dividend puzzle*. While this contribution to the solvency of the government must be lauded, the acquiescence of shareholders to such policies remains a point of controversy.

A satisfactory resolution of the puzzle seems to require that dividends to be more than just a return to capital. If dividends are important signals to investors, or serve an important corporate governance function, paying dividends despite a tax penalty makes sense. But accepting a broader economic role for dividends necessitates rethinking the effects of dividend taxation.

[16] See Allen and Michaely (2002). In a survey of financial executives, Brav *et al.* (2004), find managers willing to substitute repurchases for dividends, but believing "individual investors have a strong preference for dividends, even if dividends are tax disadvantaged." The issue is complicated by a lack of agreement on the precise implications of the *new view* – see e.g. Collins and Kemsley (2000).

3.2 Dividend taxes and Corporate Governance

The previous section posited two ways in which dividends might relate to corporate governance. The first is that dividends might be signals about insiders' willingness to disburse free cash flow. The second is that dividends might be the result of effective governance institutions causing firms to disburse free cash flow. La Porta *et al.* (2000) present evidence consistent with the second way, but this need not negate the first.

If dividends are signals, dividend taxes make signaling more expensive. It seems intuitive that dividend taxes should thus make firms less transparent and aggravate governance problems. Feldstein and Green (1983) criticize signalling models of dividends as implausible because of the high tax cost of the signal. However, John and Williams (1985), Bernheim and Reading (2001), and others argue that high dividend taxes actually make dividends more credible signals because only strong firms can pay dividends high enough to offset higher taxes.

Still, signalling models are silent as to why financially sound firms do not devise less costly but equally informative signals. This question has risen to the fore in other fields that use signalling models, notably biology. An example of a signalling model in that field is Zahlavi's (1975) model of metabolically costly accessories, like peacock tails, as signals of health to prospective mates. Lachmann *et al.* 2001, questions the viability of costly signals, arguing that both the sender and receiver of a signal benefit from more cost effective signals. Evolution should favour innovations that lower signalling costs and raise signal information content. Such thinking may also be useful in economics.

If dividends are an outcome of good governance, dividend taxes perhaps provide self-interested corporate insiders with an excuse to retain free cash flow. Black's (1979) *dividend puzzle* has featured in virtually every M.B.A. finance textbook for over two decades, with the clear message that lowering or eliminating dividends is justifiable to reduce corporate taxes. Fama and French (2001) find sharply falling dividend yields on US stocks over then past twenty years, and show that this reflects not just the changing composition of listed firms, but a genuine disinclination to pay dividends. Figure 4 extends their result to the present.

[Figure 4 about here]

Ample evidence, reviewed by Shleifer and Vishny (1997) and others, shows that free cash flow agency problems are economically important in the United States. Cutting dividend taxes might thus improve corporate governance by depriving corporate insiders of taxes as a justification for retaining earnings despite a dearth of profitable investment opportunities.

But a cogent corporate governance argument also exists for levying a tax on individuals' dividend income. This is because most large US firms are widely held, in that they are owned by a multitude of small shareholders. For example, the largest shareholder in Minnesota Mining and Manufacturing (3M) is a pension fund with a stake of about three percent. Top managers together own less than one percent, and any residual founding family stakes are too small to register. In such a widely held firm, collective action problems prevent shareholders from monitoring and disciplining errant

top managers. This is because taking action to correct governance problems has a high cost for any shareholder, but benefits all shareholders. Consequently, each shareholder rationally opts to be a free rider. Grossman and Hart (1980) argue that this collective action problem perpetuates poor governance in an economy of widely held firms.

Shleifer and Vishny (1986) show that institutional investors, such as pension funds, can mitigate such collective action problems. By pooling the savings of many small investors, they can achieve a scale large enough to justify the costs of action to improve governance. Although empirical evidence that pension funds improve corporate performance remains scant, institutional investors like the California public Employees Retirement System (CalPERS), now vocally demand change in firms they regard as misgoverned.

Investments undertaken through pension funds are exempt from individual dividend taxes. Allen, Bernardo, and Welch (2000) argue that individual dividend taxes penalize free rider shareholders who invest independently and favor investors who pool their savings through pension funds and bear the cost of improving corporate governance. Of course, the delineation is not this simple. Some institutional investors, like mutual funds, provide no tax advantage; while lone investors using 401(k) plans or Individual Retirement Accounts (IRAs) escape individual dividend taxes.

Figure 5 shows that institutional investors grew in importance dramatically since their entry into US equity markets in 1978, and their tax advantaged status cannot have hindered this growth.

[Figure 5 about here]

3.3 Dividend Taxes, the State and Corporate Governance

Dividend taxation may have more profound implications for an economy than mere corporate governance, important as that is. Franklin Delano Roosevelt (1933-1945) used dividend taxation to radically change the structure of corporate ownership by breaking up highly concentrated economic power he believed unhealthy for American democracy.

Berle and Means (1932, p. 183-5) show that many listed US companies were organized into control pyramids prior to this. A control pyramid is a structure in which an ultimate owner controls a first tier of listed companies, each of which controls other listed companies, each of which controls yet more listed companies, and so on *ad valorem*. La Porta *et al.* (1999) show that control pyramids are the predominant ownership structure for large firms outside the United States, and that the ultimate owners are usually very wealthy families. This was apparently also the case in pre-Roosevelt America, though further research is needed here.

[Figure 6 about here]

Figure 6 displays a pre-depression era pyramidal group controlled by the van Sweringen brothers. This pyramid is small enough to fit on a single page. Others were much larger. Speaking to the Senate Finance Committee, Assistant General Counsel to the Treasury Department Robert Jackson, describes an American pyramid that,

> "as of December 31, 1933, contained approximately 270 companies of which 128 were public utility operating companies located in several and widely separated states, and at least 31 of which would be classed as subholding companies." [17]

[17] Senate Finance Committee Hearings, pp. 223-224.

The van Sweringen group is, however, large enough to illustrate the basic features of control pyramids.

First, pyramids leverage wealth sufficient to control one corporation into control over a group of companies worth far more. Berle and Means (1932, p. 69) report that the van Sweringens use "an investment of less than twenty million dollars … to control eight Class I railroads having combined assets of over two billion dollars." [18] Morck, Wolfenzon, and Yeung (2004) argue that pyramidal groups are the structures that let tiny elites control the corporate sectors of many developing economies.

