

# Dividend Taxation and Corporate Governance

Randall Morck and Bernard Yeung

**T**he U.S. government subjects corporate dividends to double taxation: It first taxes corporate income, then taxes the same income again when shareholders receive dividends paid out of corporate income. Until 2003, individuals were taxed on dividend income at the same rates as on other forms of income, resulting in overall taxes on dividends much higher than those in most other countries (PriceWaterhouse-Coopers, 2003a, b). After the passage of the Job Growth and Taxpayer Relief Reconciliation Act of 2003, dividends are still paid out of after-tax corporate income, but the individual tax rate on dividend income was cut to a maximum of 15 percent. We argue that this act, by substantially reducing double taxation of dividends but not eliminating such taxation, strikes a useful balance between competing objectives.

Many economists have long opposed the double taxation of dividends because of the high overall tax rates this imposed on corporate income. They argued that double taxation deterred corporate investment and distorted corporate financing decisions, favoring debt over equity financing and earnings retention over dividend payouts. More recently, financial economists stressed how higher dividends (and consequently reduced retained earnings) can improve corporate governance by discouraging empire-building financed by retained earnings.

■ *Randall Morck is Stephen A. Jarislowsky Distinguished Professor of Finance, School of Business, University of Alberta, Edmonton, Alberta, Canada; William Lyon Mackenzie King Visiting Professor of Canadian Studies at Harvard University, Cambridge, Massachusetts; and Research Associate, National Bureau of Economic Research, Cambridge, Massachusetts. Bernard Yeung is Abraham Krasnoff Professor of Global Business, Professor of Economics and Professor of Management, Stern School of Business, New York University, New York, New York. Their e-mail addresses are <randall.morck@ualberta.ca> and <byeung@stern.nyu.edu>, respectively.*

We begin with an historical example—the early dividend policy of the Hudson’s Bay Company, one of the world’s oldest listed companies—to illustrate how dividends and corporate governance interact. We then discuss traditional arguments about distortions arising from high taxes on dividends and more recent arguments based on corporate governance, and how both suggest reducing taxes that deter dividends. But the link between dividends and corporate governance also suggests two reasons why some taxation of dividends should remain.

First, the 2003 act retains an exceptional feature of American dividend taxation—a tax on intercorporate dividends introduced in 1935 that discourages pyramidal business groups. A pyramidal group is a collection of listed firms with a common ultimate controlling shareholder, usually a wealthy family, that holds control blocks in a first tier of listed firms, each of which controls yet more listed firms, each of which controls still more listed firms, and so on. Though pyramids were commonplace in the United States until the Roosevelt era, and remain common in the rest of the world even today, they are now almost unknown in the United States.

Second, taxing individuals’ dividend income makes stocks relatively unattractive to taxable individual investors and relatively attractive to tax-exempt institutional investors, like pension funds. Institutional investors can potentially overcome the collective action problems that plague corporate governance in widely held corporations, where each individual shareholder rationally opts to free ride on other shareholders’ efforts to improve governance. Retaining a tax on individual dividend income preserves this advantage for tax-exempt institutional investors.

The dividend provisions in the Job Growth and Taxpayer Relief Reconciliation Act are defensible as applying pressure on companies to disburse more cash to shareholders, while retaining a tax incentive for institutional investors to hold stock and a tax penalty on corporate groups. This preserves America’s unique flavor of capitalism—its economy of free-standing firms—while applying balanced pressure for better corporate governance.

## **The Original Dividends: The Hudson’s Bay Company**

The *Oxford English Dictionary* traces the usage of “dividend” in the context of a shareholder-owned firm to a 1690 edition of the *London Gazette*, which reports that “Sir Edward Dering, the Deputy-Governor of the Hudson’s Bay Company Presented to his Majesty a Dividend in Gold, upon His Stock in the said Company.”<sup>1</sup> The usage is likely older, but this reference is a useful entrée into the economics of dividends.

The North American fur trade promised vast wealth, but only after a huge capital expenditure on ships, forts and trading posts. The necessary outlay exceeded even the resources of royalty. Consequently, King Charles II signed a

<sup>1</sup> See definition 3b, *Oxford English Dictionary*, 2<sup>nd</sup> on-line Edition, 1989.

Charter in 1670 granting a fur trade monopoly to 18 investors led by his cousin, the inventor and Civil War general Rupert Palatyné, who formed The Company of Adventurers Trading into Hudson's Bay, a joint stock company. The company's profits would be divided periodically among its owners, with each payment to be called a "dividend." Newman (2000) presents a superb history of the Hudson's Bay Company (the Bay).

In an age of horses and carriages, gathering the "adventurers" for every company decision was impractical, so the Charter mandated they elect a Governor, a Deputy Governor and a seven-member Committee to manage the company. However, the other remaining investors needed assurances that the company would be well-governed and that their streams of dividends would be as great as possible. To assuage these governance concerns, the Charter granted a "Generall Asemblee" of the company's owners the right to dismiss the Governor, Deputy Governor and Committee, granting each owner "for every hundred pounds by him subscribed or brought into the present Stock one vote."

The company paid its first dividend in 1685, 50 percent of book value, and continued paying fat dividends through 1690. The Bay's share price doubled as new investors thirsted for further distributions. Meanwhile, six of the original Committee members quietly sold all their shares and resigned. The new investors were to be disappointed. The excessive dividends of 1685 to 1690 had drained the Bay's coffers, and it paid no further dividends for 28 years, while new managers slowly rebuilt its balance sheet. The six Committee members arranged for the "Dividend in Gold" cited by the *Oxford English Dictionary* to be paid to the King alone (dividends were not yet necessarily paid simultaneously to all shareholders), perhaps to buy official acquiescence for their deceit.

