The Effect of the May 2003 Dividend Tax Cut on Corporate Dividend Policy: Empirical and Survey Evidence

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Abstract –

We analyze the impact of the May 2003 dividend tax cut on corporate dividend policy. First, we fi nd that while there was a temporary increase in dividend initiations, this increase was not long–lasting. While dividend payments were increased right after the tax change, there was a larger and more pronounced increase in repurchases during the same time period. Second, we survey 328 fi nancial executives to determine the effects of the May 2003 dividend tax cut. We fi nd that the tax cut led to initiations and dividend increases at some fi rms. However, executives say that among the factors that affect dividend policy, the tax rate reduction is less important than the stability of future cash flows, cash holdings, and the historic level of dividends. Tax effects have roughly the same importance as attracting institutional investors and the availability of profi table investments. We also fi nd that press releases only occasionally mention the dividend tax cut as the reason for an initiation. Overall we conclude that the dividend tax reduction had only a second–order impact of payout policy.

INTRODUCTION

In December 2002, the Bush administration floated a radical proposal to reduce the taxation on dividends to zero. The official motive behind the proposal was to give the economy a boost by increasing investors' disposable income. Andrews (2003) quotes R. Glenn Hubbard, Bush's economic adviser at the time, as stating that reducing dividend taxation could boost overall stock prices by 20 percent, increasing spending and consequently economic growth. Moreover, many argue that the dividend taxation should be eliminated for the simple reason that dividends are taxed twice: Once at the corporate level since companies pay dividends from after–tax earnings, and then again at the level of the investor, who must pay income tax on dividends received. Interest income on the other hand, is taxed only at the investor level (because debt interest is paid from before–tax corporate income). This disparity between dividends and interest taxation creates a tax advantage to debt fi nancing. Proponents of the proposal, therefore, argue that reduction in dividend taxation will reduce the corporate bias towards using debt fi nancing. Finally, it is argued that the reduction in dividend taxation will reduce the cost of capital and increase investment

Since the majority of dividends are received by very wealthy individuals, opponents of the proposal argue that the elimination of dividend taxation is a tax break to the rich, which they claim makes this proposal unfair and ineffective: unfair because the tax reduction will disproportionally benefi t the rich and increase the income disparity in the US, and ineffective because the marginal propensity to consume among those wealthy individuals is rather low and, thus, a very signifi cant portion of dividends will not be consumed but will instead be saved. Moreover, the estimated cost of the proposal is more than $300 billion over the fi rst ten years of implementation. Finally some economists argue that the reduction in dividend taxation will increase the amount of dividends paid by corporations and will reduce corporate investment and, therefore, it might have a counter–productive impact on the economy (Auerbach, 1979).

After a period of negotiations between the White House, Senate and House, a modified version of the original proposal went into effect in May 2003. The dividend tax rate for individual investors fell dramatically but was not eliminated. The top statutory tax rate on dividend income dropped from more than 38 percent to 15 percent and the top rate on capital gains declined from 20 percent to 15 percent. According to theory, this tax cut should have led to greater dividend payout because it reduced the tax disadvantage of dividends relative to capital gains. (Capital gains are still somewhat tax–favored because they can be delayed until the investor sells the stock or avoided altogether at death.)

In this paper, we use survey and other empirical evidence to explore how this large reduction in the tax cost of dividends affects corporate payout decisions. Several recent empirical papers (described in the fifth section) argue that the May 2003 tax reduction led to increased dividend payments. We do not dispute this conclusion. Rather, we examine whether the tax reduction affected payout policy in a fi rst–order or second–order manner. In the latter case, we could imagine that some fi rms were "on the fence" about paying a dividend, given the existing equilibrium. The tax cut might have led these fi rms to initiate dividends but, overall, the effects of the tax effect might still have been modest. It seems plausible that the tax effect was second–order because the May 2003 tax cut reduced tax rates for individual investors but not for taxable institutions, and individual investors are generally not thought to be of fi rst–order importance. To examine the relative importance of taxes to corporate payout decisions, we look at three types of evidence.

In the first section we present summary information on dividend initiations and aggregate payout. This evidence indicates that there was a surge in initiations that peaked in the quarter after the tax cut and then returned to pre–cut levels. Moreover, the average age of an initiator also fell in the year after the tax cut, but has since returned to historic levels. We also fi nd that aggregate repurchases have grown much more than aggregate dividends since May 2003. Taken together, these results are not consistent with the tax cut having had a long–lasting, first–order impact. If anything, the evidence is more consistent with a spike in dividend activity

Second, in the third section we survey corporate decision–makers and ask them directly whether reduced dividend taxation caused their fi rms to initiate or increase dividends, and if so, how important the tax effect was. We also examine the relative importance of several non–tax factors. The surveyed executives indicate that investor tax rates affect corporate dividend decisions. We also fi nd weak evidence of a differential effect of tax rateson fi rms for whom individual investors are most important.