The administration was clearly uncomfortable with such concentrated economic power, for Roosevelt (1942) writes of control pyramids in the *American Economic Review* that

> "Close financial control, through interlocking spheres of influence over channels of investment, and through the use of financial devices like holding companies and strategic minority interests, creates close control of the business policies of enterprises which masquerade as independent units. … Private enterprise is ceasing to be free enterprise and is becoming a cluster of private collectivisms; masking itself as a system of free enterprise after the American model, it is in fact becoming a concealed cartel system after the European model.

Second, the family commands enough votes in each firm in the group to control its board. Less than fifty percent usually permits control because many small shareholders do not vote. The family's voting power can be magnified at various points in the pyramid by dual class shares – giving public investors common shares with one vote each while reserving a second class of common shares with many votes each for the family. Since the family holds control blocks in every group company, public shareholders have little prospect of influencing corporate governance.

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[18] Berle and Means (1932) are usually cited for their discussion of such divergence of interest problems in widely held firms; however they highlight similar problems in control pyramids. This is developed further by Morck, Stangeland, and Yeung (2000) and formalized by Bebchuk, Kraakman, and Triantis (2000).

In explaining the need to dissolve pyramids, Roosevelt (1942) disparages their controlling shareholders' immunity from public investor pressure:

> "Such control does not offer safety for the investing public. Investment judgment requires the disinterested appraisal of other people's management. It becomes blurred and distorted if it is combined with the conflicting duty of controlling the management it is supposed to judge."

Corporate governance, though the term was not used, was clearly a priority in the aftermath of the 1929 Crash and subsequent Depression. Several pyramidal groups failed spectacularly, perhaps creating a popular impression that pyramids caused the crash. While this was almost certainly false, pyramidal groups probably did have extensive corporate governance problems. A 1928 the Federal Trade Commission report detailed widespread self-dealing, poor governance, and monopolistic practices by pyramidal groups, labelling them "frequently a menace to the investor or the consumer or both." [19]

Third, the family's actual financial interest in each company in the group is very small relative to the votes it commands. Berle and Means (1932, pp. 69-71) reflect that

> "The owner of a majority of stock of the company at the apex of the pyramid can have almost as complete control of the entire property as a sole owner even though his ownership is less than one percent of the whole. … The van Sweringen investment represented 51% of the capital in the General Securities Corporation, eight percent of the capital of the Allegheny Corporation, four percent of the Chesapeake Corporation, less than one percent of the great operating company, the Chesapeake and Ohio Railway, and but one quarter of one percent of the latter's operating subsidiary, the Hocking Valley Railway. In the last named company over 99¾ per cent of the investment represented ownership without control."

A unique governance problem, which Johnson *et al.* (2000) christen *tunneling*, arises in pyramidal groups. Tunneling occurs when the controlling entity orchestrates transactions at non-market prices to shift income from one firm to another. Tunneling is analogous in many ways to income shifting in multinational firms, except that the object is to hide money from public shareholders rather than the tax authorities.

[19] FTC, Utility Corporation, Senate Document No. 92, 70th Congress, 1st session. (1928).

Of course, tunneling might also facilitate tax avoidance if, for example, income is shifted to firms in industries with especially favorable tax treatment. Robert Jackson, Roosevelt's Assistant General Counsel to the Treasury Department, elaborates:

> "Managements … shift security transactions from one company to another for the purpose of allocating losses or profits so as to avoid taxes, and can still control and divert earnings from one to another unit in the form of service charges, accountancy tax consultant, and management fees, and by various other changes can so reduce taxable income of some units and increase net income of others ..." [20]

Numerous studies, surveyed by Morck, Wolfenzon, and Yeung (2004), attest to the economic importance of all the above governance problems in pyramids, especially in countries that provide public shareholders with weak legal rights against corporate insiders. The use of tunneling to shift income away from public shareholders is amply demonstrated, but its use to avoid taxes has not, to our knowledge, been examined recently.

As important as these firm-level governance problems are, the Roosevelt administration also attacked pyramids for broader political economy reasons.

A clear problem with concentrated control is economists' traditional concern about inefficient monopoly. Roosevelt (1942) clearly accepts this reasoning, and in explaining his decision to break up control pyramids, remarks that "Men will dare to compete against men, but not against giants".

However, dynamic inefficiency concerns also arise.

One such concern is that control pyramids can retard *creative destruction*. For example, if a plastics company develops a superior substitute for a steel product, this creativity devalues steel makers' existing assets. In an economy of freestanding firms,

[20] Senate Finance Committee Hearings, pp. 223-224.

like the United States today, the destructive effect on steel companies is a negative externality that does not affect the plastics company's decision to develop its product. However, if the plastics company and steel maker are part of the same pyramidal group, the controlling shareholder may decide that the innovation is best shelved to preserve the value of the steel company.[21]

While a slower pace of innovation may be attractive to people put at risk by innovation, over the longer term it is a recipe for stagnation and magnified social dislocation. Roosevelt (1942) explains that

> "Interlocking financial controls have taken from American business much of its traditional virility, independence, adaptability, and daring–without compensating advantages. They have not given the stability they promised.
>
> Business enterprise needs new vitality and the flexibility that comes from the diversified efforts, independent judgments and vibrant energies of thousands upon thousands of independent businessmen."

A second source of dynamic inefficiency is retarded growth due to political rent-seeking – investment in political influence as opposed to productive assets. Political influence is plausibly proportional to what one controls, not what one actually owns outright. Control pyramids magnify moderate fortunes into control over corporate assets worth far more. This provides their controlling entities unparalleled political influence and elevated returns to political rent-seeking.[22] Murphy *et al.* (1993) show that highly profitable political rent-seeking is especially detrimental to growth because it induces investment in bureaucratic skills rather than technology.

The Roosevelt administration attacked control pyramids on two fronts. One was the Public Utilities Holding Company Act, which mandated that public utilities be freestanding. The second front involved dividend taxes.

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[21] Morck, Stangeland, and Yeung (2000) dub this concern one of *creative self-destruction*. Morck and Yeung (2003, 2004) develop the idea further.