This stock manipulation by Hudson's Bay Committee insiders was only a prelude to a wave of governance scandals in other companies. The South Sea Bubble of 1720, described lucidly by Balen (2003), was a frenzy of speculation, stock manipulation and fraud, in which Englishmen lost fortunes in legions of bogus joint stock companies. When the Bay was established in preindustrial Britain, business dealings outside circles of kinship and close friendship were unwise, for no legal remedy existed for ill faith. Judges had little time for business disputes, seeing no public purpose in resolving quarrels among "thieves." The investors in early joint stock companies genuinely were "adventurers," for they journeyed beyond the known institutional world.

After the South Sea Bubble, investors long shunned equity, fearing deceit and thievery in even the soundest joint stock companies. In response, the Bay's Governor and Committee viewed continued stable dividends as imperative. The Bay had commenced paying a dividend of 10 percent of book value in 1718. Its stock rose and then fell with the bubble in 1720. But unlike the sham bubble companies, the Bay survived, for it had ongoing income and continued paying its 10 percent dividend through the mania and subsequent panic. Continuity reassured investors that the company truly had a real ongoing business—and also countered memories of how insiders had used unsustainable dividend hikes to manipulate the company's

own shares in the late 1690s. The Bay's management strove to pay a dividend of 10 percent of book value for the next century and a half, until farming displaced the fur trade after the 1870s. The company then evolved from a network of trading posts into a department store chain. For most of the twentieth century, except during the Great Depression and World Wars I and II, the Bay paid steady dividends, sometimes above 10 percent of book or market value (Newman, 2000; *Financial Post Historical Report* for the Hudson's Bay Company).

The history of the Hudson's Bay Company shows that dividends are uncertain. The board of directors of any company, the modern descendants of the Bay's "Committee," can raise, cut or suspend a firm's dividend by majority vote, intimately tying dividends to corporate governance. In turn, corporate governance is linked to the institutional framework of the time. In the early history of the Hudson's Bay Company, King Charles II was a shareholder, and outside investors in the Hudson's Bay Company wrongly assumed that the royal connection would deter thievery by insiders and assure good corporate governance. In the modern U.S. economy, dividend taxation makes the state an implicit partner in dividend payments to shareholders—which might seem to imply that the government should favor high dividend payments. However, just as the King received other payments from the Hudson's Bay Company, so that the receipt of dividends did not align the King's interests perfectly with those of other shareholders, the modern state receives other streams of revenue from companies—including the corporate income tax.

The Hudson's Bay episode illustrates three key issues concerning dividends: dividends are an uncertain return to capital, the payment of dividends depends to some extent on corporate governance, and both dividends and corporate governance are intertwined with government institutions.

## **The Evolution of Arguments about Dividend Taxation**

Viewing dividends through the prism of corporate governance may seem both familiar and unfamiliar to economists. Jensen's (1986) "free cash flow" theory of corporate governance, discussed at greater length below and now widely accepted as of first-order importance, suggests that the insiders of ill-governed firms may opt to retain earnings to fund self-aggrandizing or otherwise inefficient projects. Well-governed firms, in contrast, disburse such earnings as dividends. The free cash flow theory suggests a close link from corporate governance to dividends.

In contrast, traditional arguments about dividend taxes focus on the economic distortions they induce, rather than on how they constrain or encourage deviations from value maximization. Thus, the traditional dividend taxation literature largely turns on dividends being part of the return on capital (Auerbach, 2002; Hubbard, 1993). This literature highlights the effects of dividend taxes on share prices, risk-taking, investment decisions, financing decisions and payout decisions. One such effect is a preference for debt over equity financing, arising because interest

payments are tax deductible at the corporate level, while dividends are not tax deductible to the firm. Another effect is a preference for retaining earnings to create long-term capital gains rather than paying dividends, which are subject to immediate individual taxation.

In this section, we argue that empirical, theoretical and financial developments occlude many of these traditional concerns. The next section shows how they re-emerge in new dress within a corporate governance framework.

### **Effects of Reducing Dividend Taxation**

Cutting taxes on dividends, all else equal, should raise share prices, lower companies' costs of capital and raise corporate investment. This view is implicit in Feldstein (1970), formalized by Black (1979) and empirically verified by Poterba and Summers (1984). An alternative view of Miller (1977), that tax-exempt investors are the marginal owners of dividend-paying stocks, and individual dividend taxes thus do not depress share prices, is inconsistent with the data. Shareholders who own a stock the day before the *ex dividend* date are entitled to its impending dividend. Shareholders who buy the stock on or after that date are not. Elton and Gruber (1973) and Elton, Gruber and Blake (2003) find that share prices fall by the *after-tax* value of the dividend, not its full nominal value, on the *ex dividend* date. This finding shows that marginal active investors value dividends *net* of individual taxes—which in turn implies that dividend taxes depress share prices.<sup>2</sup>

Brown, Liang and Weisbenner (2004) report that the U.S. stock market gained about 6 percent over key announcement dates associated with the Job Growth and Taxpayer Relief Reconciliation Act of 2003. This finding is roughly consistent with a back-of-the-envelope predictions by Poterba (2004), who estimates that the 2003 tax cuts on dividends reduced government revenue by \$23 billion in 2004 and more in future years. Capitalizing this gain in the return to capital using price-earnings ratios from the first half of 2003 roughly implies a 6 percent rise in U.S. equity values.

Cutting taxes on individuals' dividends, all else equal, should increase dividends. Top executives, surveyed in Brav, Graham, Harvey and Michaely (2005), report that tax considerations are only a secondary factor in dividend payout policies. Nonetheless, Brittain (1966) finds a negative correlation between personal tax rates and dividends from 1920 to 1960 in the United States. More recently, Blouin, Raedy and Shackelford (2004), Brown, Liang and Weisbenner (2004) and Chetty and Saez (2004) all report large and significant dividend increases following the 2003 reforms.

