

On Dividend Taxes, It's a Post-Partisan Race

By N. GREGORY MANKIOW

BARACK OBAMA is often described as a post-partisan politician who transcends traditional ideological divides. Is it true? At least when it comes to one small but important aspect of tax policy — the treatment of corporate dividends — the answer appears to be yes. Without much fanfare or public notice, Senator Obama has embraced a central element of the Republican agenda.

Let's start with some history. Before 2003, when a person received dividends from his stock holdings, this income was taxed at ordinary income tax rates. That is, a dollar of dividends generated the same individual income tax liability as did a dollar of wages.

But many economists have long argued against taxing dividends this way. Dividends are a stockholder's payment from corporate profits, and these profits have already been subject to the corporate income tax. Any tax on dividends represents a second tax on essentially the same income.

One can question whether this double taxation of income from corporate capital is fair. But fairness aside, there is also the problem of incentives. Taxing dividends twice substantially raises the overall tax burden on this form of income and distorts various decisions. Whenever taxes, rather than true costs and benefits, drive the allocation of resources, the economy shrinks below its potential.

Here are five ways a heavy tax on dividends messes things up:

CONSUMPTION VS. SAVING When the tax system depresses the return on a major asset class like corporate equities, households have less incentive to save for the future. Reduced saving means less funds for capital accumulation, which in turn impedes economic growth.

HOUSING VS. BUSINESS CAPITAL Wealth invested in your own home has several tax advantages. These include the mortgage interest deduction and the absence of any tax on imputed rent (the value that homeowners earn implicitly by getting a place to live). By taxing

business capital highly, the tax laws induce people to invest too much in housing and too little in businesses.

NONCORPORATE VS. CORPORATE Because noncorporate businesses like partnerships are taxed only once, they have an advantage over twice-taxed corporations. As a result, too much of the economy's capital stock ends up in the noncorporate sector.

DEBT VS. EQUITY FINANCE Because interest payments on corporate debt are deductible for corporate income tax calculations, this capital income is taxed only once. This asymmetric treatment of debt and equity finance induces companies to issue more debt than they otherwise would, increasing leverage and the economy's financial fragility.

RETAINED EARNINGS VS. DIVIDENDS Companies can avoid the dividend tax by retaining earnings rather than paying dividends. Excessive retained earnings, however, impede the movement of capital from older cash-generating companies to newer ones with better prospects.

Policy wonks like me have long hoped for changes in the tax code that would eliminate, or at least mitigate, these problems. In 2003, President Bush proposed that all dividends paid out of income that had already been taxed at the corporate level should be exempt from tax at the personal level. (Disclosure: I became a Bush economic adviser at about the time the reform was proposed and being debated.)

Although Congress did not give the president exactly what he sought, it gave him a large chunk of it. The top tax rate for dividends was cut to 15 percent, less than half the top rate for ordinary income. The adverse incentives of the tax code did not disappear, but they became much smaller.

At the time, debate over this change was highly partisan. Many Democrats pointed out, correctly, that the most immediate beneficiaries were rich. The poor don't own much dividend-paying stock. Middle-class families hold more equities, but they often do so in retirement accounts, which are already tax-preferred. Wonkish arguments that a better allocation of resources would improve the overall economy were dismissed as "trickle-down economics." In the end, a vast majority of Congressional Democrats voted against the bill.

The issue also divided the parties during the 2004 presidential campaign. President Bush argued for making his tax cuts, including the cut for dividends, permanent. (They are now scheduled to expire at the end of 2010.) Senator John Kerry, the Democratic candidate, proposed repealing many of the Bush tax cuts and again treating dividends as ordinary income.

Four years later, however, Senator Obama enters the picture with, apparently, a different point of view. He has not been coy about wanting to use the tax code to redistribute income more aggressively. He has proposed modest tax cuts (about \$1,000) for numerous middle-class Americans, cuts to be financed by much higher taxes on the richest few percent of the population. When all of Senator Obama's proposed tax increases on the rich are added up, the top marginal rate on wage income would be nearly 50 percent.

But for dividend income, Senator Obama has proposed only a modest increase in the top tax rate, to 20 percent from 15 percent. That is, the personal income tax would continue to tax dividends at a far lower rate than ordinary income. This decision must surprise many of his Congressional supporters. But it should be making President Bush smile.

In light of Senator Obama's stand, the politics of dividend taxation may take some surprising twists. Senator John McCain wants to maintain the current tax rate of 15 percent on dividends (while cutting the corporate tax), but it is a good bet that if Senator McCain is elected president, while Congress remains Democratic, Congress won't give the Republican president what he wants. They would instead let the Bush tax cuts expire, returning the dividend tax for high-income taxpayers to about 40 percent.

By contrast, if Mr. Obama is elected, Congressional Democrats will be less likely to balk at his proposed 20 percent dividend tax rate and thus embarrass the new president from their own party.

This leads to one of the great ironies of the political season. On the issue of dividend taxation, Barack Obama may be the candidate with the best chance of preserving George Bush's legacy.