[22] Morck and Yeung (2004b) develop this argument in detail.

In 1935, the Roosevelt administration applied double taxation to intercorporate dividends. Previously, corporations paid no taxes on dividends they *received*, allowing large pyramids to pass dividends from company to company with no tax liability except for the initial corporate payer of the dividend and its ultimate individual recipient. The House initially rejected the administration's proposal to tax intercorporate dividends at 15% of the regular rate, and the 1935 Act contained a compromise rate of 10%. The 15% figure was implemented in 1936.

At present, the United States taxes intercorporate dividends at seven percent, one fifth of the regular 35% corporate income tax rate if the parent's stake in the dividend paying subsidiary falls between 20% and 80%. There is no tax if the stake exceeds 80% and a 10.5% tax for stakes below 20%. Extracting a seven percent tax as dividends pass from firm to firm in a control pyramid creates a tax disadvantage proportional to the number of tiers.

The United States remains the only country with a substantial stock market to tax intercorporate dividends on control blocks like those used to hold control pyramids together. Canada levies no tax if the parent's stake exceeds 20%, and the 2003 European Commission Parent-Subsidiary Directive mandates that member states not tax intercorporate dividends if the parent's stake exceeds 10% - down from 20% in the previous Directive. Australia, Japan, Singapore, Switzerland, and all other developed countries have similar provisions. Most developing countries with substantial stock markets also exempt most intercorporate dividends from taxation, though a few, like Korea and India, nominally levy taxes but have an "exempt list" of companies. Such provisions presumably act as a barrier to entry against new pyramids.

Unsurprisingly, La Porta *et al*. (1999) find that the United States is also virtually the only country with a corporate sector devoid of pyramids. While Holderness *et al.* (1999) and others show that moderately large shareholders have been and remain important in the United States; and that American firms do buy and sell blocks of stock in each other, the United States is now basically an economy of free standing firms. This is probably a key, though largely unappreciated, feature of American exceptionalism.

That the United States taxed intercorporate dividends to raze pyramids is clear, for Roosevelt (1942) writes that

> "Tax policies should be devised to give affirmative encouragement to competitive enterprise. Attention might be directed to increasing the intercorporate dividend tax to discourage holding companies …".

Blakey and Blakey (1936), economists close to the Roosevelt Whitehouse, are more explicit, summing up the administration's taxation objectives thus:

> "There can be no denying that the President's message was an attack upon … concentrated, monopolistic, tax-evading, unsocial wealth, and particularly upon that taken from the masses by the vicious, pyramided, consciousless holding companies."

They concede that "the diverting of taxation from the primary purpose of raising revenue to other major purposes involves great hazards." But, they justify the Roosevelt tax reforms, arguing in the *American Economic Review* that

> "Statesmanship requires that the Ship of State shall not be allowed to rot in a stagnant Sargasso Sea nor be rent asunder by explosions of dynamite in its hold nor be dashed upon the rocks by the tidal waves of radically revolutionary storms and earthquakes."

As ensuing decades deflowered writing styles in the *American Economic Review*, the purpose of intercorporate dividend taxation faded from academic memory. The initial tax reform proposal sent by the Bush administration to Congress proposed an imputation system that would have made intercorporate dividends exempt if the initial dividend

payer paid corporate income taxes. The proposal spelled out (p. 15) that

> These additions … ensure that multiple levels of corporate ownership do not result in more than one level of tax on income that has been previously taxed at the corporate level.[23]

This would have permitted a revival of pyramidal ownership in the United States, and the return of corporate governance problems not seen since the 1930s.

However, the economic advisors to the Bush administration and congress appear to have intervened before the legislation took final form. The final version simply lowered the individual tax rate on dividend income to 15%.[24] Corporate taxes on both dividends paid and intercorporate dividends received did not change, leaving the United States with its exceptional taxes on intercorporate dividends and economy of freestanding companies.

Although it is tempting to regard the US tax on intercorporate dividends as obviously preferable on both efficiency and political economy grounds, this would be premature. More work is needed on the economic costs and benefits of pyramidal groups before intercorporate dividend taxes on control blocks can be advocated in other countries.

4. The United States Dividend Tax Reforms of 2003

The *Jobs and Growth Tax Relief Reconciliation Act* (2003 Reform), which President Bush signed into law on May 28, 2003, reduces the top marginal personal tax rate on

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[23] See the 2003 Blue Book - General Explanations of the Administration's Fiscal Year 2004 Revenue Proposals, published by the United States Treasury Department, February 2003, p. 15.

[24] Summary of Conference Agreement on H.R. 2, The Jobs And Growth Tax Relief Reconciliation Act of 2003, JCX-54-03, released by the Joint Committee on Taxation on May 22, 2003.

dividend income to fifteen percent. Figure 7 compares the taxes on $100 of before-tax corporate earnings paid out as dividends under the old and new rules.

[Figure 7 about here]

The effect of the 2003 Reform is clearly substantial, cutting the overall tax bite on disbursed corporate earnings from 67.54% to 54.32% for California residents receiving dividends from California corporations. The precise tax bite varies depending on the state, and California's taxes are quite high. At the other extreme, Nevada has no individual or corporate income tax, reducing the bites to 60.7% before the Reform and 44.8% after.

Assessing the economic effect of the tax cut, whether in traditional or corporate governance terms, must taking into account the temporary nature of the Reform. The fifteen percent rates on individuals' received dividends are to apply until 2008, and then expire. The Bush administration vows to make the reductions permanent, but the Democrats vow to reverse them long before 2008. Regarding the cuts as having a substantial probability of being temporary seems sensible.

4.1 Forecasts

Reducing dividend taxes, even temporarily, should raise dividends and share prices. Gravelle (2003, p. 661) reports an estimated stock market gain of five to six percent.[25] She argues that this is small compared to the market's typical yearly fluctuations, and still

[25] She attributes the calculation to James Poterba of MIT.

may be an overestimate if investors rebalance their portfolios to maintain fixed ratios of stocks and bonds. Higher share would then trigger stock sales and bond purchases, depressing share values. Moreover, rational investors should also be considering how the United States will likely deal with its growing budget deficit. Increased borrowing, higher taxes, and erratic inflation each should bear weight in this calculus, and put downward pressure on share prices.