Whether cutting taxes on dividends paid by individuals raises or lowers social welfare is unclear. The evidence suggests that cutting taxes on individual's dividends, all else equal, reduces the cost of external investment funds (for example,

<sup>2</sup> Alternative explanations of Elton and Gruber's (1973) result, like those expressed in Frank and Jagannathan (1998), are possible. However, Elton, Gruber and Blake (2003) show that the original interpretation remains valid.

Brown, Liang and Weisbenner, 2004).<sup>3</sup> The overall effect, however, is likely less clear-cut. Gravelle (2003) runs simulations with general equilibrium effects. In her simulation, the low 15 percent top individual rates on dividends ends in 2008, which is the current law. (The Bush administration vows to make the dividend tax reductions permanent, but Democrats vow to let them expire.) Gravelle's simulations show (p. 659) that "capital income tax cuts, financed by government deficits, induce negative effects on output in a full employment model." While her results are explicitly speculative and clearly depend on her assumptions, including the behavior of future presidential administrations and Congresses, the reductions in dividend taxes in the 2003 act need not inevitably enhance social welfare.

### **Share Repurchases and Dividend Payments**

If a firm wishes to make cash payments to its investors, but to avoid or minimize the overall dividend tax burden of such payments, it has several options. One possibility is to take on more debt, so that the firm's cash payments to its investors take the form of interest payments, which are tax deductible from corporate income. However, unforeseen calamities can trigger bankruptcies of highly levered firms, while skipping or cutting a dividend triggers lesser corporate crises. Another option is for firms to make cash payments to shareholders by repurchasing their own shares, as in Bagwell and Shoven (1989). Repurchases subject individual investors to capital gains taxes, which usually have lower effective rates than dividend taxes.

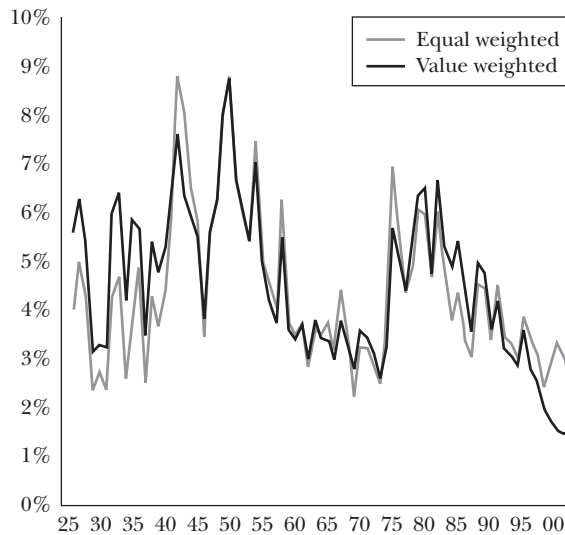
Black's (1979) "dividend puzzle," which asks why companies continue paying cash dividends given these alternatives, appears in virtually every corporate finance textbook and conveys the clear message that lowering or eliminating dividends can help to reduce investors' taxes. This message has perhaps contributed to the decline in dividend "yields" (dividends divided by the share price) that Fama and French (2001) find for U.S. stocks in the final two decades of the twentieth century. They show that this decline reflects not just more new firms that avoid paying dividend, but also a growing disinclination to pay dividends even among firms that have traditionally done so. Figure 1 illustrates their findings.

Since firms can make cash payments to their investors without dividends, and do so in ways that avoid dividend taxes, cutting dividend taxes may have less effect now than several decades ago. Moreover, the Job Growth and Taxpayer Relief Reconciliation Act of 2003 lowers taxes on the alternatives described above as well as those on dividends, so the "dividend puzzle" of why firms pay dividends at all remains an open question. Empirical work, summarized in Allen and Michaely

<sup>3</sup> The tax literature stresses a firm's source of marginal financing. Dividend taxes raise new equity costs because investors demand competitive after-tax returns. The *old view* (implicit for example in Feldstein, 1970) has this tax wedge distorting payout and capital investment policies. The *new view* (King 1977; Auerbach, 1979; Bradford, 1981) stresses the neutrality of dividend taxes if firms use retained earnings, rather than new equity, to finance capital spending. Most firms issue equity and grow from retained earnings at different points in their lives, and both financing sources are in continual general use. For a technical overview of the dispute, see Auerbach (2002).

Figure 1

## Average Dividend Yield on New York Stock Exchange Stocks, 1926 to 2002



Notes: Dividend yield is quarterly dividend divided by share price at the end of each quarter. Value weighting assigns greater weights to companies with greater stock market capitalizations.

Source: Center for Research in Securities Prices, University of Chicago.

(2002), shows that companies use repurchases in lieu of extraordinary dividends, but not ordinary dividends. One survey of financial executives reports that managers are willing to substitute stock repurchases for dividends, but believe “individual investors have a strong preference for dividends, even if dividends are tax disadvantaged” (Brav, Graham, Harvey and Michaely, 2004). We argue in the next section that if dividends serve an important corporate governance function, paying dividends despite a tax penalty might make sense.

### Signaling

Bhattacharya (1979) and others have built a large literature in which dividends are *signals* from corporate insiders to shareholders about the expected future profits of the firm. Since dividend hikes raise share prices and dividend cuts lower them, a signalling role for dividends seems plausible. However, the theory that firms use dividends to send signals about future profits raises some difficult questions.

Why don't firms devise less costly but equally informative signals? John and Williams (1985), Bernheim and Reading (2001) and others propose that high taxes actually make dividends better signals because only healthy firms can afford to pay dividends high enough to offset the taxes. But this issue arises in other fields that use signalling models, notably biology. For example, Zahlavi (1975) models metabolically costly accessories, like peacock tails, as signals of health to prospective



mates. Lachmann, Szamado and Bergstrom (2001) questions costly signal models, arguing that both the sender and receiver of a signal benefit from more cost effective signals. Perhaps in economics, as well as biology, evolution favors innovations that lower signalling costs and raise signal information content.

