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The President Obama stimulus packages and the President Bush dividend tax cut

Charles J. McPeak MBA/CPA

On January 7, 2003, President Bush proposed a plan to stimulate the struggling U.S. economy by encouraging consumer spending, promoting investment, and providing assistance to the unemployed. To achieve these initiatives, the proposal would:

1. "Speed up the 2001 tax cuts to increase the pace of recovery and job creation
2. Encourage job-creating investment in America's businesses by ending the double taxation of dividends and giving small businesses incentives to grow.
3. Provide help for unemployed Americans, including extending unemployment benefits and creating new re-employment accounts to help displaced workers get back on the job ."[1]

Shortly thereafter, the stock market experienced a revitalization following the onset of the bear market and a stimulus to the economy as a result of additional cash being put in the hands of individual stockholders. The reduced tax rate was approved by Congress and has been in effect for a number of years. It was originally set to expire in 2008. In 2006 the dividend tax cut was extended to 2010. When congress addresses the possible extension of the tax cuts, it must balance a complex set of factors. "Were the tax cuts effective?" "If they were effective, will they continue to be effective in 2010?"

There are those who believe that the cuts were effective. John Mello, in the December 2003 edition of *CFO* claims that "Since the 1980's, companies in the S&P 500 that pay dividends to their stockholders are a vanishing breed. But in 2003, that trend turned around in a big way."[2]

Following a major downsizing, in a November 10, 2005 news release, "Intel announced a 25 percent cash dividend increase and authorized $25 billion in share repurchases."[3]

In "Serving Up Dividends" Ronald Fink says "U.S. companies are increasingly in a position to initiate or increase dividends even if they also begin to reinvest in their business or make big acquisitions." [4]

In an attempt to clean up its tarnished image, on February 9, 2006, Trend Micro announced “an increase in dividend ratio from 30% to 40%." [5]

In December 2004, Standard and Poor’s announced that “232 of the S&P 500 increased their dividends in 2004. About half are expected to raise them in 2005.” [6]

In the December 3, 2004 issue of Business Week, Joseph Lisanti reported, “With taxes on dividends now below the ordinary income tax rate, we expect the trend of higher of higher payments by U.S corporations to their shareholders will continue.” [7]

In October 2004, Stephen Moore and Phil Kerpen published the results of the Cato Institute study on the relationship of the Bush tax cut and dividend payouts. They state that “the dividend tax cut was designed to spur investment and boost the stock market by increasing the after-tax return on corporate earnings, thus raising stock valuations. The tax cut also reduced the tax bias against dividends to spur larger payouts to shareholders. That reduces the amount of discretionary cash available to executives and will likely reduce the number of Enron-style corporate financial scandals.” [8] The Cato Institute study found a highly positive response to the tax cut:

- Annual dividends paid by S&P 500 companies rose from $146 billion to $172 billion, an increase of $26 billion.
- In addition, special dividends of $7 billion have been paid, raising the total first-year dividend increase to $33 billion.
- Thus, dividends increased 18% without special dividends and 23% with special dividends.
- Twenty-two companies that did not previously pay dividends have initiated regular dividends.
- Equity values rose more than $2 trillion after the tax cut.

In the March 1, 2004 issue of Business Week, Joseph Webber, David Henry, Michael Arndt, and Timothy Mullaney reported that "a huge shift in corporate finance began in December 2003, when the Bush administration began sounding out ways to cut taxes on dividends. Some 370 companies in the Standard & Poor's stock index are now paying dividends, 19 more than in 2002. and last year these companies paid out $161 billion, up 8.8% from the year before. This year, the S&P expects payouts to rise by an additional 10.7%, the biggest increase since 1989. So why are dividends back in fashion? The biggest reason may simply be the surge in corporate profits at the end of last year. And the dividend tax cut last year probably encouraged companies to share more of those profits. What's more, companies hoping to woo skeptical investors back to the market after several years of earnings games and financial scandals may have used dividends to assuage doubts about corporate accounting." [9]

On June 28, 2004 Heather Landy of Knight Ridder Tribune Business News reported that the increase in dividends from the George Bush tax cut has an additional benefit to investors "of enhancing corporate governance in the executive suite, according to the Washinton-based American Shareholders Association. Before the tax cut, cash now earmarked for dividends might have been used to buy back shares, invest in operations, make acquisitions or pay down debt. When the new legislation made tax rates comparable to capital gains, companies expected that investors would favor stocks offering dividends, because the cash distribution would be a sure thing, unlike stock price appreciation that might or might not come from share buybacks or mega-mergers." [10]