All of this makes any estimate of net wealth or consumption effects speculative. Although Elton and Gruber (1970) show that prices are set by taxable stock traders, many buy-and-hold investors may be tax-exempt institutions, like pension funds. This means dividend tax cuts do not affect their inframarginal valuations, and affect their wealth only should they sell shares to taxable investors. Overall, the 2003 Reform's effect on consumption through traditional channels is likely to be slight.

In the *old view*, dividend taxes raise the cost of new equity capital, so the 2003 Reform should cheapen capital for start-ups and firms issuing shares. However, the temporary nature of the reform works against this effect being large for two reasons. First, the projects undertaken would have to generate dividend income before the cuts are reversed to gain anything from them. Indeed, temporary dividend tax cuts might thus induce an inefficient bias towards investing in short-term projects. Second, new shareholders have to share any gains with old shareholders, diluting any gains. Third, although the 2003 Reform sets the statutory individual dividend and capital gains tax rates equal at fifteen percent, Poterba (2004) argues that the effective capital gains tax is roughly one fourth of the statutory rate. If so, the effective tax on capital gains is 3.75%, far lower than the fifteen percent rate on dividends, preserving a tax incentive to retain

earnings rather than pay dividends. Empirical studies of the actual effects of the 2003 Reform will be useful in quantifying the importance of these qualifications.

The *new view* of dividend taxation is not applicable to the 2003 reforms because they are temporary. The *new view* compares economies with different fixed eternal dividend tax rates, but does not apply to a temporary cut. The logic underlying the new view, comparing disbursing dividends now versus reinvesting earnings and paying higher future dividends, suggests that dividends ought to be higher during the period of low taxes.

Gravelle (2003) conducts simulations to assess the effect of the 2003 Reform on output, using commonly accepted investment, saving, and labour supply behavioural assumptions. She concludes (p. 659) that “capital income tax cuts, financed by government deficits, induce negative effects on output in a full employment model.” While her results clearly depend on her assumptions, including about how the government manages its budget deficits, her results overall suggest at best a very limited macroeconomic stimulus.

4.2 Corporate Governance Considerations

We believe that, all else equal, higher dividends reflect better corporate governance. Dividend taxes provide managers with a reason to retain earnings, and by cutting dividend taxes, the 2003 Reforms diminish that rational.

Corporate governance considerations clearly played a role in the Bush administration’s 2003 Reforms. For example, a 2003 position paper by the Joint Economic Committee argued that lower dividend taxes would mean “[p]aying dividends

rather than retaining earnings would become a more attractive proposition for companies; this change would promote a more efficient allocation of capital and give shareholders, rather than executives, a greater degree of control over how a company's resources are used."[26]

Some work analysing dividend tax reforms considers corporate governance. Nadeau (1988) models the effects of taxes on dividend payout, financing, and investment. His model balances dividends being unattractive because they expose investors to taxes, yet because they force firms into capital markets regularly, making them more transparent to investors. Analysing the 1986 Tax Reform Act, he shows that reducing personal income tax rates on dividends while raising the capital gains tax rate induces rational managers to raise their dividend payout rates.

Poterba (2004) predicts that the dividend tax cuts in the 2003 Reform should increase corporate dividends, and Blouin *et al.* (2004) observe this. Moreover, they find this increase primarily involves companies issuing extraordinary dividends in lieu of their normal dividends, rather than increasing the latter. If companies typically retain excessive free cash flow, as Jensen (1986) argues, even a temporary increase in disbursements ought to be efficiency enhancing.

Dividend taxes bias pension funds towards holding stock, and this may improve governance. If individual investors hold stock through such institutional investors, this could overcome collective action problems that perpetuate governance problems in widely held firms. Fama and French (2001) find dividend paying firms to be mature companies with ample cash flow and few profitable investment opportunities – that is,

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[26] "Dividend Tax Relief and Capped Exclusions", an Economic Policy Research Paper for the Joint Economic Committee, Chairman Robert F. Bennett, May 13, 2003. See jec.senate.gov.

companies likely to have free cash flow agency problems of the sort described by Jensen (1986). If dividend tax cuts reduce institutional investors' holdings of such shares, the 2003 Reform could worsen corporate governance.

Since evidence on the economic significance of free cash flow agency problems is abundant, while evidence of the effectiveness of institutional investors in improving corporate performance remains patchy, the 2003 Reform reflects a reasonable balance shifting towards encouraging higher payouts even if at the expense of reduced incentives for pension funds to hold shares. Empirical studies should be able to inform policy in this area more confidently once data of the effects of the 2003 Reforms are available.

Finally, the 2003 Reforms may have their biggest corporate governance impact because of what this did not do. The final version of the reforms, unlike the initial version, did not eliminate America's exceptional intercorporate dividend tax. This may have had a profound impact on the nature of American corporate ownership, even if it collects little or no revenue. The Bush Administration's decision to retain intercorporate dividend taxes makes a resurgence of pyramiding in America unlikely, and preserves America's economy of freestanding firms and distribution of corporate governance power.

6. Conclusions

Recent work suggests that dividends are intricately connected with corporate governance. Corporate managers seem to retain more earnings than they can reinvest profitably is amply demonstrated in the data. In other words, inefficiently low dividends appear to be a commonplace corporate governance problem. Firms pay higher dividends in countries

with stronger shareholder rights, suggesting that high dividends are an outcome of shareholder power.

Viewing dividends as intimately tied to corporate governance suggests new perspectives on dividend taxation (without in any way invalidating traditional models). Much evidence suggests that corporate insiders prefer to retain earnings even when the firm has no profitable investment opportunities. This permits insiders to fund private benefits, such as corporate empire building. High dividend taxes justify leaving earnings in such firms as a tax avoidance strategy. High dividend taxes may thus provide insiders with an excuse to do what they want to do in any event, aggravating such governance problems.

In contrast, certain dividend signalling models argue that higher dividend taxes help shareholders identify higher quality firms because only such firms can eat the tax cost of paying dividends. While we recognize the theoretical validity of such models, we find the argument that evolution ought to lower signal costs persuasive. If so, higher taxes on dividends likely discourage, rather than encourage, their use as signals. The recent decline in observed U.S. dividend payouts is consistent with shareholders accepting this.

