NATIONAL URBAN LEAGUE

Paying Dividends: How the President's Tax Plan Will Benefit Individual Investors and Strengthen the Capital Markets

Before the
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Subcommittee on Oversight and Investigations
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TESTIMONY
Concerns about the Collateral Costs of Tax Exemption for Individual Dividend Income

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By

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The Urban League is the nation's oldest and largest community-based movement devoted to empowering African Americans to enter the economic and social mainstream.

The Urban League movement was founded in 1910. The National Urban League, headquartered in New York City, spearheads our nonprofit, nonpartisan, community-based movement. The heart of the Urban League movement is our professionally staffed Urban League affiliates in over 100 cities in 34 states and the District of Columbia.

The mission of the Urban League movement is to enable African Americans to secure economic self-reliance, parity and power and civil rights. On behalf of the League, I thank Chairperson Kelly and ranking member Congressman Gutierrez for this opportunity to share the thoughts of the League on this important topic.

The National Urban League is pleased that the President and Congress recognize the need to get the economy going. We are concerned however, that the consequences of some of the proposed fiscal policy changes may not have the intended consequences, and may have some unintended consequences that would be troubling.

1. The Proposal to Exempt Dividend Income for Individuals

The President has proposed excluding dividend income from the taxes of individual taxpayers. As currently constructed, the proposal would allow for the tax-free distribution of corporate earnings on which the corporation has paid taxes. This does not, however, include income against which the corporation could apply a tax credit. Under current law, however, there are a number of programs Congress has authorized to benefit the public good from lowering corporate tax liability.

It is suggested by the Treasury Department, in its Blue Book, that taxing corporate profits and individual dividend income both creates a bias for corporations to favor debt over equity—because interest payments are deductible to the corporation but dividend payments are not—and that taxing individual taxpayers' dividend income encourages corporations to finance investments using retained earnings instead of debt financing—which would impose more scrutiny on the decisions. This contradictory position in the likely effects of removing taxes on dividend income for individuals however does not mean that the effect of the proposed change will be ambiguous for other outcomes. Namely, the Treasury Department argues that a bad thing about taxing dividend income for individuals is that it leads corporations "to engage in transactions for the sole purpose of minimizing their [corporate] tax liability." Actions taken to lower corporate income taxes are at the heart of a number of federal programs supported by the current tax code.

The Congressional Budget Office estimates the cost of excluding dividend income for individuals from taxation to be nearly $8 billion in FY2003 and total $388 billion over FY2004-2013. That is a large personal and private benefit extended to those who receive dividend income.

The Joint Tax Committee cites several studies by prominent economists confirming there is a lack of consensus from econometric evidence on the responsiveness of aggregate investment to tax policy. Of course, in part, this is due to the very large amount of corporate equity owned by those who do not face U.S. income tax, such as foreign persons and tax-exempt institutions like pension funds. And, the immediate benefit of this proposal would be to give a tax benefit for investments already made by corporations, not for new investment decisions. This means that there may be very little public gain in the form of new investment.

On the other hand, there are several key programs with significant public benefits that are put in jeopardy if corporations take actions to raise shareholder after-tax income as opposed to raising the corporation's after-tax income. Among those programs are the Low-income Housing Tax Credit, the Tax credit for Rehabilitation of Historic Structures, Empowerment Zone Tax incentives, Renewal Community Tax incentives, Tax Credit for Employer-provided Child Care and the Tax Credit for Holders of Qualified Zone Academy Bonds. Of these programs, the largest by far is the Low-Income Housing Tax Credit, and the ramifications of switches in policy on dividend income would be greatest to the public for undermining that tax credit.

And, to the extent that the tax incidence on investment matters, there are significant implications for the cost of capital for states and municipalities, who benefit from tax-exempt bonds. Those potential costs will be passed on to the public in higher state and local taxes.

2. The Low-Income Housing Tax Credit

Under current law, Congress provides through the tax code, a number of incentives to encourage corporate investment in specific areas. Under the current proposal on the treatment of dividend income, these corporate tax provisions would not pass through to the individual shareholder. This creates a gap in effects between decisions to increase corporate after-tax income and shareholder after-tax income. Several of the current provisions encourage corporate investment in the needs of our nation's low-income neighborhoods and cities.

The Joint Tax Committee evaluates all tax expenditures, including these incentives to corporations. It estimated for FY2002 to FY2006 that these tax expenditures to help America's low-income neighborhoods attributable to corporations would amount to: $15.1 billion for the Low-Income Housing Tax Credit, $2 billion for the Tax Credit for the Rehabilitation of Historic Structures, $1.4 billion on Empowerment Zone Tax Incentives, $700 million on Renewal Community Tax Incentives, $500 million on New Markets Tax Credits, $400 million for Tax Credits for Employer-provided Child Care and $300 million on Tax Credits for Holders of Qualified Zone Academy Bonds. Two other programs with important implications for low-income rural and urban communities—the Welfare-to-Work Tax Credit, and the Work Opportunity Tax Credit, totaling a projected $600 million—are set to expire. In a related category would be the $9.1 billion for tax credits or Puerto Rico and possessions income.

Corporations make these investments in helping America's communities for several reasons. One of them is to lower the corporation's effective tax rate and so increase their after-tax earnings. A study of the implications of the current proposal by Ernst & Young found that corporate decisions on dividends are sensitive to the tax implications for shareholders, and so the proposal would diminish the participation of corporations in these programs. The President's own proposal for a tax credit to encourage single-family home ownership would fall into this category.

The Low-Income Housing Credit is unique in its importance to low-income neighborhoods because of its size—relative to the other credits and incentives, relative to the importance of corporate investment to the credit and relative to the stock of low-income housing that it underwrites. Ernst & Young's study found that corporations provide nearly all the annual Housing Credit investment, and that since the credit's inception in 1986, it has "become the leading tool for the development of affordable renting housing."

