The tax cut that could pay dividends

By Michael Porter

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In the wake of the stock market meltdown and a shaky economy, George W. Bush has proposed eliminating the double taxation of dividends. While most of the discussion has focused on the impact on near-term economic growth and stock prices, the greater significance of this policy change for the economy may be on long-term corporate productivity.

Done properly, it would change how corporations compete. Eliminating the bias against dividends would markedly improve company strategies by better aligning them with true economic fundamentals. Sounder strategies that result in better utilisation of capital in the economy are the best way to restore confidence in business.

In the current system, paying dividends is tax-inefficient. Instead, the motivation has been to plough retained earnings and even borrowed capital into expansion and acquisitions. With shareholder value the overriding focus of management, and equity dominating executive compensation, growth became the overarching goal of most companies. Dividends were passé and dividend pay-outs fell. With little or no dividend pay-out, share prices were driven largely by growth expectations.

This encouraged too much debt and other dubious financial practices but the biggest cost was in corporate strategy. The bias towards growth and against profits and dividends lies at the root of many of the strategic blunders and corporate scandals that have recently come to light, as well as the disappointing profit performance registered by so many companies.

The growth imperative led companies to seek market share at all costs, often destroying the profitability of their entire industry. It also drove diversification into questionable new fields and encouraged acquisitions that created no economic value, while providing opportunities to manipulate reported earnings. Examples of such strategies include WorldCom (market share at all costs), AOL Time Warner (growth justified by illusory synergies), Cisco (expensive acquisitions for growth's sake) and Disney (ill-advised attempts to grow beyond its areas of competitive advantage).

Ending double taxation of dividends would go a long way towards restoring sound strategic thinking in a way that corporate governance reform and ever more intricate accounting rules alone cannot accomplish. In a world no longer biased against dividends, strategies that maintain a clear business focus, earn attractive profits and pay them to shareholders would be rewarded.

Companies would be able to provide attractive investor returns without depending on uncertain stock price appreciation. Company moves to grow faster than their industry by buying market share would be penalised rather than encouraged. Forays into new segments or new businesses without a compelling competitive advantage would look far less attractive.

Mergers to pump up growth, arguably the greatest destroyer of shareholder value over the last few decades, would be received warily by investors (though doubtless still marketed heavily by

fee-driven investment bankers). Growth would still matter but only in the context of acceptable risk and profitability. Some industries and companies would continue to be growth-driven but this logic would not be foisted on businesses that had modest underlying growth prospects.

Attempting to police management decisions through corporate governance and reporting reforms, without changing the underlying incentives leading to poor corporate choices, will result only in an endless cycle of more and more intricate rules and regulations. Far more effective would be a shift to rewarding profits paid regularly to shareholders that aligned decisions with true economic value. In virtually every recent corporate failure, an imperative to pay out real cash would have done wonders in clarifying the management's strategic thinking.

To reap the greatest benefit from this policy change, the tax exemption should be at the corporate, not the individual level. A corporate exemption would more directly influence management choices, would probably be less costly owing to offsetting taxes on elevated pay-outs and would help eliminate uneconomic corporate tax avoidance tactics such as moving corporate headquarters to Bermuda and formulating complex transfer pricing schemes.

A corporate exemption is likely to benefit everyone, because its effects would almost certainly be passed on to consumers via lower prices. Since individuals with lower incomes tend to have the highest rates of consumption as a percentage of income, an exclusion at the corporate level is likely to be far more progressive than one that benefits only stock-owning individuals. And the last thing the US needs is another personal tax exemption in a system already far too complicated.

Sceptics who label the proposal a gimmick, or a tax break for the rich, fail to grasp the benefits of lower corporate taxes for everyone and miss the larger point. A dividend exemption, especially at the corporate level, would have sustained benefits for investors and workers alike. And it might just be a relief for managers, many of whom have felt trapped in a system that creates intense pressures to make questionable decisions.

The writer is Bishop William Lawrence university professor at HarvardBusiness School