Another argument, that high dividend taxes directly better corporate governance, centers on institutional investors. High dividend taxes encourage investors to hold stocks through tax-exempt institutional investors, like pension funds. Unlike individual investors, institutional investors are large enough to finance the monitoring and disciplining of errant corporate managers. This argument seems more intuitively

plausible, but empirical evidence of better performance by firms with large institutional block holders is scant.

The preponderance of empirical evidence favours Jensen's (1986) argument that average dividends are inefficiently low. Although high personal dividend taxes might well boost institutional investors, this effect appears less economically important. On balance, lower dividend taxes seem likely to improve corporate governance. The *Job Growth and Taxpayer Relief Reconciliation Act* of 2003, which reduces the top Federal US tax rate on individual dividend income to fifteen percent, is thus broadly defensible.

Unlike higher personal dividend taxes, higher taxes on intercorporate dividends – dividends paid by subsidiaries to parents – may well be related to better corporate governance. Large listed companies in most countries are organized into vast pyramidal groups, structure in which a wealthy individual or family controls a listed company, which controls other listed companies, each of which controls yet more listed companies, and so on. Pyramids of this sort are the devices that allow small elites to control the greater parts of the corporate sectors of many developing countries.

The United States began taxing intercorporate dividends in the 1930s with the explicit purpose of discouraging pyramidal groups, which have been shown to be vulnerable to a host of governance problems. America is currently the only country with a substantial stock market that taxes intercorporate dividends from the sorts of control blocks that hold pyramidal groups together. It is also virtually the only country whose large corporate sector is essentially devoid of pyramidal groups.

The final version of the *Job Growth and Taxpayer Relief Reconciliation Act* of 2003 retains America's unique tax on intercorporate dividends, and is thus also broadly

defensible. The circumstances surrounding the disappearance of pyramidal groups from the United States are not well understood. However the advent of intercorporate dividend taxes seems a well timed explanation. If so, America's dividend taxation rules may be responsible for her exceptionally competitive and innovative economy of freestanding firms.

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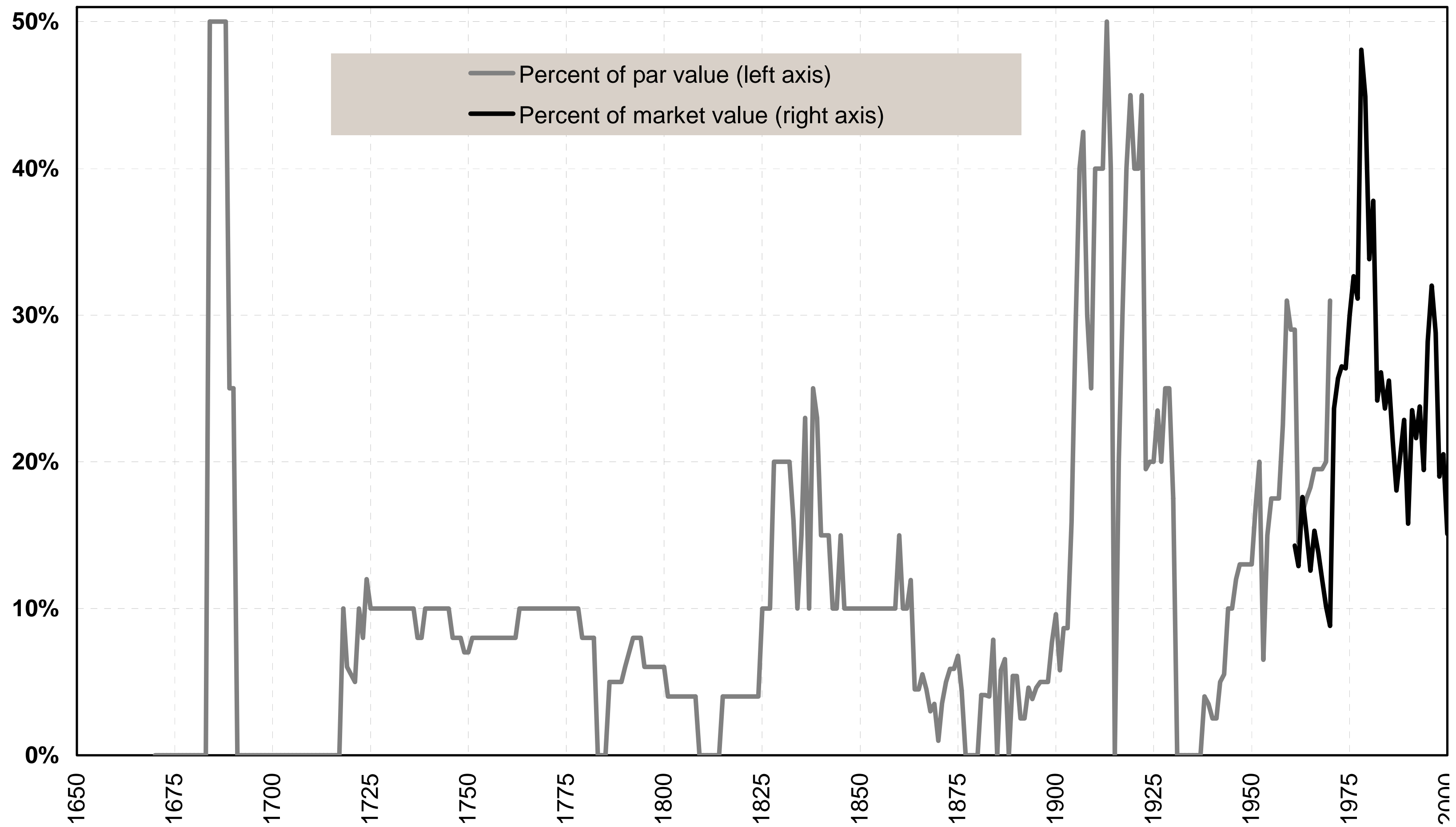
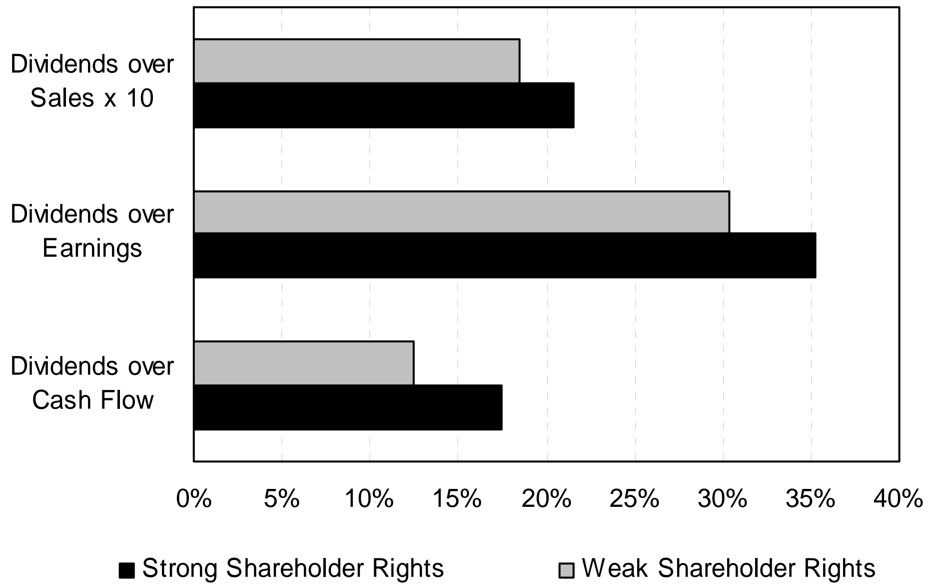
Figure 1. Hudson's Bay Company Annual Dividend, 1670 to 2000
Expressed as percent of par value until 1970 and as a percent of equity market value from 1961 to 2000.



