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The Economic Effects of the Lower Tax Rate on Dividends

By
Robert Carroll
Senior Fellow
Tax Foundation

Executive Summary

Corporate profits are subject to a double level of taxation in the United States, which discourages productive capital formation and ultimately reduces wages and the living standards of U.S. citizens. In January 2003, President Bush proposed to eliminate the double tax on corporate profits. In May of 2003, Congress passed, and the President signed, the Jobs and Growth Tax Relief Reconciliation Act of 2003, which reduced the double tax on corporate profits by lowering the top individual tax rate on dividends and capital gains to 15 percent.

The lower tax rates on dividends and capital gains are set to expire at the end of 2010 with the capital gains tax rate rising to 20 percent and the rate on dividends rising to 39.6 percent. Without any change in the tax

Key Findings

- *Corporate profits are subject to double taxation in the U.S.: The return on a new equity-financed investment is taxed under the corporate income tax and again under the individual income tax when received by individual investors as dividend payment or realized as capital gains. This double taxation discourages productive capital formation and ultimately reduces wages and living standards.*

- *The U.S. partially addressed the double-tax problem in the Jobs and Growth Tax Relief Reconciliation Act of 2003, which synchronized and reduced both the tax rate on dividends and capital gains to 15 percent.*

- *The lower rates will expire at the end of 2010 with the capital gains tax rate rising to 20 percent and the dividends rate rising to 39.6 percent. Without any change in tax law, the top effective tax rate on dividends will rise from 50 percent prior to the passage of the health insurance reform legislation to 68 percent in 2011, a far higher rate than is levied in other G-7 and OECD nations*

- *When the high dividend tax rate is considered in conjunction with the high U.S. corporate tax rate—the second-highest among OECD countries, exceeded only by Japan—concern over the competitiveness of the United States as a place to locate investment can only grow.*

law, the top effective tax rate on dividends is set to rise from 50 percent prior to the passage of the health insurance reform legislation to 68 percent in 2011, a far higher rate than is levied in other G-7 and OECD nations (see Figure 1).

This report examines the economic rationale for reducing the double tax and, correspondingly, the economic harm associated with the sunset of the lower tax rates.

Introduction

One of the major tax policy accomplishments of the Bush Administration was the reduction in the tax rates on dividends and capital gains in 2003. The top tax rate on dividends was reduced from 39.6 percent to 15 percent and the tax rate on capital gains was reduced from 20 percent to 15 percent. Importantly, not only were both rates lowered, but they were also synchronized.

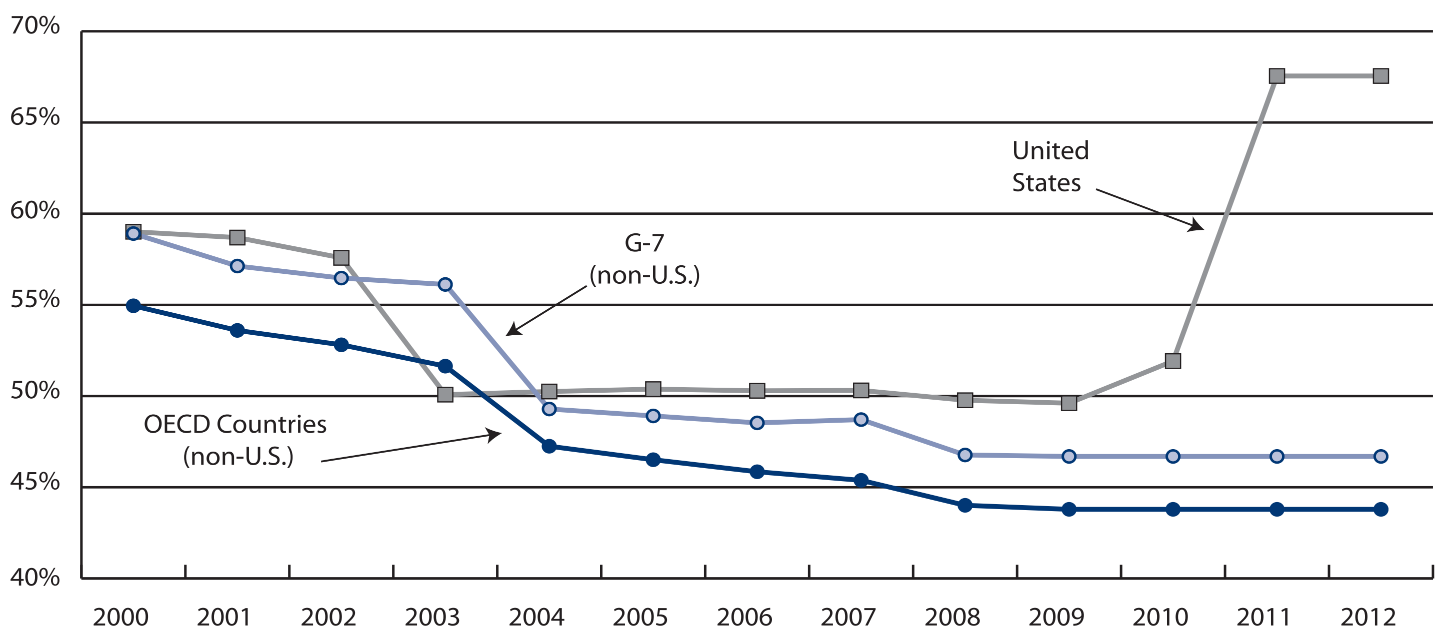
These reductions helped provide a boost to the economy during the economic recovery following the 2000-2001 recession. They lent support to the equity markets after the bursting of the internet bubble in 2000, they helped with corporate governance issues, and they helped boost business investment, a weak spot during the economic recovery.

