

# Tax & Budget

BULLETIN

No. 12 January 2003



## Dividend Taxes: U.S. Has the Second-Highest Rate

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Federal policymakers are considering proposals to reduce taxes on corporate earnings distributed as dividends. Dividend tax cuts would boost the stock market, lessen the tax code bias against savings, and reduce incentives for firms to take on too much debt and excessively retain earnings.

Earnings distributed as dividends may face both the 35 percent corporate income tax and the individual income tax, which has a top rate of 38.6 percent. That double taxation leads to federal marginal tax rates of up to 60 percent.<sup>1</sup> By contrast, interest is deductible to the corporation and thus only taxable at the individual level.

The Bush administration's plan to fully exclude dividends from tax at the individual level would save taxpayers a projected \$364 billion over the next 10 years.<sup>2</sup>

### U.S. Has the Second-Highest Dividend Tax Rate

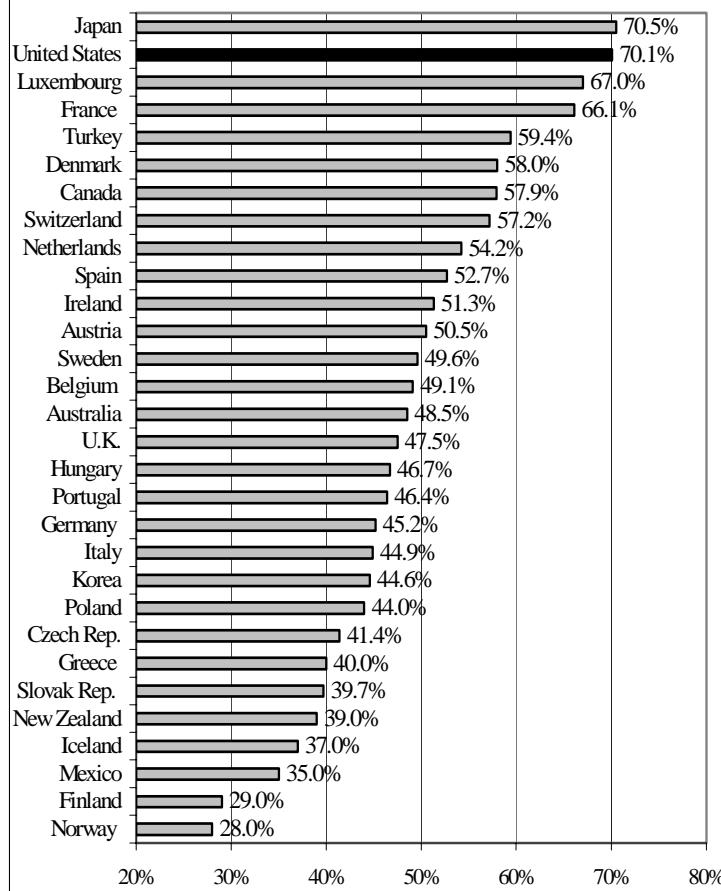
Nearly all major nations allow full or partial relief of dividend double taxation, and thus have much lower dividend tax rates than does the United States. Indeed, new data shows that the United States has the second highest top dividend tax rate in the 30-nation Organization for Economic Cooperation and Development (see Figure 1).<sup>3</sup> The OECD data includes corporate and individual taxes imposed by both national and subnational governments.

### Problems Caused by High Dividend Taxes

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 because interest is deductible against the corporate income tax but dividends are not. 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 tax rates on dividends and other types of capital income greatly increase the wasteful efforts of financial engineers to design ways of avoiding taxes.<sup>4</sup>

Figure 1. Top Dividend Tax Rate  
Combined Individual and Corporate



Source: OECD. Data is for 2001 and 2002 for a resident in the top tax bracket.

## Methods of Relieving Double Taxation

Table 1 shows that 27 of 30 OECD countries have adopted one or more ways of reducing or eliminating dividend double taxation.<sup>5</sup> Only Ireland, Switzerland, and the United States do not relieve double taxation. However, Ireland's corporate tax rate is just 12.5 percent compared to the U.S. federal rate of 35 percent.

**Individual rate reduction.** Numerous countries set the tax rate on dividends lower than the ordinary top rate on wages, including Austria, Belgium, Italy, Korea, the Netherlands, Poland, and Portugal. Some countries, such as Finland, Norway, and Sweden, have “dual income tax systems” that impose high rates on wage income but lower flat rates on all forms of capital income. (The second

Table 1. Dividend Tax Relief in the OECD

Country	Individual Tax Credit	Reduced Dividend Tax Rate	Individual Exclusion	Corporate Deduction
Australia	full credit			
Austria		25%		
Belgium		15% and 25%		
Canada	partial credit			
Czech Rep.		15%		partial deduction
Denmark		25% and 40%		
Finland	full credit	29%		
France	partial credit			
Germany		50% exclusion		
Greece		full exclusion		
Hungary		20% and 35%		
Iceland		10%		partial deduction
Ireland		no double taxation relief		
Italy	full credit or 12.5% flat rate			
Japan	various tax relief alternatives			
Korea	partial credit or 16.5% flat rate			
Luxembourg		50% exclusion		
Mexico	full credit			
Netherlands		30%		
New Zealand	full credit			
Norway	full credit	28%		
Poland		15%		
Portugal		20%		
Slovak Rep.		15%		
Spain	partial credit			
Sweden		30%		
Switzerland		no double taxation relief		
Turkey	partial credit			
U.K.	partial credit	10% and 32.5%		
U.S.		no double taxation relief		

Sources: Author based on 2001 and 2002 data from Ernst & Young and OECD. Data is for domestic investment. Foreign investment may face different rules.

column in Table 1 shows the maximum individual tax rate on dividends if it is lower than the ordinary top rate).

**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.

**Individual credit.** Numerous countries provide individuals a dividend tax credit to fully or partially offset the corporate income tax paid on the earnings.<sup>6</sup> Countries offering partial credits 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 rate of 28 percent on all capital income, with the result that it has the lowest combined dividend tax rate in the OECD (see Figure 1).

**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.

## Conclusion

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. Policymakers in many countries are recognizing that high capital income taxes distort savings and investment and reduce economic growth. In this country, Congress should sharply cut dividend taxes by enacting either an individual dividend exclusion or tax rate reduction, or allowing corporations a full dividend deduction.

<sup>1</sup> Calculated as 35% + 38.6%\*(1-35%).

<sup>2</sup> Council of Economic Advisors, “Eliminating the Double Tax on Corporate Income,” January 7, 2003.

<sup>3</sup> Data is from the OECD Tax Database, e-mailed 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.

<sup>4</sup> William Gentry and R. Glenn Hubbard, “Fundamental Tax Reform and Corporate Financial Policy,” National Bureau of Economic Research Working Paper 6433, February 1998.

<sup>5</sup> Table 1 was compiled by the author on the basis of 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. Lazar Antonic helped research this table.

<sup>6</sup> Often called the “dividend imputation” method.