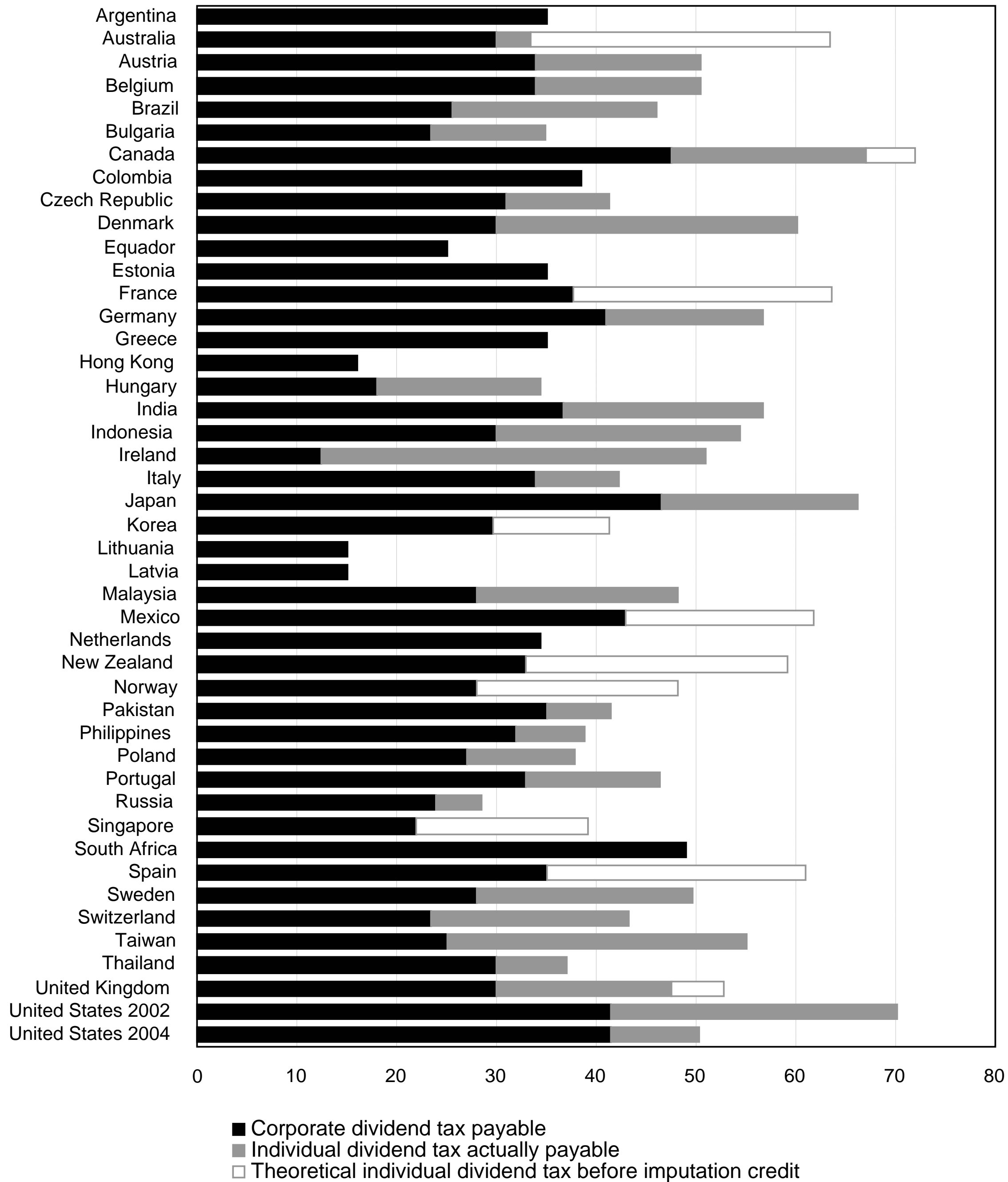
Source: Newman (2000) and *Financial Post Historical Report* for Hudson's Bay Company.