These reductions also helped promote economic growth in the longer term. They lowered the cost of capital. A lower cost of capital encourages more capital formation, which raises labor productivity and living standards. They also reduced the double tax on corporate profits, which lessens the role played by taxes in a number of important economic decisions such as the tax bias against investment in the corporate sector, the tax bias favoring debt over equity finance, and the tax bias against company dividend payments.

Absent action by the Congress, in 2011 these rates are set to rise dramatically for higher-income taxpayers. They don't just revert to the pre-Bush Administration rates, but rise

Figure 1

United States' Integrated Dividend Tax Rate Set to Rise Dramatically



Source: Organisation for Economic Cooperation and Development (www.oecd.org). G-7 and OECD integrated tax rates are weighted by each country's gross domestic product (in 2000$ and adjusted for differences in purchasing power).

to even higher levels because of changes in the Patient Protection and Affordable Care Act of 2010 signed into law earlier this year. The tax rate on capital gains will rise to as much as 23.8 percent without taking into account state tax rates. For dividends, the tax rate will rise to 43.4 percent.[1]

If the 2003 reduction in the dividend tax rate is allowed to sunset at the end of 2010, the United States' integrated dividend tax rates will be substantially higher than in other nations – 45 percent above the average dividend tax rate among the G-7 countries and 54 percent above the 30 OECD member nations.

These large rate increases, particularly for dividends, will mean that taxes, rather than economic merit, will play a much more prominent role in driving some of the important financial decisions of firms. Moreover, these tax rates only tell part of the story because they do not account for the fact that taxes on dividends have already been taxed at the corporate level. Taking into account both the individual and corporate layers of tax, the Medicare tax, and state and local taxes, the top effective tax rate on dividends will rise to 68 percent.

Earlier this year President Obama proposed to keep in place the lower rates for dividends and capital gains for families earning less than $250,000, but to increase the rates for families with higher incomes to 20 percent.[2] Although the Obama Administration proposal would bring the tax rate on capital gains back to where it stood before the 2003 reduction, by keeping the two tax rates synchronized the proposal can be credited with retaining most of the reduction in the dividend tax rate enacted in 2003.

This report examines the various ways the double tax affects economic decision making, and it discusses worldwide trends in dividend taxation. The United States has one of the highest integrated dividend tax rates among the 30 OECD nations. Integrated dividend tax rates abroad have fallen, in large part, due to the lower corporate tax rates. If the 2003 reduction in the dividend tax rate is allowed to sunset at the end of 2010, the United States' integrated dividend tax rates will be substantially higher than in other nations – 45 percent above the average dividend tax rate among the G-7 countries and 54 percent above the 30 OECD member nations.

The Double Tax on Corporate Profits

Since the inception of the corporate income tax in 1909 and the individual income tax in 1913, the return to new equity-financed investment in the U.S. has been taxed twice in most cases. First, the return on investment is taxed under the corporate income tax and then again under the individual income tax when received by individual investors as dividend payment or realized as capital gains. The result is a much higher level of tax than most people probably realize, an integrated effective tax rate on dividends of about 50 percent today (without the recent application of the Medicare tax to dividends). Moreover, this tax rate is scheduled to be much higher – over 68 percent – in 2011.