This fi nding is consistent with the theoretical tax prediction. However, the executives indicate that tax rates are a second–order concern, less important than several other factors. One in 11 fi rms in our survey sample had initiated dividends during the previous three years, and these fi rms report that on average, the dividend tax cut had a small to moderate effect on their initiation decision. Among initiators, the long–term stability of cash flows and cash position of the fi rm are more important than tax considerations, and the reduced availability of profi table investments and the desire to attract institutional investors are on par with taxes. More than 40 percent of the fi rms in our sample have continuously paid dividends over the past several years. These dividend–payers report that the historic level of the dividend is more important than are tax considerations, as are the stability of cash flows, cash on hand, investment opportunities, and attracting institutional investors.

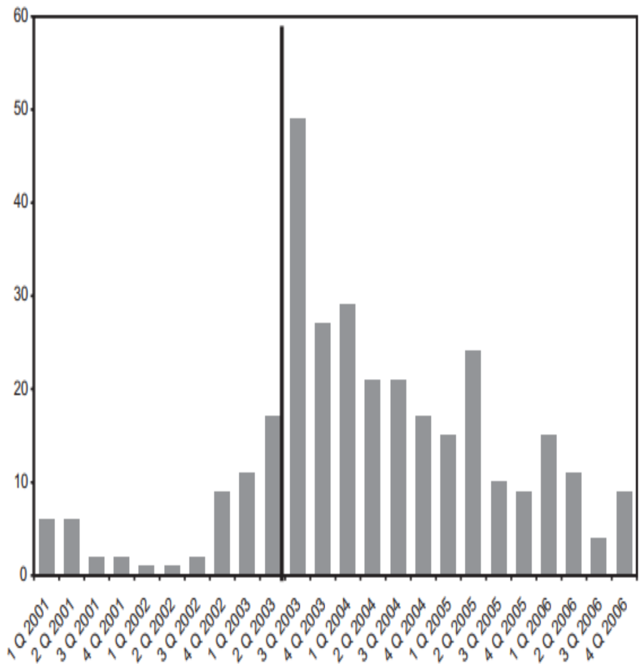
Third, in the fourth section, to document the explanations initiators give when they begin paying a dividend, we examine the press releases issued by 265 companies that initiated dividends between the fi rst quarter of 2002 and the end of 2005. Out of the 76 fi rms that initiated dividends during the second half of 2003, 24 explicitly mention the dividend tax reduction in their press release explanation of why they began paying dividends, although taxes were not necessarily the primary reason cited. However, even though reduced dividend taxes are still in effect, starting in 2004 very few fi rms mention dividend tax rates as a reason for initiating. We argue that this pattern is consistent with the tax cut influencing on–the–fence fi rms to initiate a dividend, but for the majority of companies, dividend taxation remains second–order in importance. In the fifth section we interpret our fi ndings. The sixth section concludes the paper

SOME EMPIRICAL EVIDENCE ON DIVIDENDS AND REPURCHASES SINCE 2000

To put the effects of the 2003 tax cut in perspective, we present before–and–after information about dividend initiations and overall payout. (We defi ne a dividend initiation as the payment of a regular dividend (i.e., not a special dividend) by a fi rm that has not paid a regular dividend in the past three years. We also separately consider special dividends below.) The initiation pattern provides evidence about whether the surge in dividends that followed the tax cut was temporary or permanent.

Similarly, if dividend taxation of investors affects corporate decisions in important ways, then we would expect the relative share of payout attributable to dividends to increase at the expense of share repurchases. Figure 1 presents the number of dividend initiations by quarter for the constant number of fi rms sample that Chetty and Saez (2005) use to document that a surge in dividend initiations occurred in the third quarter of 2003, immediately following the tax reduction. To reduce denominator effects in the analysis, the sample contains only the largest 3,582 non–utility, non–fi nancial fi rms by market capitalization. Figure 1 shows that there was a spike in regular dividend initiations in the third quarter of 2003. Figure 2 shows the same pattern for regular plus special dividends.1 Given that dividend increases and initiations are approved by the board of directors prior to implementation, the thirdhas not paid a regular dividend in the past three years. We also separately consider special dividends below.) The initiation pattern provides evidence about whether the surge in dividends that followed the tax cut was temporary or permanenthas not paid a regular dividend in the past three years. We also separately consider special dividends below.) The initiation pattern provides evidence about whether the surge in dividends that followed the tax cut was temporary or permanenthas not paid a regular dividend in the past three years. We also separately consider special dividends below.) The initiation pattern provides evidence about whether the surge in dividends that followed the tax cut was temporary or permanent

