

Dividend Taxation: Nearly All Major Nations Relieve Double Taxation

Statement of Chris Edwards, Director of Fiscal Policy, Cato Institute
before the Senate Democratic Policy Committee

January 21, 2003

Mr. Chairman and members of the Committee, thank you for inviting me to testify today regarding the President's new tax proposals.

President Bush has proposed a generally pro-growth package that would save taxpayers \$670 billion over 10 years. The tax package will have positive effects on short-term economic growth. More importantly, most features of the plan are winners for long-term economic growth. Long-term growth will be spurred by the proposals to accelerate the individual marginal tax rate reductions, expand small business capital expensing, and the proposed reduction in taxation of capital income in the form of the dividend and capital gains tax cuts.

The highest marginal rates in the federal tax system cause the largest distortions or so-called deadweight losses to the economy. The Bush plan focuses on reducing high tax rates. The current double taxation of corporate earnings paid out as dividends results in a marginal federal tax rate as high as 60 percent. The Bush proposal would exempt dividends from tax at the individual level, which would drop the top dividend rate to 35 percent and make the tax treatment of dividends roughly similar to the treatment of interest.

Problems Caused by High Dividend Taxes

As the administration and others have observed, high dividend tax rates reduce economic growth by creating numerous distortions. First, high dividend taxes add to the income tax code's general bias against savings and investment. Second, high dividend taxes cause corporations to rely too much on debt rather than equity financing. Highly indebted firms are more vulnerable to bankruptcy in economic downturns. Third, high dividend taxes reduce the incentive to pay out dividends in favor of retained earnings. That may cause corporate executives to invest in wasteful or unprofitable projects. Fourth, high dividend tax rates create a bias against business organized in the corporate form. And fifth, high tax rates on dividends and other types of capital income greatly increase the wasteful efforts of financial engineers to design ways of avoiding and evading taxes.¹

U.S. Has the Second Highest Dividend Tax Rate in the OECD

The benefits of reduced dividend taxation have been recognized by nearly every other industrial country. Indeed, the latest data from the Organization for Economic Cooperation and Development (OECD) shows that the U.S. has the second highest top

tax rate on dividends, when considering both the corporate and individual taxes. (Figure 1 in my written testimony) The OECD data includes state and local taxes, but even just the U.S. top federal rate of 60 percent would give us the fifth highest tax among the 30 countries.²

Methods of Relieving Double Taxation

The U.S. has the second highest top rate of dividend taxation for two reasons. First, the U.S. has one of the highest statutory corporate income tax rates in the industrial world. Again, looking at the 30 OECD countries, the U.S. has the fourth highest corporate tax rate, according to KPMG data. Second, 27 of 30 OECD countries have adopted one or more ways of reducing or eliminating dividend double taxation.³ Only Ireland, Switzerland, and the United States do not relieve dividend double taxation. But Ireland and Switzerland have much lower corporate tax rates than we do.

Table 1 in my written testimony details the different methods that the 27 OECD countries use to partly or fully relieve double taxation.

Individual rate reduction. The most popular way to relieve double taxation is to simply tax dividends at a flat rate, lower than the ordinary rate on wages. Countries that provide a special low rate on dividends include Austria, Belgium, the Czech Republic, Denmark, Italy, Korea, the Netherlands, Poland, and Portugal.

Some countries, such as Finland, Norway, and Sweden, have moved to so-called “dual income tax systems” that impose higher rates on wage income but lower flat rates on all forms of capital income. Those countries have lowered rates on capital income because of increasingly global tax competition, which is drawing billions of dollars of investment capital to low-tax countries. Many countries are realizing that high tax rates on capital income are becoming unsustainable in today's global economy.

Individual exclusion. Two countries, Germany and Luxembourg, provide a 50 percent dividend exclusion to individuals (e.g. if \$1,000 in dividends is received, only \$500 is taxed). Greece fully exempts domestic dividends from individual taxation – basically the approach taken by the Bush administration.

Individual credit. The traditional way to provide double taxation relief was to provide individuals a dividend tax credit to fully or partially offset the corporate income tax paid on the earnings.⁴ This is sometimes called a dividend imputation credit. Countries offering tax credits that partially offset corporate-level tax include Canada, France, and the U.K. Countries providing credits that fully offset double taxation include Australia, Finland, Italy, Mexico, and New Zealand.

Norway provides a full dividend credit and has a flat individual tax rate of 28 percent on all capital income, with the result that it has the lowest overall dividend tax rate in the OECD of just the 28 percent.

The New Zealand system is also interesting. That country provides a full credit to eliminate dividend double taxation, and it also dropped its individual capital gains tax rate to zero to eliminate any bias against retained earnings that would have otherwise resulted.

Nonetheless, there has been a movement away from the individual dividend credit approach toward simply offering lower dividend tax rates in recent years.

Corporate deduction. Dividends can be given parallel treatment to interest by allowing corporations to deduct dividends at the corporate level. The Czech Republic and Iceland allow a partial dividend deduction. A full corporate dividend deduction may be the most simple and straightforward method of creating neutrality between interest and dividends, and thus should be considered by Congress as an alternative to the Bush approach.

Conclusion

To conclude, there is a global trend toward lower tax rates on all forms of capital income, including corporate income taxes and individual taxes on dividends and capital gains.⁵ Policymakers in many countries are recognizing that high capital income taxes distort savings and investment decisions and reduce economic growth. As just one example, Canada is currently implementing a phased-in cut in its federal corporate income tax rate from 28 percent to 21 percent.

In this country, Congress should begin reforming the tax code in line with global trends and reduce the high tax rates that are currently placed on dividends.

Thank you for holding these important hearings, and I look forward to working with the Committee on these issues.

¹ William Gentry and R. Glenn Hubbard, "Fundamental Tax Reform and Corporate Financial Policy," National Bureau of Economic Research Working Paper 6433, February 1998.

² Data is from the OECD Tax Database emailed to author from OECD-Paris, January 13, 2003. See also Isabelle Joumard, "Tax Systems in European Union Countries," Working Paper no. 301, OECD, June 29, 2001.

³ Table 1 was compiled by the author based on Ernst & Young, "The Global Executive 2002," October 2001; Paul van den Noord and Christopher Heady, "Surveillance of Tax Policies," Working Paper no. 303, OECD, July 17, 2001; and various other sources. Credits, exemptions, and lower rates are often only available for domestic investments.

⁴ Often called the "dividend imputation" method.

⁵ See Chris Edwards and Veronique de Rugy, "International Tax Competition, A 21st Century Restraint on Government," Cato Institute Policy Analysis no. 431, April 12, 2002.