Two Simple Cures for What Ails America

Enron, WorldCom, and company failed by making unusually bad business decisions, *not* by violating accounting standards. Almost all of the public debate about the failure of these large corporations, however, has focused on how to improve accounting standards and auditing procedures with little attention to the effects of other government policies on the reasons why corporations fail. Without changes in the policy-related conditions that contribute to corporate failure, improved accounting rules and auditing procedures will accelerate bankruptcies with little effect on their frequency or magnitude. A blatant violation of accounting rules clearly offends the general public and the political community, but the losses to a corporation's investors, creditors, employees, and local communities are more directly related to the failure of the corporation than to the measures its managers may have taken to delay recognition of its financial weakness.

Corporations go bankrupt when they can no longer meet their obligations to their creditors. This, in turn, is a result of some combination of unusually risky investments and unduly high debt. Bankruptcy is part of the process of reallocating capital; the optimal number of bankruptcies is not zero because the interests of the broader economy are served by corporations being willing to take some risks and to use some amount of debt finance. The primary policy problem is that the current U.S. tax code *increases* the conditions that lead to corporate bankruptcy. The corporate earnings subject to tax, for example, exclude interest payments but not dividends; this leads corporations to use more debt finance than would be the case if the tax treatment of interest and dividends were the same. The combined federal and state corporate income tax rate in the United States is now the fourth highest among the industrial nations, so one should expect American corporations to be relatively dependent on debt finance. Second, for most investors, the tax rate on dividend income is much higher than the rate on long-term capital gains; this leads corporations to rely more on retained earnings and capital gains than on dividends as the return to equity. This bias also leads to several other adverse effects—reducing the cash-flow discipline to meet dividend payments, increasing the incentive to inflate the stock price, and increasing the role of corporate managers relative to investors in the allocation of capital.

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The simplest direct way to reduce these tax-related problems is to allow corporations to deduct one-half of their dividend payments from the earnings subject to the corporate income tax. This would make the combined corporate and personal tax rate on capital gains and dividends about the same for most investors without changing any other feature of the corporate or personal income tax code, roughly eliminating those adverse conditions attributable to the current difference in these rates. Over the past several years, in addition, this would have reduced corporate income tax liability by about $60 billion a year, substantially reducing the bias in favor of debt finance. Other tax revenues, of course, would increase—due to an improved allocation of capital, increased corporate investment, and higher personal income tax revenues from increased dividend payments. For those who would otherwise be opposed to reducing corporate income tax liability or considering any supply-side benefits of lower tax rates, Cato has long maintained a list of federal corporate welfare spending, the elimination of which would more than offset the reduction of corporate income tax liability.

A second important problem is that both the federal and state governments have passed an accumulation of laws that protect corporate management against the interests of the general shareholders. The first and most important of these laws is the federal Williams Act of 1968, which requires any person or group that acquires more than 5 percent of the shares of a corporation to provide extensive information within 10 days to the corporation, the exchanges, and the Securities and Exchange Commission, including "if the purpose of the purchases or prospective purchases is to acquire control of the business of the issuer of the securities," and increased the authority of the SEC to regulate tender offers. Following this act, the number of hostile takeovers declined substantially in the 1970s and, following a series of court decisions and state anti-takeover laws beginning in the late 1980s, the number of hostile takeovers again declined substantially in the 1990s. The primary protection of general shareholders against an abuse of authority by corporate management has been substantially eroded by public policy. The second simple cure for what ails American corporations is to begin to reverse this process by repealing the Williams Act of 1968.

A candidate for Congress who endorses these two simple cures—the deduction of one-half of dividends from the earnings subject to the corporate income tax and the repeal of the Williams Act of 1968—would be among the few to demonstrate that they understand what happened to American corporations and the most important policy changes to restore their financial health and integrity.

—William A. Niskanen