Also, many firms only begin paying dividends when they are a decade or two old. For example, Microsoft, founded in 1976 and listed on the stock exchange in 1986, paid its first dividend in 2003. But young firms ought to be hardest for investors to value and so ought to need signalling the most.

## **Dividends, Free Cash Flow and Corporate Governance**

The Hudson's Bay Company's early history illustrates the link between dividends and corporate governance. Corporate insiders usually have better information than public shareholders about how efficiently their firm is run—that is, how well it is governed. A sustained high-dividend policy lets insiders credibly prove to public shareholders that the firm is indeed well-governed, for an ill-governed firm could not long match such a policy.

In a highly influential paper, Jensen (1986) argues further that a mature firm, whose operations generate more income than it needs to finance profitable investment opportunities, *should* pay out its leftover income, or “free cash flow,” as dividends.<sup>4</sup> However, corporate insiders prefer to retain this free cash flow to pay for what financial economists call “private benefits of control,” like excessive executive benefits and perks, palatial head offices, corporate empire-building or the use of corporate monies to fund their personal political agendas. When poor corporate governance takes the form of excessive free cash flow retention, Jensen says the firm has a *free cash flow agency problem*—corporate insiders fail to disburse free cash flow and thus fail to act as faithful agents of public shareholders. A large body of empirical work, surveyed by Shleifer and Vishny (1997), Denis and McConnell (2003), Durnev, Morck and Yeung (2004), and others shows that free cash flow agency problems are of first order importance in the United States and elsewhere.

If dividends mainly signal insiders' willingness to disburse free cash flow, and in that sense serve as a measure of good governance, it can help to answer the puzzle of why firms pay dividends. Young growing firms' investment opportunities usually exceed their income—they have no free cash flow and hence no free cash flow agency problem. But mature firms, whose cash flows surpass their profitable investment opportunities, can have such problems and so need to pay dividends. Lang and Litzenberger (1989) find that dividend hikes raise share prices the most in firms with ample cash flows and few profitable investment opportunities. Such dividend hikes might signal better governance.

<sup>4</sup>Jensen (1986) also considers higher debt and higher corresponding interest payments as ways of insuring that free cash flow is paid out to investors.



Through much of the twentieth century, firms typically sought to keep dividends stable or steadily rising (for example, Lintner, 1956). Although Fama and French (2001) show a decline in U.S. average dividend yields in recent years, Jagannathan, Stephens and Weisbach (2000), Guay and Harford (2000), Lie (2000) and others show that ordinary dividends remain roughly proportional to the permanent component of corporate income (see also DeAngelo, DeAngelo and Skinner, 2000). Firms use extraordinary dividends or repurchases to disburse abnormal income. These patterns too are broadly consistent with dividends disbursing free cash flow, which grows as the firm matures because more mature firms typically generate more income and have fewer profitable investment opportunities.

The decline in dividend yields observed by Fama and French (2001) is not fully understood. In the 1990s, many new non-dividend-paying firms listed in U.S. markets, and many firms repurchased stock in lieu of dividends. Fama and French demonstrate an overall decline in the propensity of U.S. firms to pay dividends even after accounting for these factors.

Lambert, Lannen and Larcker (1989) propose a corporate governance explanation consistent with the Fama and French (2001) findings. In the 1990s, stock options became a predominant form of top executive compensation. Stock options reward executives for higher share prices, but are almost never adjusted for dividends (Murphy, 1999). This means the *ex dividend* day stock declines found by Elton and Gruber (1970) and Elton, Gruber and Blake (2003) reduce the value of executive stock options. Thus, top executives might retain earnings or repurchase shares, both of which raise share prices, rather than pay dividends, which lower share prices, even when dividends are efficient. Lambert, Lannen and Larcker (1989), Fenn and Liang (2001) and Kahle (2002) all report evidence consistent with this view.

This combination of theory and evidence links corporate governance with dividends. But a chicken-and-egg question arises here. Do corporate insiders raise dividends to signal their commitment to good governance? Or do economic institutions, such as stronger legal rights of minority shareholders, let public investors insist on higher dividends, thereby checking governance problems? As with many chicken-and-egg problems in economics, both directions of causation are tenable—but one is probably more important.

Desai, Foley and Hines (2002) examine dividends that unlisted foreign subsidiaries pay to their U.S. parents. Although these dividends trigger a tax liability for the parent, they are typically steady or rising, like the dividends of listed firms. Desai, Foley and Hines conclude that these “dividend policies are largely driven by the need to control managers of foreign affiliates. Parent firms are more willing to incur tax penalties. . . when their foreign affiliates are partially owned, located far from the United States, or in jurisdictions in which property rights are weak.” Thus, the head office insists on higher dividends from subsidiaries located where its property rights are weaker and local managers might be more able to misappropriate free cash flow.

La Porta, Lopez-de-Salines, Shleifer and Vishny (1998) show that many other countries, even with otherwise highly developed legal systems, provide few legal rights to public shareholders harmed by self-interested corporate insiders. La Porta, Lopez-de-Salines, Shleifer and Vishny (2000) find higher average dividend payout ratios in countries where public shareholders' rights are stronger. They also find a bigger difference between the dividends of high-growth and low-growth firms in countries with stronger shareholder rights. Reasoning that low-growth firms have fewer investment opportunities, they find that stronger shareholder rights promote higher dividends in firms with greater free cash flows.

The findings of La Porta, Lopez-de-Salines, Shleifer and Vishny (2000) suggest that good governance causes high dividends: public investors demand higher dividends where free cash flow problems are likely worse if they have the legal force to do so. The findings of Desai, Foley and Hines (2000) suggest that parent companies mandate higher dividends from subsidiaries in countries with poor ambient governance standards. In both cases, better governance forces higher dividends.

Cutting taxes on dividends weakens insiders' excuses for low dividends. It also raises the returns that public investors can receive from monitoring and disciplining insiders. These considerations highlight the potential contribution of the 2003 dividend tax cut to good corporate governance. But higher dividends might still signal a commitment to better governance in some circumstances. The full intricacies linking corporate governance to dividends remain incompletely understood.