Figure 2. Average Dividend Payout Ratios in Countries with Strong versus Weak Legal Protection for Public Shareholders, 1994



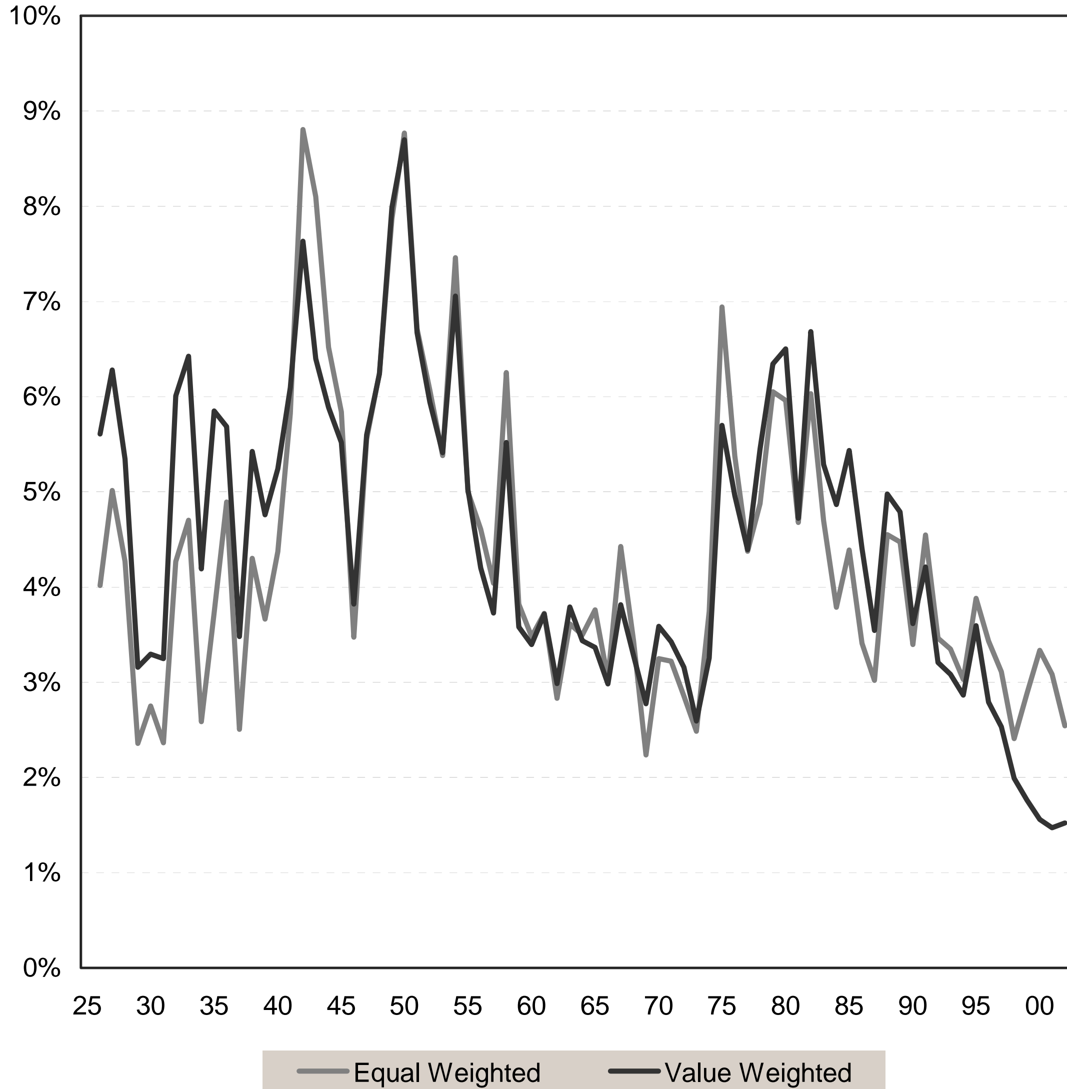
Source: La Porta et al. (2000).

Figure 3. Top Total marginal Tax Rates on Dividends in 2003 for Different Countries, and for the United States Prior to and After the 2003 Tax Reforms



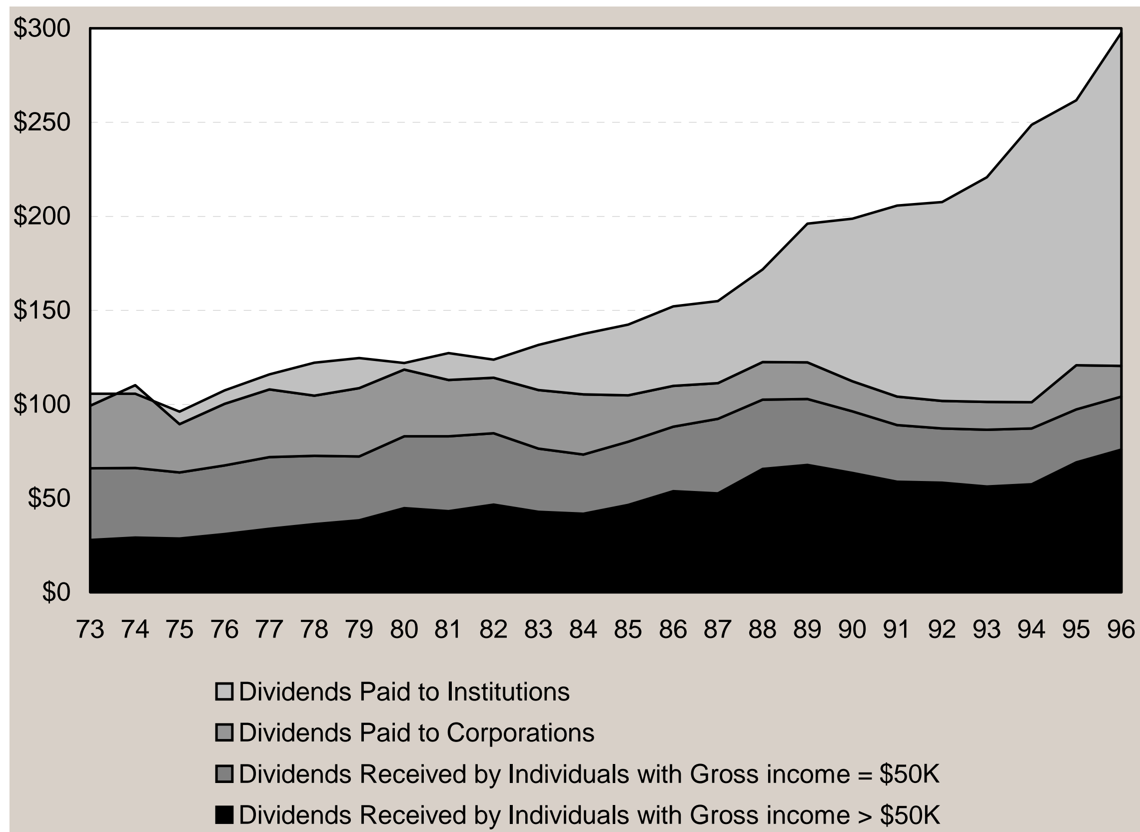
Source: PriceWaterhouse-Coopers (2003ab)

Figure 4. Average Dividend Yield of NYSE Stocks, 1926 to 2002
Dividend yield is quarterly dividend divided by share price at the end of each quarter. Value weighting assigns greater weights to companies with greater stock market capitalizations.