The credit is effective because it decentralizes decision making on low-income housing, making it function on a market-based model. States are allocated a set amount of housing credits based on the state's population. Those seeking to use the credits are certified by the state. Syndicators then bundle the investments to make them large enough, and diverse enough, to create attractive investments for corporations. Corporations purchase those instruments as they would a bond. The higher corporations are willing to pay, the lower the cost of raising funds for low-income housing. The lower the price corporations pay, the higher the cost of raising funds.

Ernst & Young report that, on average, developers of low-income housing obtain about 42 percent of the property's cost from using the credit. They report that first mortgage financing helps to fund a portion of the rest, with subordinate financing, primarily from state and local governments closing the gap. With a much lower first mortgage than conventionally financed housing, low-income housing produced with the credit is able to charge reduced rents compared to the market.

The price corporations are willing to pay to purchase the credits has risen over time. Ernst & Young show it going from around $0.55 per dollar credit in 1987 to $0.82 per dollar credit in 2001. Part of this reflects a marked increase beginning in 1994, coincident both with declining interest rates brought on by Federal Reserve Policy, an increase in corporate earnings and investment, changing the credit from facing annual reauthorization to being made permanent, and changes in the Community Reinvestment Act.

Because Ernst & Young found that the major corporations claiming the credit are also subject to provisions of the CRA, the decision to invest is related both to tax implications and regulatory issues. Clearly, some of it is also related to corporations making investments in-line with corporate mission and expertise.

But, it also reflects a perception that the program has performed well, lowering initial perceptions of risk and thus allowing the rate of return to lose some its risk adjustment. And, Ernst & Young argue that Congressional support for the credit, especially its change from being subject to annual reauthorization to being made permanent, has assured corporations of the value of the instrument in their tax strategies. Thus, this proposed change in the treatment of individual dividend income and its implication for corporate tax strategies is very important.

The higher price that corporations are willing to pay for the credit allows more housing units to be built for the credits each state is allocated. That in turn, allows states to expand their programs and reach lower-income families and special need households. Since the switch from annual reauthorization to permanent status for the credit, the number of units placed in service each year, has increased from just fewer than 60,000 in 1994 to slightly over 100,000 in 2002 despite increasing construction costs.

To the extent that corporations lower their willingness to buy the credit, the costs of financing low-income housing will increase, resulting in fewer units coming on-line. This is just at the time that our nation's housing is creating a tremendous problem because rising housing costs are exacerbating affordability issues for low-income families.

Ernst & Young estimate that low-income housing unit production could drop by 40,000 units a year, effecting about 80,000 low-income individuals.

3. Proposed Solutions May Not Mitigate Collateral Effects

In addition to the various tax incentives to encourage corporate investments in low-income areas, states and municipalities benefit from lower capital costs by being able to issue tax-free bonds. While tax policy may not affect aggregate investment decisions, by affecting relative after-tax income, it can influence choices among investment alternatives. To that extent, proposed changes to pass through corporate tax incentives to individual shareholders by changing the excludable dividend amount (EDA) formula would only exacerbate the problems faced by states and municipalities in raising their capital costs.

On the other hand, changing the EDA would lower another collateral effect of the proposed change on corporate investment decisions. The Joint Tax Committee estimates that tax expenditures accounted for by corporate investment in state and local bonds for FY2002 to FY2006 were estimated to amount to: $42 billion on public purpose bonds, $2 billion on private non-profit hospital facility bonds, $1.5 billion on owner-occupied housing bonds, $1 billion on sewer, water and hazardous waste facilities bonds, $1 billion on private airport, docks and mass-commuting facilities bonds, $500 million on rental housing bonds, $500 million on small-issue industrial development bonds, and $500 million for student loan bonds. So, corporations would be neutral on whether to continue these investments.

But, again, passing through the corporate tax benefits to the shareholders in this case could have an ambiguous outcome for the problems faced by state and local governments because it would increase the cost of capital for each of those programs. So, while corporations may continue to make these investments, the costs to tax payers at the state and local level will be higher.

Because the major beneficiaries of this proposal on dividend income are corporate officers and directors, it is not clear how this resolves investor angst about corporate decision-making. Institutional investors, who are major holders of corporate equity, clearly have a different stake in whether dividend income is taxable than do the individual officers and directors for whom the income is taxable. And, whether the officers and directors are acting on behalf of shareholder after-tax income or corporate after-tax income is a conflict from that perspective.

Under the current, or "classic" law treatment of corporate income, it is important to note the difference in the liabilities of the corporation on individual stockholders versus that of partnerships and self-proprietors. In that sense, the income of the corporation is not at all like that of other business forms. Nor is it clear that the proposal's attempt to recreate the notion of corporate income to be that of the collective owners to end the so-called double taxation would lead to tax-free dividend income, as opposed to treating dividends as an expendable item for the corporation like wages and thus retain the tax on the individual shareholder.

4. Conclusion

Finally, changing the EDA, to create a pass through would increase the cost of the proposed tax exemption. This would be disturbing given the inconclusive evidence linking tax policy to aggregate investment. The size of this proposed change is very large. It is enough to support the U.S. Department of Education, following the President's proposed budget, for four years. Or, it could fund the U.S. Department of Labor and the Small Business Administration combined over that same period.

So, we would hope you would carefully weigh consideration of this proposal. Its potential costs are much higher than currently estimated. And, while its private gains are huge, its public gains are murky. The potential damage this does to the federal budget is vitally important, as we are now all called to share the sacrifices of paying for the upcoming resolution of issues in Iraq.