## **Dividend Taxes and Collective Action**

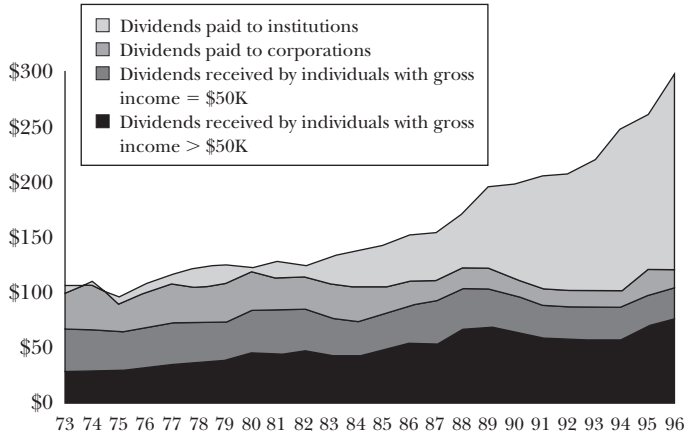
Given both the traditional arguments for reducing double taxation of dividends to avoid distortions and the more recent arguments for reducing taxation of dividend to improve corporate governance, should dividend taxes be cut to zero? A cogent corporate governance argument exists for levying a positive tax on individuals' dividend income. Most large U.S. firms are owned by a multitude of small shareholders. Any residual founding family stakes are typically small. In widely held firms, collective action problems discourage shareholders from monitoring and disciplining errant top managers.

Certain institutional investors, such as pension funds, can mitigate such collective action problems (Shleifer and Vishny, 1986). Because pension funds pool the savings of many small investors and pay no taxes, they can devote resources to corporate governance activism, yet still match the after-tax returns of individual investors. In the United States, the Employee Retirement Income Security Act and other laws and regulations encourage large tax-exempt investment funds. Of course, not all tax-exempt investment is by institutional investors, and not all institutional investors are tax-exempt. Lone investors' 401(k) plans or Individual Retirement Accounts escape individual dividend taxes; and standard mutual funds confer no tax advantage. Econometric evidence that pension funds improve

Figure 2

**Cash Dividends Paid by United States Corporations, by Type of Recipient**

(in billions of 1996 dollars)



Note: Dividend payments are adjusted for inflation using annual Consumer Price Indexes.  
 Source: Allen and Michaely (2003).

corporate performance is mixed, but institutional investors like the California Public Employees Retirement System now vocally demand change in firms they regard as misgoverned. The link that Shleifer and Vishny (1986) posit between tax-exempt institutional investors and corporate governance activism remains potentially important.

Figure 2 shows the share and size of dividends received by institutional investors growing dramatically since the entry of tax-exempt pension funds into U.S. equity markets in 1978. We believe that this argument is compelling enough to justify retaining some individual-level tax on dividends, but we confess that empirical evidence of better performance by firms specifically because of large institutional blockholders is scant.

**Taxes on Intercorporate Dividends and Corporate Pyramids**

So far, we have focused on double taxation of dividends paid by a corporation to an individual. However, the United States also has double taxation of dividends paid by one corporation to another. These are taxed at 7 percent, one-fifth of the regular 35 percent corporate income tax rate, if the parent’s stake in the dividend-paying subsidiary falls between 20 percent and 80 percent. There is no tax if the stake exceeds 80 percent and a 10.5 percent tax for stakes below 20 percent. This 7 percent tax is paid each time dividends pass from firm to firm, so a significant tax disadvantage accrues to structures containing partially owned subsidiaries of partially owned subsidiaries of partially owned subsidiaries.

The initial tax reform proposal sent by the Bush administration to Congress proposed a system that would have made intercorporate dividends exempt if the initial dividend payer paid corporate income taxes. In the words of the U.S. Department of the Treasury (2003, p. 15): “These additions . . . ensure that multiple levels of corporate ownership do not result in more than one level of tax on income that has been previously taxed at the corporate level.” However, by the time the final version of the bill left Congress and was signed into law, the tax on intercorporate dividends was restored.

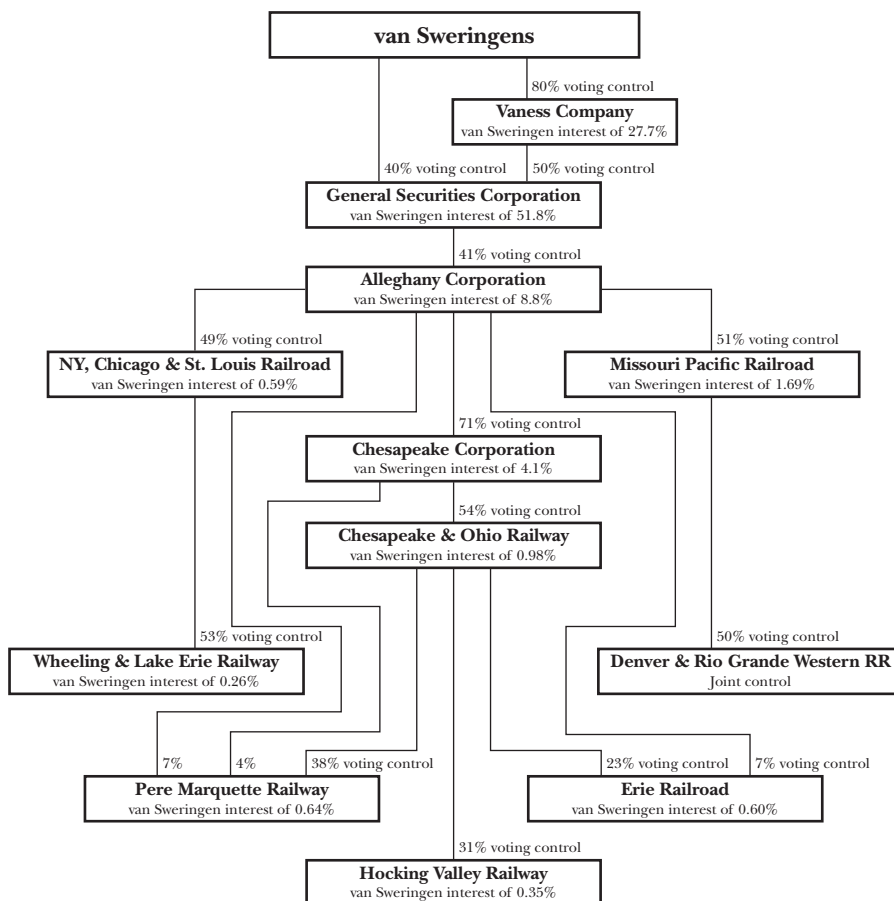
The United States is almost the only country with a large stock market to tax intercorporate dividends on control blocks. Before the mid-1930s, the United States did not tax intercorporate dividends either. Morck (2004) describes how Franklin Delano Roosevelt, as part of his New Deal, applied intercorporate dividend taxation explicitly to alter the structure of American corporate ownership.