Table 1 illustrates how the integrated dividend tax rates are calculated. First, the corporate tax is paid on earnings at the firm level at a top corporate tax rate of 39.1 percent

1 These tax rates include both the rise in the income tax rate on capital gains and dividends with the sunset of the Bush tax cuts at the end of 2010 and the application of the just increased 3.8 percent Medicare tax to all income rather than just earnings under the Patient Protection and Affordable Care Act of 2010.

2 The income threshold for single taxpayers would be set at $200,000.

(i.e., the 35 percent federal corporate tax rate plus an average 4.1 percent state corporate tax rate after taking into account deductibility for federal tax purposes). For income distributed as a dividend, the second layer of tax is then paid by individual shareholders. Prior to the passage of the health insurance reform legislation earlier this year, individual shareholders paid a top dividend tax rate of 17.3 percent (i.e., the 15 percent federal tax rate plus an average 2.3 percent state tax rate after taking into account deductibility). Alternatively, for corporate earnings that are retained and reinvested in the firm, shareholders pay tax at a maximum statutory federal capital gains tax rate of 15 percent on the appreciation in stock value.

The total tax on corporate income is then calculated by simply combining these two layers of tax. For corporate income distributed to shareholders as dividends, the combined tax is about 50 percent (not counting the Medicare tax).[3] For corporate income that is retained by the firm and realized by a shareholder as a capital gain, the combined tax rate can be somewhat over 40 percent, after accounting for the ability of taxpayers to defer payment of capital gains taxes until they are realized.[4]

The failure to provide meaningful dividend tax relief is in stark contrast to the longstanding practice amongst other developed nations.

Table 1

Top Effective Dividend Tax Rate

	Tax Law as of Jan. 2010		Tax Law in 2011	
	Tax Rate	**Amount**	**Tax Rate**	**Amount**
Corporate-Level Tax				
Corporate Earnings		$100.00		$100.00
Corporate-Level Tax (Federal plus State)	39.1%	$39.10	39.1%	$39.10
Individual-Level Tax				
Distributed Corporate Earnings		$60.90		$60.90
Federal Dividend Tax Rate	15.0%	$9.14	39.6%	$24.12
State Dividend Tax Rate	2.25%	$1.37	3.3%	$2.02
Medicare Tax	0.0%	$0.00	3.8%	$2.31
Individual-Level Tax (Federal plus State)		$10.50		$28.45
Total Tax		$49.60		$67.55
Top Effective Dividend Tax Rate	49.6%		67.6%	

Source: Computations by author.

With the enactment of the Patient Protection and Health Affordability Act of 2010, these rates are actually now somewhat higher. For the first time in the history of Medicare, this Act extended Medicare taxes to unearned income. Now, both dividends and capital gains are subject to the Medicare tax. The Act also increased the Medicare tax from 2.9 percent to 3.8 percent. Adding in the Medicare tax and state and local taxes increases the effective tax rate on dividends to 51.9 percent and the effective tax rate on capital gains (accounting for the benefits of tax deferral) to 47.4 percent.

With the sunset of the Bush Administration's tax cuts for higher-income taxpayers, the integrated effective dividend tax rate will rise dramatically to 68 percent.

Prior Interest in Addressing the Double Tax on Corporate Profits

The double tax has been addressed to some extent under the current income tax by allowing some businesses to operate as flow-through entities, the earnings from which are only taxed when received by the owners, and by allowing deductions or credits for dividends and lower effective tax rates on capital gains during some periods.

3 The formula for computing the total dividend tax equals $t_c + (1 - t_c)^*t_d$, where t_c is the corporate rate and t_d is the dividend tax rate.

4 The effective tax rate on capital gains is lower than the effective rate on dividends because of the ability to defer the tax on capital gains until realized. The benefit of tax deferral is often assumed to decrease the statutory tax rate on capital gains by 50 percent (i.e., from 15 percent to 7.5 percent).

Prior to 2003, relief provided to dividends had generally been relatively minor. For example, in the early 1980s, a dividend exclusion of $200 for joint filers and $100 for single filers was provided, but no relief was provided for dividends above these amounts.

