

August 13, 2003

BUSINESS WORLD

By HOLMAN W. JENKINS, JR.



Why the Dividend Tax Cut Still Isn't a Giveaway

Oh, how flummoxed, betrayed and belied we're feeling by the news! Hundreds of companies, in response to the Bush dividend tax cut, have been upping their dividend payouts. But executives who make these decisions are themselves often big holders of their companies' shares. Ipso facto, executives are approving large pay raises for themselves when they approve dividend increases for their shareholders.

How embarrassing. Eight months ago, this column called the Bush administration's proposed dividend tax cut a tonic for the economy but "no giveaway for stockholders." What a bonehead thing to say, right?

Nope. One thing to notice is that dividends are not paid out of newly found money. Paying a dividend is merely a different way of deploying the same earnings kitty that otherwise might go to share buybacks or be reinvested in the business to increase the asset value of the corporation. All things being equal, money is moved from one pocket to another, but all pockets belong to shareholders ultimately. There is no windfall here sprouting from Mr. Bush's pen.

Hence another mystery that turns out to be no mystery at all, though it has been treated as such: Why have share prices of companies that announce big dividend hikes not shown a pronounced tendency to rise? Certain proponents clamored for a dividend tax cut precisely as a way to boost stock prices and give a big smooch to the "investor class." This was always misguided.

ABOUT THE AUTHOR

Holman W. Jenkins Jr. is a member of the editorial board of The Wall Street Journal and writes editorials and the weekly Business World column.

Mr. Jenkins joined the Journal in May 1992 as a writer for the editorial page in New York. In February 1994, he moved to Hong Kong as editor of The Asian Wall Street Journal's editorial page. He returned to the domestic Journal in December 1995 as a member of the paper's editorial board and was based in San Francisco. In April 1997, he returned to the Journal's New York office. Mr. Jenkins won a 1997 Gerald Loeb Award for distinguished business and financial coverage.

Born in Philadelphia, Mr. Jenkins received a bachelor's degree from Hobart and William Smith Colleges in Geneva, N.Y. He received a master's degree in journalism from Northwestern University in Evanston, Ill., and studied at the University of Michigan on a journalism fellowship.

Mr. Jenkins invites comments to holman.jenkins@wsj.com¹.

Were they thinking straight, even supporters of the tax cut should have anticipated lagging share-price performance for companies that immediately up their dividends. The reason leaps out: If an investor is receiving more of his return in the form of dividends, he can expect to receive less in the form of capital appreciation.

Think about it this way: Any investment for sale in the marketplace will be priced at a level to provide no more than an acceptable return. After all, as a seller of shares, I have no desire to make a charitable contribution to you, the buyer. I want the best possible price for my shares. That's why you're going to have to settle for a market rate of return, however divided between dividend and capital appreciation.

This logic is nicely borne out by statistics recently produced by Howard Silverblatt, equity-market analyst S&P. He juggled some numbers and found out that shares of dividend-paying companies in the S&P 500 have risen 2.5% since the beginning of June, compared with a 3.9% rise for nonpaying firms. The difference is even more striking for the year to date: Dividend payers are up more than 13%, while nonpayers are up almost 33%.

Heck, it's almost as if investors understand they are not personally being made richer simply because a company chooses to distribute its earnings to them in a different way. That's true as much for the executive shareholders as for the unaffiliated shareholder in the street. A Journal rendition Monday noted that Sandy Weill will receive \$17 million a year in additional dividend income from his ownership of Citigroup stock, Sumner Redstone an additional \$40 million a year because of his Viacom stock, Bill Gates \$80 million because of Microsoft, etc.

What each gains through the dividend account, however, he more than likely forgoes through the capital-gains account.

We hasten to amend, however, a statement made earlier in this column. In fact, all things are not always equal. Microsoft shares recently jumped sharply on a rumor (wrong, it turned out) that it would pay a \$10 billion special dividend on its \$50 billion cash hoard. Where a company sits on a large pile of cash and investors fear it may be reinvested unwisely, in other words, a higher dividend payout may indeed be regarded as a reason for giving a company a higher share price.

Here, all along, was the attraction of cutting dividend taxes. The appeal resided not in hopes of higher share prices but in hopes that it would make capital allocation across the economy more efficient for exactly the reason illustrated in *extremis* by Microsoft.

Until Mr. Bush rendered it null and void, a debate had long been entertained in various academic cloisters about how much dividend tax was capitalized in share prices. Not much was the conclusion of the predominant contestants: Stock prices were seen as reflecting an expectation that all earnings would eventually be taxed at the capital gains rate, since that's the rate companies can't avoid on their investors' behalf.

In turn, paying a dividend was deemed an essentially mysterious behavior of companies, since the tax code made it a highly unattractive way of returning money to shareholders. Maybe they did it for some other reason, like advertising the stability and predictability of their earnings to investors?

Whole armies of economists once made a living debating what became known as the "dividend puzzle." Now George Bush has put them out of business. Tax policy no longer disfavors dividends so there's no longer any mystery about why companies might or might not choose to pay them. To wit, those with high growth prospects hold onto their cash so they can reinvest it; investors expect to get their reward entirely in the form

of a higher share price in the future.

Contrariwise, companies paying a substantial dividend are making a statement (often echoing a perception already held by investors) that their cash flow exceeds their good investment opportunities. In other words, management judges itself no better equipped than the average investor to reinvest the company's profits successfully.

Let's be clear that such companies should be applauded. This was the very reason economists long argued for eliminating the punitive dividend tax, and why the Bushies were wise to heed them. Though it was a mistake to believe share prices would be boosted specifically for those companies that availed themselves as the opportunity to increase their dividend, there can't be much doubt that the incentive for greater efficiency in capital allocation has been good for the market (and economy) as a whole.

URL for this article:

<http://online.wsj.com/article/0,,SB106073826538488300,00.html>

Hyperlinks in this Article:

(1) <mailto:holman.jenkins@wsj.com>

Updated August 13, 2003

Copyright 2003 Dow Jones & Company, Inc. All Rights Reserved

Printing, distribution, and use of this material is governed by your Subscription agreement and Copyright laws.

For information about subscribing go to <http://www.wsj.com>