Before the mid-1930s, Berle and Means (1932, p. 183–185) show that many U.S. companies were organized into control “pyramids”—structures in which an ultimate owner controls a first tier of listed companies, each of which controls other listed companies, each of which controls yet more listed companies and so on. Figure 3 displays an American pyramidal group controlled by the van Sweringen brothers. While this pyramid is small enough to fit on a single page, others were much larger. Speaking to the Senate Finance Committee hearings (pp. 223–224), Assistant General Counsel to the Treasury Department Robert Jackson, describes an American pyramid that, “as of December 31, 1933, contained approximately 270 companies of which 128 were public utility operating companies located in several and widely separated states, and at least 31 of which would be classed as subholding companies.” But the van Sweringen group is large enough to illustrate the basic features of control pyramids.

Pyramids leverage family wealth sufficient to control one corporation into control over a group of companies worth far more. Berle and Means (1932, p. 69) report that the van Sweringens use “an investment of less than twenty million dollars. . . to control eight Class I railroads having combined assets of over two billion dollars.”<sup>5</sup> Berle and Means (pp. 69–71) reflect: “The owner of a majority of stock of the company at the apex of the pyramid can have almost as complete control of the entire property as a sole owner even though his ownership is less than one percent of the whole. . . . The van Sweringen investment represented 51% of the capital in the General Securities Corporation, eight percent of the capital of the Allegheny Corporation, four percent of the Chesapeake Corporation, less than one percent of the great operating company, the Chesapeake and Ohio Railway, and but one quarter of one percent of the latter’s operating subsidiary, the Hocking

<sup>5</sup> Berle and Means (1932) are usually cited for their discussion of such divergence of interest problems in widely held firms; however they highlight similar problems in control pyramids. This theme is developed further by Morck, Stangeland and Yeung (2000) and formalized by Bebchuk, Kraakman and Triantis (2000).

Figure 3  
The van Sweringen Control Pyramid



Source: Berle and Means (1932).

Valley Railway. In the last named company over 99¾ per cent of the investment represented ownership without control.”

Nonetheless, the family commands enough votes in each group firm to control its board. Less than 50 percent usually permits control because many small shareholders do not vote. The family’s voting power can be magnified at various points in the pyramid by dual class shares—giving public investors common shares with one vote each while reserving a second class of common shares with many votes each for the family.

A Federal Trade Commission (1928) report details widespread governance problems in pyramidal groups, labelling them “frequently a menace to the investor or the consumer or both.” Writing in the *American Economic Review*, Franklin Roosevelt (1942) worries that “private enterprise is ceasing to be free enterprise and is becoming a cluster of private collectivism; masking itself as a system of free

enterprise after the American model, it is in fact becoming a concealed cartel system after the European model.” He rues: “Such [pyramidal] control does not offer safety for the investing public. Investment judgment requires the disinterested appraisal of other people’s management. It becomes blurred and distorted if it is combined with the conflicting duty of controlling the management it is supposed to judge.” Roosevelt also expressed concern that such interlocking control structures impede innovation: “Interlocking financial controls have taken from American business much of its traditional virility, independence, adaptability, and daring—without compensating advantages. They have not given the stability they promised. Business enterprise needs new vitality and the flexibility that comes from the diversified efforts, independent judgments and vibrant energies of thousands upon thousands of independent businessmen.”<sup>6</sup>

The Roosevelt administration attacked control pyramids on several fronts. One was the Public Utilities Holding Company Act, which limited pyramiding in public utilities industries. A second front was the Securities and Exchange Commission, which increased corporate transparency and enhanced public shareholders’ legal rights. A third front banned investment fund pyramids. But most relevant to our discussion was the tax code. In 1935, the Roosevelt administration applied double taxation to intercorporate dividends. Previously, corporations paid no taxes on dividends they received, allowing large pyramids to pass dividends from company to company. The 1935 act taxed intercorporate dividends at a rate of 10 percent of corporate taxes, which increased to 15 percent in 1936. Meanwhile, capital gains from consolidating subsidiaries were eliminated, and the filing of consolidated returns for business groups was sharply curtailed. Roosevelt (1942) wrote: “Tax policies should be devised to give affirmative encouragement to competitive enterprise. Attention might be directed to increasing the intercorporate dividend tax to discourage holding companies. . .”

In modern times, other developed countries still do not tax intercorporate dividends much or at all. Canada levies no tax if the parent’s stake exceeds 20 percent, and the 2003 European Commission Parent-Subsidiary Directive mandates that member states not tax intercorporate dividends within Europe if the parent’s stake exceeds 10 percent (down from 20 percent in the previous Directive). Australia, Japan, Singapore, Switzerland and all other developed countries have similar provisions. Most developing countries with substantial stock markets also exempt most intercorporate dividends from taxation, though a few, like Korea, nominally levy such taxes but provide special intercorporate dividend tax relief for pyramidal groups.