As discussed in greater detail below, the failure to provide meaningful dividend tax relief is in stark contrast to the longstanding practice amongst other developed nations. France adopted an imputation credit system in 1965. Germany introduced a split-rate system in 1953 and an imputation credit system in 1976. The United Kingdom adopted its version of an imputation credit system in 1972.[5]

The small exclusion available in the early 1980s in the United States was repealed as part of the base broadening under the Tax Reform Act of 1986. In exchange for its repeal, the Congress mandated that the U.S. Department of the Treasury complete a study considering the integration of the individual and corporate income taxes. The Treasury study, *Integration of the Individual and Corporate Tax Systems*, which was released in January 1992, recommended that the double tax on corporate profits be eliminated by integrating the individual and corporate income taxes, and laid out for consideration and discussion four different approaches for integration.[6] A dividend exclusion was found to have the advantages of simplicity and ease of administration while achieving most of integration's goals.

In December 1992, the U.S. Treasury Department recommended an exclusion for dividends previously taxed under the corporate income tax as the most practical approach. This dividend exclusion formed the basis for President Bush's proposal to eliminate the double tax on corporate profits, unveiled on January 7, 2003. This proposal eventually evolved into the reduction in the tax rates on dividends and capital gains enacted in May 2003. Instead of an exclusion that eliminated the double tax, the reduction in tax rates for dividends and capital gains reduced the double tax and equalized the statutory rates applied to these income sources.

Economic Effects of the Double Tax on Corporate Profits

Research on dividend taxes has long questioned their effect. Part of the controversy is whether dividend taxes are capitalized into share prices (the so-called "new view") or whether they affect firm dividend policy (i.e., payout rates) and firm investment decisions (the so-called "old view").

> *If the lower tax rate on dividends and capital gains is not extended, the overall effective marginal tax rate on investment for the entire economy will be 10 percent higher than under current law, 19.1 percent instead of 17.3 percent.*

This is an important issue because if the lower tax rate on dividends is capitalized into share values, the lower rate will benefit not only households that own dividend-yielding stocks, but all households with equity investments because their share values will rise. Of course, the reverse also holds; that is, a higher tax rate on dividends would negatively affect all households with investments in equities.

Also, to the extent the lower tax rate on dividends is capitalized into share values, the lower rate will have less of an effect on economic decision making because, rather than affecting incentives by creating a wedge between before- and after-tax returns, the lower

5 Harry G. Gourevitch. "Corporate Tax Integration: The European Experience," *Tax Lawyer* 31(1) (Fall, 1977): 65–112.

6 U.S. Department of the Treasury, Integration of the Individual and Corporate Tax Systems: *Taxing Business Income Once,* January 1992. See http://www.treas.gov/offices/tax-policy/library/integration-paper/

rate is simply affecting the value of the underlying assets.

While numerous papers have been written on this subject, one by Auerbach and Hassett (2003) makes a compelling case that either view may hold, depending on a firm's source of finance.[7] For newer, immature firms whose source of finance is more likely to be newly issued equity, the old view may well dominate. For older, mature firms whose source of finance is more likely to come from retained earnings rather than equity, the new view may well dominate.

Much of the case for the distorting effect of the double tax presumes that dividend taxes affect firm dividend policy and investment decisions. Nevertheless, in 2003, there was also concern over the effect the difficulty in the equity markets was having on the overall economy. Thus, it was viewed that the capitalization of a portion of the dividend tax cut into equity values might provide some near-term support to the weak economy. As mentioned above, the capitalization effects are spread over all households who hold equities at the time of the change in dividend tax rates.

Under both the old and new views, dividend taxes are important to new equity-financed investment. Thus, the lower tax rates on dividends and the lower capital gains tax rate enacted in 2003 can be considered from this perspective where they can affect a number of economic decisions. The double tax, for example, may reduce corporate investment, encourage debt finance over equity finance, discourage the payment of dividends, and also discourage investment generally.

Economists often use marginal effective tax rates to measure the impact of taxes on investment decisions. Marginal effective tax rates capture how various provisions in the tax code, including the statutory tax rate, depreciation deductions, interest deductions, deferral of tax liability, and both the individual and corporate levels of tax affect the after-tax rate of return to a new investment. The concept tells us how much larger an investment's economic income needs to be to cover taxes over its lifetime.

The double taxation of an equity-financed corporate investment is not the only source of uneven taxation in the tax code. Many types of investment face uneven treatment because of the various ways tax rates, depreciation deductions, deferral of tax, and inflation interact and lead to different effective tax rates on different types of investment.

The misallocation of investment and capital translates into lower national income than would occur absent the distorting effects of the double tax.