Howard Silverblatt, equity-market analyst at Standard & Poor's reported that "the dividend tax-cut has definitely helped to stimulate the stock market, and has contributed to the slow but steady increase in dividend payouts in 2005. According to Mr. Silverblatt's research, the tax cuts on dividends and long-term capital gains will result in individual investors saving a total of $114 billion from 2003 to 2008. A lot of that will filter back into the stock market because investors often reinvest their windfalls in other stocks." [11]

In the October 30, 2006 issue of Fortune, David Stires reported that he identified a fund that was created as a direct result of the dividend tax cut. Stires says that "Among the 300 funds tracked by Morningstar that sell themselves as equity-income funds, the average yield is 1.5%. In a savvy marketing move, Alpine Woods Investments, a privately owned investment firm, introduced Alpine Dynamic Dividend soon after the dividend tax cut was passed. After three years, the $535 million fund has returned a spectacular 18.7% per year, outpacing the S&P by a wide margin. As for yield, it's a staggering 13%, by far the highest in its category." [12]

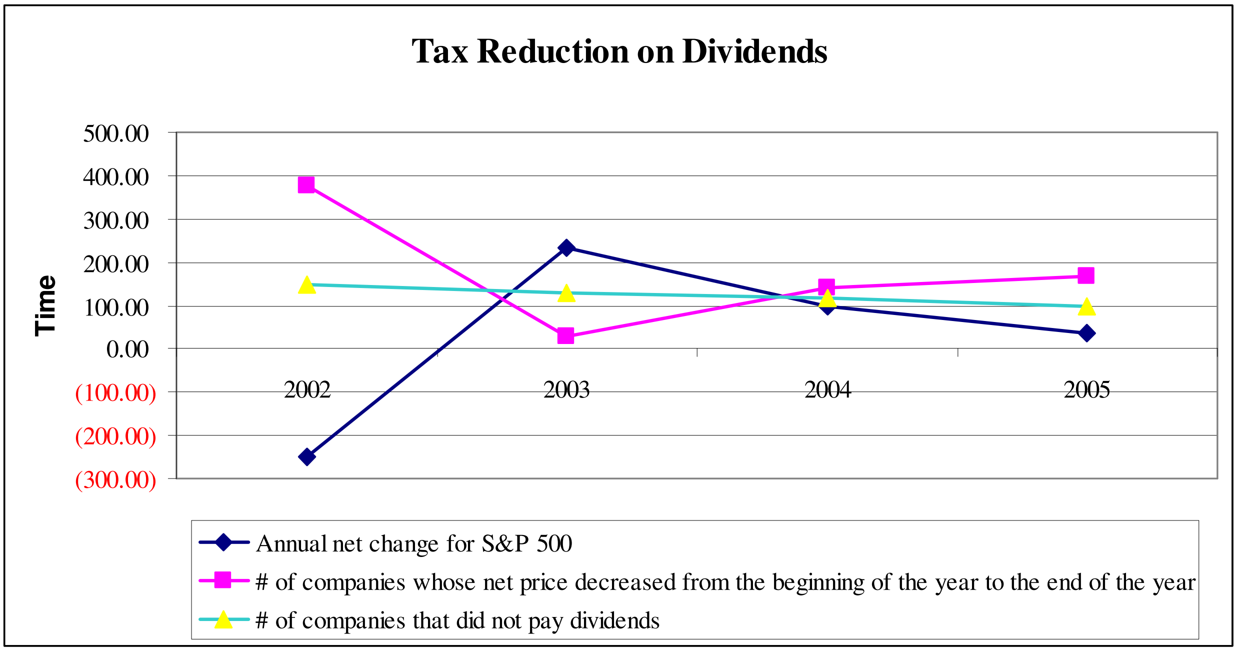
In May 2007, the American Gas Association started laying the foundation for an all-out advocacy effort to keep the dividend tax cuts in place, permanently it hopes. As a first step in its upcoming effort to convince Congress to make the tax cuts permanent, the American Gas Association is setting the stage for a major grass-roots campaign by helping to promote the formation of utility shareholder groups in states that don't already have them. The state utility shareholder organizations are important because their members are likely to be vocal supporters of maintaining the dividend income and capital gains tax cuts, according to Annette Henkel, president of Minnesota Utility Investors, a 17 year-old state utility shareholder organization.[13]

The questions that we will address in this paper are as follows:

- Did the reduction in tax on dividends help to stimulate the stock market out of the bear market that followed the Enron collapse?
- What is the relationship between a company declaring its first dividend and the performance of the company's stock?
- Are companies which are paying more in dividends also re-purchasing more of their own shares?

1. Did the reduction in tax on dividends help to stimulate the stock market out of the bear market that followed the Enron collapse?