Perhaps unsurprisingly, La Porta, Lopez-de-Salines, Shleifer and Vishny (1999) find that pyramidal groups are the predominant ownership structure for large firms outside the United States and that the ultimate owners are usually very wealthy

<sup>6</sup> Morck, Stangeland and Yeung (2000) echo this, and question whether firms are willing to engage in *creative self-destruction* or whether the process of innovation and creative destruction requires the pressure of independent competitors. Morck and Yeung (2003, 2004) develop the idea further.

families. Morck, Wolfenzon and Yeung (2004) explain how pyramidal groups let tiny elites control the greater parts of the corporate sectors of many economies.

Numerous studies, surveyed by Morck, Wolfenzon and Yeung (2004), attest to the importance of governance problems in pyramids, especially in countries that provide public shareholders with weak legal rights against corporate insiders. One governance problem of pyramid groups is what Johnson et al. (2000) christen “tunneling.” Tunneling occurs when the controlling entity orchestrates transactions at nonmarket prices to shift income from one firm to another. Tunneling is analogous in many ways to income-shifting in multinational firms, except that the object is to hide money from public shareholders rather than from tax authorities. Another governance problem arises because control pyramids magnify moderate fortunes into control over corporate assets worth far more. This puts the controlling shareholders of control pyramids in much the same position as the managers of a widely held firm—they control vast corporate dominions assembled mainly with other people’s money. Indeed, Berle and Means (pp. 69–71) argue that this separation of ownership from control, which Jensen and Meckling (1976) show to underlie a broad range of corporate governance problems, is rarely as extreme as in large pyramidal groups.

In many countries, pyramidal groups vest unparalleled political influence in tiny elites. Morck and Yeung (2004) argue that pyramidal groups greatly magnify their controlling shareholders’ returns to political rent seeking. Highly profitable political rent seeking is especially detrimental to economic growth because it induces investment in bureaucratic skills rather than technology (Murphy, Shleifer and Vishny, 1993).

With its tax on intercorporate dividends, the United States has a highly exceptional corporate sector, almost devoid of pyramids (La Porta, Lopez-de-Salines, Shleifer and Vishny, 1999).<sup>7</sup> Large shareholders remain important in the U.S. economy, and American firms do buy, hold and sell blocks of stock in each other; but the U.S. economy is basically made up of free-standing firms (Holderiness et al., 1999). America’s intercorporate dividend taxation rules is probably a key, though largely unappreciated, reason for this exceptionalism.

Whether or not other countries should enact similar dividend taxes is a useful line of inquiry for future research. More work is needed on the economic costs and benefits of pyramidal groups before a fully persuasive answer can be formulated.

<sup>7</sup> Thermo Electron retains stakes in publicly traded high tech firms as an intermediate step to spinning them off. This two-tiered pyramid, and a few others described in Amit and Villalonga (2005), are far simpler than those typical elsewhere. We are grateful to Martin Feldstein for bringing Thermo Electron to our attention. According to La Porta, Lopez-de-Salines, Shleifer and Vishny (2000), the only other country largely bereft of pyramids is the United Kingdom. Franks, Mayer and Rossi (2003) argue an active takeover market permitted a 1968 rule requiring that bids for 30 percent or more be for 100 percent to eliminate most British pyramids.



## Conclusion

The Jobs and Growth Tax Relief Reconciliation Act, which President Bush signed into law on May 28, 2003, reduces the top marginal individual tax rate on dividend income to 15 percent. Corporate governance considerations clearly played a role in motivating the 2003 act. The Joint Economic Committee (2003) argues that reducing dividend taxes means “[p]aying dividends rather than retaining earnings would become a more attractive proposition for companies; this change would promote a more efficient allocation of capital and give shareholders, rather than executives, a greater degree of control over how a company’s resources are used.”

The 2003 dividend tax cuts apparently raised dividend payouts. If companies pay inefficiently low dividends to retain excessive free cash flow, as Jensen (1986) argues, or to maximize executive stock option values, as Lambert, Lannen and Larcker (1989) suggest, higher dividends ought to enhance efficiency.

Though the case for cutting taxes on the recipients of dividends from their pre-2003 levels is strong, persuasive arguments hold that taxes on dividend income should not fall to zero. Taxing individuals’ dividend income encourages investors to hold stocks through tax-exempt institutional investors, like pension funds. These are large enough to pay the fixed costs entailed in monitoring and disciplining errant corporate insiders. Despite the zeal with which the Bush administration cut individual dividend taxes, it preserved America’s exceptional tax on intercorporate dividends, rendering unlikely a resurgence of pyramiding, with all its attendant governance and other problems.

■ *We are grateful for assistance, comments and ideas from Dave Backus, Lucian Bebchuk, Ned Elton, Dan Feenberg, Martin Feldstein, James Hines, R. Glenn Hubbard, Jim Poterba, Emmanuel Saez, Andrei Shleifer, Joel Slemrod, Timothy Taylor, Michael Waldman, Lawrence White and Luigi Zingales.*

## References

- Allen, Franklin and Roni Michaely.** 2002. “Payout Policy,” in *Handbook of the Economics of Finance*. George Constantinides, Milton Harris and Rene Stulz, eds. Amsterdam: North-Holland, chapter 7.
- Allen, Franklin, Antonio Bernardo and Ivo Welch.** 2000. “A Theory of Dividends Based on Tax Clientele.” *Journal of Finance*. 55:6, pp. 2499–536.
- Amit, Raffi and Belén Villalonga.** 2005. “When Does Family Succession Create Value?” Working paper, Harvard Business School.
- Auerbach, Alan.** 2002. “Taxation and Corporate Financial Policy,” in *Handbook of Public Economics, Volume III*. Alan Auerbach and Martin Feldstein, eds. Amsterdam: North-Holland, pp. 1251–292.
- Auerbach, Allen.** 1979. “Wealth Maximization