Table 1 shows the marginal effective tax rates on different types of investment by type of financing and economic sector for both current law and for the higher tax rates on dividends and capital gains if the Bush tax cuts are allowed to expire.[8] Currently, the overall effective tax rate on an investment is 17.3 percent across all types of investment for the entire economy.

The uneven taxation of investment can clearly be seen from Table 2. For investment in the business sector the effective tax rate is 25.5 percent, but in the corporate sector it is 29.4 percent, nearly 50 percent higher than for the non-corporate sector because of the double tax on corporate profits. Equity-financed investment in the corporate sector faces an effective

7 Alan J. Auerbach and Kevin A. Hassett, (2003), "On the Marginal Source of Investment Funds," *Journal of Public Economics* 87 (1), January, 205-232.

8 In other words, the comparison is between current law marginal effective tax rates assuming that dividend and capital gains cuts are permanent, and the marginal effective tax rates that occur under current law if the dividend and capital gains rates were not in place.

tax rate of 39.7 percent, while a debt-financed investment is effectively subsidized at a rate of 2.2 percent. The high tax rate on an equity-financed investment is caused by the high corporate tax rate and the additional taxes at the investor level (i.e., capital gains and dividends).

Even if the sunset of the 2003 reduction in the dividend tax rate is limited to families with incomes over $250,000 (and single taxpayers with incomes over $200,000), as suggested by the Obama Administration, all households that hold dividend-paying stocks, regardless of their income, would be affected.

Debt-financed investments are taxed at a much lower rate – near zero – because interest expenses are a deductible business expense and roughly 50 percent of interest income escapes taxation because the underlying debt is held by pension funds, 401(k)s, or foreigners, all of which are either untaxed or lightly taxed.

If the lower tax rate on dividends and capital gains is not extended, the overall effective marginal tax rate on investment for the entire economy will be 10 percent higher than under current law, 19.1 percent instead of 17.3 percent. The effective marginal tax rate for investment in the business sector would also be about 10 percent higher than under current law, increasing to 28.1 percent. This higher level of tax on investment, particularly investment in the business and corporate sectors, would discourage investment and would reduce labor productivity and, ultimately, living standards.

Not only is the overall level of tax on investment reduced, but the relief from the double tax on corporate profits enacted in 2003 also results in a more even taxation of different types of investment. This is accomplished by reducing the effective marginal tax rate of equity-financed investment in the corporate sector *relative* to investment elsewhere in the economy.

Why is more even or neutral taxation important? Simply put, it improves the allocation of capital in the economy. Rather than encouraging investment decisions to be made based on their tax treatment, neutral tax policy allows them to be based more on underlying economic merits. This improves the allocation

Table 2

Marginal Effective Tax Rates for Different Types of Investment

Effective Tax Rates (percent)	Current Law*	Without Lower Dividends and Capital Gains Tax Rates*
Economy-Wide	17.3	19.1
Business Sector	25.5	28.1
Corporate	29.4	33.5
Debt-Financed	-2.2	-2.2
Equity-Financed	39.7	44.2
Non-corporate	20	20
Owner-occupied housing	3.5	3.5

Source: U.S. Department of the Treasury, *Treasury Conference on Business Taxation and Global Competitiveness: Background Paper*, July 26, 2007
*The estimates of the effective marginal tax rates under current law and with the expiration of the lower tax rates on dividends and capital gains do not incorporate the deduction for certain production activities enacted as part of the American Jobs Creation Act of 2004.

of capital and allows economic resources to be used more productively in the economy. The end result is a higher level of output and living standards.

The reduced distortion of business decisions would be equivalent to receiving additional income of $43 billion every year in perpetuity.

Reducing the double tax on corporate profits reduces the distortionary impact of taxes on a number of important economic decisions:

The decision to invest in the corporate or noncorporate sectors.

The double tax on corporate profits raises the before-tax rate of return on corporate capital above the before-tax rate of return on noncorporate capital (assuming that after-tax risk-adjusted rates of return are equal). This tax bias against investment in the corporate sector means that there is too little investment in the corporate sector.

The misallocation of investment and capital translates into lower national income than would occur absent the distorting effects of the double tax. The greater tax burden on corporations encourages business owners to choose organizational forms, such as partnerships and other pass-through entities, which enjoy a single level of taxation, but do not have the benefits of limited liability or centralized management found in the corporate structure. Also, investment in inherently corporate industries is discouraged by the double tax.