Figure 1. Regular Dividend Initiations



quarter spike indicates that some fi rms responded and paid their fi rst dividend shortly after the tax cut went into effect. However, in the 13 quarters after that initial spike, dividend initiations gradually returned to the level found in the several quarters just preceding the tax cut. We also calculate the average age of initiator fi rms for the years leading up to and after May 2003 (i.e., 2001Q3 to 2002Q2, 2002Q3 to 2003Q2, 2003Q3 to 2004Q2, 2004Q3 to 2005Q2, and 2005Q3 to 2006Q2). We measure age as the number of years that the fi rm has been listed on Center for Research in Security Prices (CRSP).

The average age of initiators in each of these fi ve periods is 18.3, 15.4, 14 (in the four quarters following the tax cut), 16.2, and 16. Thus, the age of initiators fell in the year after the tax cut, but rebounded in years two and three after the tax cut. Overall, the pattern in initiations and the age of initiator fi rms is consistent with the tax cut accelerating the commitment to pay dividends at some fi rms but not having a long–lasting effect that dramatically changed the payout equilibrium.

Figure 3 presents aggregate dividends compared to aggregate repurchases for Compustat firms. There is a spike in dividends in 2003 that corresponds to the reduction in dividend taxation. However, there is an even greater increase in repurchases following the May 2003 tax act. Brown, Liang, and Weisbenner (2007) argue that the reaction to the tax cut at the fi rm level was a substitution away from repurchases at fi rms for which dividends increased. However, the aggregate numbers in Figure 3 indicate that repurchases

SURVEY SAMPLE AND SUMMARY STATISTICS

Our survey is part of an ongoing quarterly joint effort by Duke University and CFO magazine. Based on theoretical and empirical work about dividend decisions, we developed an initial set of questions to pose to chief fi nancialofficers (CFOs). Given the nature of the questions, we solicited feedback from academics on the initial version of the survey, incorporated their suggestions, and revised the survey. The questions are available at http://faculty. fuqua.duke.edu/cfosurvey/05q4/html/ Duke–8–05_cookie_cutter.html.

CONCLUSION

Given an equilibrium in which some firms pay dividends, an exogenous reduction in the cost of dividends, such as halving the dividend tax rate, makes dividends more attractive. Therefore, at the margin, the May 2003 dividend tax cut should have led to additional dividends being paid. Several papers document such tax effects. Our goal in this paper is to determine whether the dividend tax cut affected the payout equilibrium in a fi rst–order manner or whether its effects were marginal, primarily affecting fi rms that were on the fence about initiating or increasing dividends. By asking managers about the motives underlying their fi rms' payout policies, we provide a unique perspective on corporate payout decisions made in response to the May 2003 reduction in dividend tax rates. We fi nd evidence that the tax cut did increase the propensity to initiate dividends. However, we do not fi nd that aggregate dividends increased relative to repurchases. The main contribution of our paper is to help gauge the relative importance of dividend tax rates on dividend decisions. We fi nd that the tax rate reduction increased the likelihood of dividend initiation, but the effect was only second–order important. We also fi nd that the tax cut had a smaller effect on increases in payout by long–time dividend payers. We corroborate these results by showing that fi rms only occasionally mention the dividend tax rate when publicly explaining why they initiate dividends. Combining these results with the observation that aggregate repurchases have increased more than dividends since the May 2003 tax cut, we conclude that taxes are second–order important in dividend decisions. These results may have important policy implications because the reduction in dividend taxes is scheduled to expire late this decade. Our results suggest that the proportion of earnings paid out as dividends will not dramatically decrease if at the end of the decade dividend tax rates return to historic levels. Because individual investors are not perceived to be particularly important investors in stocks, we would not expect corporations to respond dramatically to an increase in the relative tax rates of individual investors. At the same time, if it becomes evident that tax rates will increase, we would not be surprised if a modest number of fi rms pay a one–time special dividend just before the increase in dividend tax rates

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