

**Written Statement of John H. Schaefer
President and Chief Operating Officer,
Individual Investor Group, Morgan Stanley & Co.
on behalf of
The Securities Industry Association
on the
PROPOSAL TO END THE DOUBLE TAX ON CORPORATE EARNINGS
IN THE PRESIDENT'S ECONOMIC GROWTH PROPOSALS**

**Before the
Committee on Ways and Means
U.S. House of Representatives
on
March 5, 2003**

Mr. Chairman and members of the Committee, my name is John H. Schaefer, and I am President and Chief Operating Officer of Morgan Stanley & Co's Individual Investor Group. I am testifying today as Chairman of the Securities Industry Association ("SIA")¹. I thank the Chairman and the Committee for the opportunity to present SIA's views on the potential economic consequences of the Administration's proposal to eliminate the double taxation of corporate dividends.

SIA strongly supports the proposal to eliminate the double taxation of corporate earnings. The elimination of the double tax on dividend income would enhance the long-term growth potential of the U.S. economy, promote job creation and higher wage growth, strengthen corporate governance, and put the United States on a more equal footing with our major trading partners.

Current tax policy encourages corporations to rely too heavily on debt rather than equity financing, because interest is deductible but dividends are not. The bias favoring debt over equity financing, for example, led many companies to take on high levels of debt that left them vulnerable to the economic downturn. The President's proposal would improve the performance of our economy by relieving numerous distortions caused by the current corporate tax regime, including the income tax code's general bias against savings and investment.

CURRENT TAX POLICY CREATES NUMEROUS DISTORTIONS

Corporate income from a newly equity-financed project is subject to two layers of federal income tax. First, when the corporation earns a profit it pays tax at rates as high as 35 percent. A second level of tax is imposed if the corporation pays dividends to its shareholders out of its after-tax income, at individual tax rates that range as high as 38.6 percent. The total effective tax on corporate income from investments financed with new share issues can be as high as 60 percent, far in excess of tax rates imposed on other types of income. Even if the corporation retains earnings, the maximum combined effective tax rate approaches 50 percent on the appreciation in stock value (arising from corporate earnings that are retained and reinvested in the firm).

Under current law, interest payments are deductible to the corporation. This policy encourages corporations to retain earnings rather than distribute them, and to issue debt rather than stock. In addition, the double taxation of dividends encourages artificial shifting by businesses and investors into entities that will not be taxable as corporations under the Internal Revenue Code. Such distortions raise the cost of capital for investment financed with new share issues. The President's proposal would improve the efficiency of the capital markets by reducing artificial biases in current law to retain earnings and to issue debt.

U.S. POLICY LAGS OUR MAJOR TRADING PARTNERS

Importantly, eliminating the double tax on equity-financed investments would bring United States tax policy more in line with our major trading partners. With the exception of the United States, all G-7 countries provide protection against the double tax on dividends. In addition, the United States has the second highest dividend tax rate among the 30 OECD nations. Twenty-seven of the 30 OECD countries have adopted one or more ways of alleviating the double tax. Whether competing at home or abroad, the double tax makes it more difficult for a U.S. company to compete successfully against a foreign competitor.

ELIMINATING DOUBLE TAXATION WOULD BENEFIT U.S. ECONOMY

The end of the double taxation of dividends would help move our tax system to one that taxes income only once. This, in turn, promotes savings and investment, increased capital formation, job creation, and economic expansion. The increased economic activity would generate additional tax revenues that could offset a significant percentage of the tax revenues foregone by the proposal.

The immediate impact of eliminating the tax on dividends would be an annual tax savings of approximately \$30 billion, or .3 percent of GDP. This savings would be distributed broadly and shared by the more than 50 percent of U.S. households that own stock. Moreover, in the case of the tax cut on dividends, there are additional factors that would help boost the economy in the long run. Because the after-tax value of dividends would increase, investment in stocks would become more attractive. It has been estimated that the value of the equity market would increase by as much as 5-10 percent. This increase in equity values would provide further economic stimulus through the wealth effect (people spend more as their net worth increases). It is no accident that a rising stock market is a leading indicator of economic growth.

The initial approximately \$30 billion in tax savings is actually a very conservative estimate because it assumes no change in the current dividend policies of U.S. companies. But it is likely that more companies would issue dividends. Now that a tax cut on dividends has been proposed, companies that have previously retained large amounts of cash have said they may distribute some of that cash to shareholders.

As useful as a tax cut on dividends would be in reviving the current sluggish economy, the main benefits would be long term. The double taxation of corporate earnings reduces companies' return on capital and therefore increases the cost of capital. Lowering the cost of capital by eliminating taxes on dividends would encourage companies to invest more in plants, equipment

and other capital stock, enhancing long-term growth and leading to more jobs and higher wages.

DIVIDENDS BENEFIT TAXPAYERS ACROSS THE INCOME SPECTRUM

According to the most recent IRS data, 34.1 million tax returns (or 26.4 percent of total tax returns, representing 71 million people) reported some dividend income in 2000. Of all taxpayers that claimed some dividend income in 2000, nearly half (45.8 percent) earned less than \$50,000 in adjusted gross income (including dividends). This proposal would also benefit more than 13.1 million small-business owners or self-employed taxpayers.

Importantly, almost half of all savings from the dividend exclusion would go to taxpayers 65 and older, thereby giving retirees an additional reliable, long-term source of income to supplement their social security earnings and other retirement savings. The average annual tax savings for the 9.8 million seniors receiving dividends would be \$936.

IMPROVING CORPORATE GOVERNANCE WILL BOOST INVESTOR CONFIDENCE

Perhaps the greatest long-term benefit from the elimination of the double taxation of dividends would be the incentives for companies to return to the principles of sound financial management. With half of American families invested in the market, nothing is more important to the securities industry than restoring the public's trust in the strongest capital markets in the world. While we cannot blame the bubble of the late 1990s and its painful aftermath on the tax system, the current system did little to reign in the excesses and in some cases contributed to them. From the standpoint of both shareholders and the health of our economy, companies should be encouraged to concentrate on real earnings.

In that vein, encouraging companies to pay dividends would limit excesses because dividends offer proof of real profits. The payment of dividends by a company may give investors a strong signal of the company's underlying financial health and profitability. Indeed, a firm cannot pay dividends for any length of time unless the company has the earnings to support such payments. In an environment where reported earnings are viewed with some skepticism, cash dividends will bolster the credibility of earnings reports. Moreover, the payment of dividends would better align the interests of shareholders and managers by allowing shareholders to participate in decisions regarding corporate investment. Finally, because dividends serve as a stronger foundation for long-term value, companies that pay them will have fewer motives to artificially inflate profits just to cause temporary increases in stock prices.

CONCLUSION

Mr. Chairman, SIA commends you again for holding a hearing to review the potential economic consequences of a tax system in which corporate earnings are taxed only once. We believe the President's proposals will help restore investor confidence by increasing jobs, expanding the economy, and providing economic security to Americans. The proposal to exclude dividends from the individual income tax will help investors, boost stock prices, increase capital investment, strengthen corporate governance, provide retirees an additional reliable, long-term

source of income, and put the United States on a more equal footing with our major trading partners. Thank you for allowing me to share the securities industry's views on this vitally important subject.

1 SIA brings together the shared interests of more than 600 securities firms to accomplish common goals. SIA member firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. Collectively they employ more than 495,000 individuals, representing 97 percent of total employment in securities brokers and dealers. The U.S. securities industry manages the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2001, the industry generated \$ 280 billion in U.S. revenue and \$ 383 billion in global revenues.