The decision to finance new investment with debt or equity.

The greater taxation of equity-financed investments leads to an over-reliance on debt finance for corporate investment. Higher debt burdens increase a firm's risk of bankruptcy during temporary industry or economy-wide downturns. Business failures generate losses to both shareholders and employees, and the heightened bankruptcy risk can make the entire economy more volatile. Over-reliance on debt also leads to misallocation of resources in the economy and, by extension, lower economic performance and lower living standards. These issues would appear to be particularly relevant in light of the recent financial crisis.

The decision to retain or distribute earnings through dividends or share repurchases.

Corporations are discouraged from distributing earnings through dividend payment to the extent that dividends are more heavily taxed than capital gains generated through share repurchases or retained earnings. This distortion in dividend payout policy may lead to an over-investment in established firms that are able to finance investment through retained earnings and a less efficient allocation of investment among firms in the economy.

The payment of dividends also may improve corporate governance by providing an important signal to investors of a company's underlying financial health and profitability. Generally, a firm cannot be expected to pay dividends for a long period of time unless the company has earnings to support such payments. Regular dividend payments also limit funds over which corporate managers have discretion and may be one way for shareholders to ensure that managers invest only in projects that raise shareholder value.[9]

The economics literature suggests dividend payments are sensitive to the difference between the effective tax rates on dividends and capital gains. By reducing the distortion in the treatment of dividends and capital gains, the lower tax rates on both which were enacted

9 For a review of research on dividends and corporate governance issues, see Randall Morck and Bernard Yeung. 2005. "Dividend Taxation and Corporate Governance." *Journal of Economic Perspectives* Vol. 19, No. 3, pp. 163-180.

in 2003 should have increased dividend payments. One study estimated that dividends would eventually increase by approximately 30 percent.[10] Another study evaluating actual dividend payments after the reduction found that the dividend tax cut increased regular dividend payments by publicly traded corporations by approximately 20 percent by the end of the second quarter in 2004.[11]

Importantly, changes in firm dividend policy can have broad effects across households. For example, even if the sunset of the 2003 reduction in the dividend tax rate is limited to families with incomes over $250,000 (and single taxpayers with incomes over $200,000), as suggested by the Obama Administration, all households that hold dividend-paying stocks, regardless of their income, would be affected. Thus, raising the dividend tax rate can be expected to directly affect many of the 27.1 million tax returns – roughly one-fifth of all tax returns filed – who reported qualified dividends in 2007.[12]

The decision whether to consume today or invest and consume in the future.

Table 1 indicates that the 2003 Act lowered the overall tax burden on capital income. Taxing capital income increases the price of future consumption (i.e., savings) compared to consuming today, as income consumed today will be taxed once, while income saved for consumption in the future will be taxed today and again in the future as the return to saving is included in income. Lowering the price of future consumption should increase savings and capital accumulation, which raises living standards over time as the larger stock of capital increases worker productivity.

The effects of these economic distortions and options to reduce them through integrating the corporate and individual income tax systems are discussed in detail in Treasury's 1992 integration report. That study suggested that eliminating the double taxation of corporate profits could eventually raise economic welfare in the United States by about 0.5 percent of national consumption, or about $43 billion per year (in 2005 dollars), not including the economic gains from reducing the distortion between present and future consumption. Put differently, the reduced distortion of business decisions would be equivalent to receiving additional income of $43 billion every year in perpetuity.

The combination of the high dividend tax rate and high corporate tax rate raises serious concern over the competitiveness for the U.S. as a place to locate investment.

The lower dividend and capital gains tax rates passed in 2003 reduced, but did not eliminate the double tax on corporate profits. Thus, the economic gains are likely smaller than estimated in the 1992 Treasury integration study.

The reduction in the double tax on corporate profits not only improves the allocation of capital, but also reduces the overall level of tax on capital income. As shown in Table 1, the overall effective marginal tax rate on investment would be 10 percent higher economy-wide without the reduction in the double tax on corporate profits under the 2003 Act.

10 James Poterba. 2004. "Taxation and Corporate Payout Policy." *American Economic Review* Vol. 94, No. 2, pp. 171-175.

11 Raj Chetty and Emmanuel Saez. 2005. "Dividend Taxes and Corporate Behavior: Evidence from the 2003 Dividend Tax Cut," *Quarterly Journal of Economics*, Vol. CXX, No. 3, pp. 791-833. As with the previous two studies, financial and utility companies are excluded from the sample. The 20 percent figure is likely to increase over time and suggests a faster adjustment that previously estimated by Poterba (2004).