   Both the S&P 500 and the Dow Jones experienced annual net decreases in 2002. Subsequent to the reduction in tax on dividends in 2003, both indices increased by more than 25% in 2003. Although the stock market did not continue to enjoy such rich growth as in its initial year 2003, the number of companies with declining stock prices decreased 93%. Even more, the number of S&P 500 companies that did not pay dividends or companies that decreased their dividends continued to decrease each year after 2003.



2. What is the relationship between a company declaring its first dividend and the performance of the company's stock?

Using the CATO Institute's list of 21 companies initiating dividends in 2003,[8] we researched the change in stock price of these companies and discovered that the average stock price increased 42% from May 2003 to May 2004 with just one anomaly. That year, the S&P 500 Index increased 15%. 18 of the 21 companies that initiated dividends subsequent to the tax reduction outperformed the S&P 500, indicating that there is a significant positive relationship between a company declaring its first dividend and the performance of the company stock.

S&P 500 Aggregate Dividend Changes, May 2003 to May 2004

Dividend Payout Change	**$ Billions**
Increases	$32.4
Initiations	$2.7

Decreases	-$1.7
Total	$33.4

Source: CATO Institute Briefing Papers: Show Me the Money! [8]

3. Are companies which are paying more in dividends also re-purchasing more of their own shares?

First, we reviewed the 20 S&P 500 companies that initiated dividends in 2003. The number of companies that increased treasury stock balances decreased from 17 to 14 from 2002 to 2004. Second, we reviewed the complete S&P 500 listing that displayed similar results decreasing from 23% to 20% of companies that increase treasury stock balances. This reflects a decrease in stock repurchasing. This might suggest that some of the excess cash that had been used for the purchase of treasury stock has been shifted to the payment of dividends.

CONCLUSION

The research would indicate that the tax cut had a threefold stimulus to the economy:

- The reduction in the tax rate on dividends gave shareholders more cash to stimulate the economy.
- This, in turn, encouraged companies to begin issuing dividends or to increase dividends.
- The increase in dividends, combined with the reduced tax on dividends, encouraged the purchase of shares which helped to stimulate the stock market out of the bear market. The ensuing bull market put more cash in the hands of shareholders.

Entering 2008, the research suggests that the first two stimuli remain as solid justification for continuing the reduced tax on dividends. Even though a bear market is not in existence and therefore the third element of stimulus might not be necessary, an argument could be made that, elimination of the reduced tax on dividends could shift investor interest out of the stock market and into fixed income instruments. This could signal the end of the bull market and take liquidity out of the economy.

THE FUTURE OF THE DIVIDEND TAX CUT --- ECONOMIC ISSUE, STOCK MARKET ISSUE OR POLITICAL ISSUE?

All of the research seems to indicate that the dividend tax cut is good for individual investors, the overall stock market, and the economy. So, is there any reason that the tax cut will not be extended? The answer is that investors, the market, and the economy may well lose out to the political issue. A leading Democrat, House Ways and Means Committee Chairman Charles B. Rangel of New York, has proposed sweeping tax reform which is, no doubt, a precursor to the elimination of the dividend tax cut. Will this tax reform be successful? It has strong backing among some Democrats; however, many recall that over 20 years ago presidential candidate Walter Mondale called for tax increases and lost the election in a landslide. The stimulaus packages of President Obama will likely require substantial tax increases. This would require President Bush's tax cuts to lapse and would mark the end of the dividend tax cuts.

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[1]White House News & Policies.
http://www.whitehouse.gov/news/releases/2003/01/20030107.html.

[2]John P. Mello Jr. "Dividends Bounce Back" *CFO* December 2003

[3]Intel News Release www.intel.com November 10, 2005

[4]Ronald Fink "Serving Up Dividends" *CFO* January 2005

[5]PRNewswire www.blackenterprise.com February 9, 2006

[6]Money.CNN. com December 15, 2004

[7]Joseph Lisanti "The Dividend Rediscovered" *Business Week* December 3, 2004

[8]Stephen Moore and Phil Kerpen "Show Me the Money! Dividend Payouts after the Bush Tax Cut" *CATO Institute Briefing Papers* October 11, 2004

[9]Joseph Webber, David Henry, Michael Arndt, Timothy Mullaney "Dividends Are Simply Divine" *Business Week* March 1, 2004

[10]Heather Landy "More Companies Pay Dividends After Recent Tax Cuts" *Knight Ridder Tribune Business News* June 28, 2004

[11]Karen Richardson "Moving the Market" *Wall Street Journal* December 6,2005

[12]David Stires "A Fund That Yields Performance" *Fortune* October 30, 2006

[13]Karen Ryan "Tax Rate Cuts Benefit Utility Shareholders" *American Gas* May 2007