Source : Centre for Research in Securities Prices, University of Chicago.

Figure 5. Cash Dividends Paid by United States Corporations, in Billions of 1996 Dollars, by Type of Recipient [a]

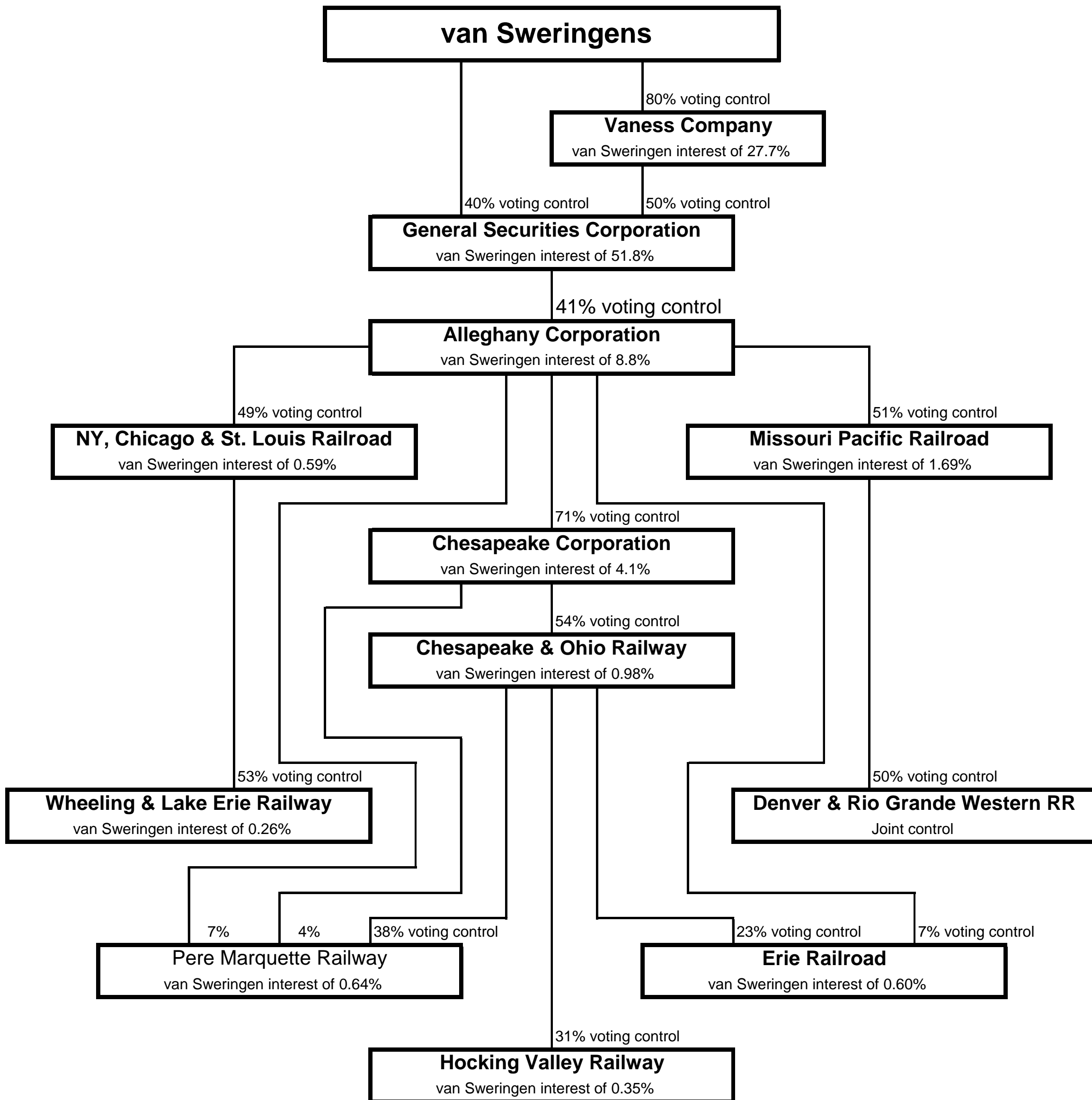


a. Dividend payments are adjusted for inflation using annual Consumer Price Indexes.

Source: Allen and Michaely (2003).

Figure 6. The Van Sweringen Control Pyramid

The van Sweringens controlled a large group of firms in Pre-Roosevelt Era America using pyramiding and dual class shares. The votes the van Sweringens control in each company's shareholder meeting thus greatly exceed their actual financial interest.



Source: Berle and Means (1932).

Figure 7. The *Jobs and Growth Tax Relief Reconciliation Act*

The United States enacted reforms in 2003 that sharply cut the individual taxes on dividends. The calculations below show taxes on corporate earnings distributed as dividends under the previous and new rules. Top individual and corporate marginal tax rates are used. State taxes are for California, and are high relative to most states.

	Pre-Reform		**Post-Reform**	
Pre-tax corporate earnings		$ 100.00		$ 100.00
Federal corporate income tax (35%) [a]	35.00%	$ 31.91	35.00%	$ 31.91
State corporate income tax (8.84% for California)	8.84%	$ 8.84	8.84%	$ 8.84
After-tax corporate income paid as dividends		**$ 59.25**		**$ 59.25**
Federal individual income tax (39.6% falls to 15%) [a]	39.60%	$ 21.28	15.00%	$ 8.06
State individual income tax (9.3% for California)	9.30%	$ 5.51	9.30%	$ 5.51
After-tax individual dividend income		**$ 32.46**		**$ 45.68**
Total taxes collected	67.54%	$ 67.54	54.32%	$ 54.32

a. State tax is deductible in calculating Federal taxable income.