12 Ernst and Young, LLP, "The Beneficiaries of the Dividend Tax Rate Reduction," Report prepared by the Quantitative Economics and Statistics Practice, Ernst and Young, LLP, on behalf of the Edison Electric Institute and the American Gas Association, January 2010.

How Do Other Countries Provide Relief from the Double Tax on Corporate Profits?

Most countries provide at least some relief from the double tax on corporate profits. All of the major economies (i.e., the G-7 countries) have done so for decades. The member nations of the OECD countries vary in how they provide relief, but it is generally provided at the shareholder level through either an imputation credit system, in which shareholders receive a credit for taxes paid at the corporate level, a dividend exclusion, or lower tax rates.[13]

Table 3

Integrated Dividend Tax Rates for OECD Countries, 2000 and 2009

	2000		2009	
Country	**Imputation Method**	**Integrated Tax Rate**	**Imputation Method**	**Integrated Tax Rate**
Australia	X	48.5	X	46.5
Austria		50.5		43.8
Belgium		49.1		43.9
Canada	X	61.1	X	47.2
Czech Republic		41.4		32.0
Denmark		59.2		58.8
Finland	X	29.0		40.5
France	X	63.2		55.9
Germany	X	60.9		48.6
Greece		35.0		32.5
Hungary		55.7		40.0
Iceland		37.0		23.5
Ireland		57.4		48.4
Italy	X	44.9		36.6
Japan*	X	66.7		45.6
Korea		44.6	X	46.4
Luxembourg		52.2		42.5
Mexico	X	35.0	X	28.0
Netherlands		74.0		44.1
New Zealand	X	39.0	X	38.0
Norway	X	28.0		48.2
Poland		44.0		34.4
Portugal*		51.4		41.2
Slovak Republic		39.7		19.0
Spain	X	52.7		42.6
Sweden		49.6		48.4
Switzerland		56.5		36.9
Turkey	X	65.0		34.0
United Kingdom	X	47.5	X	46.0
United States		59.0		49.6
Average Integrated Tax Rates:				
OECD (non-U.S.)		55.0		43.8
G-7 (non-U.S.)		58.9		46.7

Source: Organisation for Economic Cooperation and Development (www.oecd.org). G-7 and OECD integrated tax rates are weighted by each country's gross domestic product (in 2000$ and adjusted for differences in purchasing power).

As shown in Table 3, the imputation method was much more prevalent in 2000 than it is today with a number of countries shifting to shareholder exclusions or lower dividend tax rates. Thirteen OECD countries used the imputation method in 2000 as compared to only six countries in 2009. For example, France had an imputation system prior to 2005 but now applies a special rate of 18 percent to 60 percent of dividends. Germany and Italy have also shifted from imputation systems to shareholder exclusions or lower rates. Prior to 2001 Germany allowed a partial imputation credit, but now applies a flat withholding rate of 25 percent.[14] Italy, which used to allow a full imputation credit, now imposes a 12.5 percent tax rate on dividends. Nevertheless, Canada, the United Kingdom and Japan continue to use an imputation system.

The full imputation method, whereby one level of tax is completely removed, was prevalent among G-7 countries as late as the 1990s.[15] As the global economy has become more open there has been a trend away from the full imputation system.[16] By 2000, among G-7 countries, only Italy had a full imputation system.

These changes tell a broader story: Some countries have, in effect, switched dividend tax relief to the company level by not only moving

13 With an imputation credit system, shareholders gross up their dividend by the corporate tax rate (i.e., the dividend divided by one minus the corporate tax rate) to compute the gross dividend and then subtract the allowed credit. A full credit would completely eliminate the corporate level tax, whereas a partial credit would eliminate just part of it.

14 Germany increases its 25 percent rate with a 5.5 percent solidarity surcharge.

15 The imputation system seeks to relieve all or a portion of one of the two layers of tax. Corporations, of course, pay a net-of-corporate-tax dividend to shareholders. The purpose of the credit is to recognize that when individual taxpayers receive their dividend, corporate tax has already been paid.

16 To understand how an imputation credit system works, consider a full imputation credit and a corporation with $100 in corporate earnings. Suppose the corporate level tax is 30 percent. The dividend payment to shareholders would then be $70. The first step is to "gross up" the dividend by the corporate tax rate to get back to the pre-corporate tax amount. Germany increases its 25 percent rate with a 5.5 percent solidarity surcharge. Mechanically, this is accomplished by multiplying the dividend by t_c/(1-t_c), where t_c is the corporate tax rate. The individual shareholder then pays tax based on this grossed-up amount, but receives a credit for corporate taxes paid. In effect, the corporate level tax on the corporate profits is removed through the credit.

to partial integration systems, which provide more limited relief to dividends, but also by reducing corporate income tax rates.

By injecting tax considerations into investment decisions, the double tax reduces the productive capacity of the U.S. economy and serves, ultimately, to reduce the living standards of U.S. citizens.

The trend in integrated dividend tax rates among member nations of the OECD and G-7 countries is shown in Figure 1 (and Table 3). These integrated dividend tax rates generally include national and sub-national corporate and individual income taxes, and, unless otherwise noted, various surcharges and some social insurance taxes.[17] The average integrated dividend tax rates are weighted by each country's gross domestic product to account for the relative size of their economies.[18]

Several things are striking about the trends shown in Figure 1. First, the average integrated dividend tax rate has fallen considerably between 2000 and 2009 from 58.9 percent to 46.7 percent for G-7 countries (excluding the United States) and 55.0 percent to 43.8 percent for OECD countries (excluding the United States). Second, while the United States had an integrated dividend tax rate at or somewhat above these averages in 2000, the U.S. integrated dividend tax rate of 49.6 percent (and 51.9 percent with the Medicare tax) is now well above these averages.

Finally, if the lower tax rate on dividends enacted in 2003 is allowed to sunset at the end of 2010, the top integrated tax rate in the U.S. will rise to a level that is substantially above these averages. The U.S. integrated dividend tax rate of 68 percent will be 54 percent higher than the average integrated dividend tax rate among member nations of the OECD, and 45 percent higher than the average dividend tax rate among the larger G-7 economies. The integrated dividend tax rate in the U.S. will surpass the next highest rate of 58.8 percent in Denmark and 55.9 percent in France.

The high dividend tax rate set to go into effect in 2011 is in addition to the high U.S. corporate tax rate of 39.1 percent, the second-highest among OECD nations, exceeded only by Japan. The combination of the high dividend tax rate and high corporate tax rate raises serious concern over the competitiveness for the U.S. as a place to locate investment.

Conclusion

The United States made considerable progress in addressing the problems with the double tax on corporate profits in 2003 when the dividends tax rate was lowered to 15 percent. The double tax on corporate profits discourages productive capital formation, encourages debt finance, discourages investment in the corporate sector, and discourages dividend payouts.

First, by hitting corporate investments harder than other investments, the double tax leads to a misallocation of capital. Productive corporate investments are passed over in favor of less productive investments elsewhere in the economy. Second, by contributing to the overall tax burden on capital income, the double tax on corporate profits reduces aggregate investment and capital formation, which eventually contributes to lower labor productivity.

In short, by injecting tax considerations into investment decisions, the double tax reduces the productive capacity of the U.S.

17 This only reflects statutory rates and ignores the effect of accelerated depreciation deductions and other items that enter into the marginal effective tax rates shown in Table 1.

18 Gross domestic product is adjusted for both differences in the price level over time (i.e., deflated to 2000 dollars) and to reflect changes in the price level and for differences in purchasing power across countries.

economy and serves, ultimately, to reduce the living standards of U.S. citizens.

With the sunset of the 2003 Act, the statutory dividend tax rate is poised to rise to 39.6 percent under the individual income tax. Adding the corporate layer of tax, state and local taxes, and the Medicare tax pushes the integrated dividend tax rate up to 68 percent, rather than the 50 percent before the enactment of the health insurance reform.

This high integrated dividend tax rate will be far above the rates levied in other developed countries – 45 percent higher than the average integrated dividend tax rate that prevails among G-7 countries (excluding the United States) and 54 percent higher than the average among OECD countries (excluding the United States). When the high dividend tax rate is considered in conjunction with the high U.S. corporate tax rate—the second-highest among OECD countries, exceeded only by Japan--concern over the competitiveness of the United States as a place to locate investment can only grow.

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Editor and Communications Director, Bill Ahern

Copy Editor, Alicia Hansen

Tax Foundation
National Press Building
529 14th Street, NW, Suite 420
Washington, DC 20045-1000

(202) 464-6200

www.TaxFoundation.org
TF@TaxFoundation.org