- and the Cost of Capital." *Quarterly Journal of Economics*. 94:3, pp. 433–36.
- Bagwell, Laurie Simon and John B. Shoven.** 1989. "Cash Distributions to Shareholders." *Journal of Economic Perspectives*. 3:3, pp. 129–40.
- Balen, Malcolm.** 2003. *The Secret History of the South Sea Bubble: The World's First Great Financial Scandal*. London: Fourth Estate.
- Bernheim, B. Douglas and Lee Reading.** 2001. "Optimal Money Burning: Theory and Application to Corporate Dividends." *Journal of Economics and Management Strategy*. 10:1, pp. 463–507.
- Bhattacharya, Sudipto.** 1979. "Imperfect Information, Dividend Policy, and 'The Bird In The Hand' Fallacy." *Bell Journal of Economics*. 10:1, pp. 259–70.
- Black, Fischer.** 1976. "The Dividend Puzzle." *Journal of Portfolio Management*. 2:2, pp. 5–8.
- Blouin, Jennifer, Jana Raedy and Douglas Shackelford.** 2004. "Did Dividends Increase Immediately After the 2003 Reduction in Tax Rates?" NBER Working Paper No. 10301.
- Bradford, David.** 1981. "The Incidence and Allocation Effects of a Tax on Corporate Distributions." *Journal of Public Economics*. 15:1, pp. 1–22.
- Brav, Alon, John R. Graham, Campbell R. Harvey and Roni Michaely.** 2005. "Payout Policy in the 21<sup>st</sup> Century." *Journal of Financial Economics*. Forthcoming.
- Brittain, John.** 1966. *Corporate Dividend Policy*. Washington, D.C.: Brookings Institution.
- Brown, Jeffrey, Nellie Liang and Scott Weisbenner.** 2004. "Executive Financial Incentives and Payout Policy: Firm Responses to the 2003 Dividend Tax Cut." NBER Working Paper No. 11002.
- Chetty, Raj and Emmanuel Saez.** 2004. "Do Dividend Taxes and Corporate Behavior: Evidence from the 2003 Dividend Tax Cut." NBER Working Paper No. 10572.
- DeAngelo, Harry, Linda DeAngelo and Douglas Skinner.** 2000. "Special Dividends and the Evolution of Dividend Signalling." *Journal of Financial Economics*. 57:3, pp. 309–54.
- Desai, Mihir, Fritz Foley and James Hines.** 2002. "Dividend Policy Inside the Firm." NBER Working Paper No. 8698.
- Durnev, Artyom, Randall Morck and Bernard Yeung.** 2004. "Value Enhancing Capital Budgeting and Firm-Specific Stock Returns Variation." *Journal of Finance*. 59:1, pp. 65–106.
- Easterbrook, Frank.** 1984. "Two Agency-Cost Explanations of Dividends." *American Economic Review*. 74:4, pp. 650–60.
- Elton, Edwin J. and Martin J. Gruber.** 1970. "Marginal Stockholder Tax Rates and the Clientele Effect." *Review of Economics and Statistics*. 52:1, pp. 68–74.
- Elton, Edwin J., Martin J. Gruber and Christopher R. Blake.** 2005. "Marginal Stockholder Tax Effects and Ex-Dividend Day Behavior—Thirty-Two Years Later." *Review of Economics and Statistics*. Forthcoming.
- Fama, Eugene and Kenneth R. French.** 2001. "Disappearing Dividends: Changing Firm Characteristics or Lower Propensity to Pay?" *Journal of Financial Economics*. April, 60, pp. 3–43.
- Federal Trade Commission.** 1928. "Utility Corporation." Senate Document No. 92, 70th Congress, 1st Session.
- Feldstein, Martin.** 1970. "Corporate Taxation and Dividend Behaviour." *Review of Economic Studies*. April, 37, pp. 57–72.
- Feldstein, Martin.** 1983. *Capital Taxation*. Cambridge: Harvard University Press.
- Feldstein, Martin.** 1995. "The Effects of Marginal Tax Rates on Individual Taxable Income: A Panel Study of the Tax Reform Act of 1986." *Journal of Political Economy*. 103:3, pp. 551–72.
- Fenn, G. and N. Liang.** 2001. "Corporate Payout Policy and Managerial Stock Incentives." *Journal of Financial Economics*. April, 60, pp. 45–72.
- Frank, Murray and Ravi Jagannathan.** 1998. "Why Do Stock Prices Drop by Less than the Value of the Dividend? Evidence from a Country Without Taxes." *Journal of Financial Economics*. February, 47, pp. 161–88.
- Franks, Julian, Colin Mayer and Stefano Rossi.** 2003. "The History of Corporate Ownership in Great Britain." Paper presented at the NBER Conference on the History of Corporate Ownership: The Rise and Fall of Great Business Families, June 21–22.
- Gravelle, Jane.** 2003. "Effects of Dividend Relief on Economic Growth, the Stock Market, and Corporate Tax Preferences." *National Tax Journal*. 56:3, pp. 653–73.
- Guay, Wayne and Jarrad Harford.** 2000. "The Cash-Flow Permanence and Information Content of Dividend Increases versus Repurchases." *Journal of Financial Economics*. 57:3, pp. 385–415.
- Hubbard, R. Glenn.** 1993. "Corporate Tax Integration: A View from the Treasury." *Journal of Economic Perspectives*. 7:1, pp. 115–32.
- Jagannathan, Murali, Clifford Stephens and Michael Weisbach.** 2000. "Financial Flexibility and the Choice between Dividends and Stock Repurchases." *Journal of Financial Economics*. 57:3, pp. 355–84.
- Jensen, Michael C.** 1986. "Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers." *American Economic Review*. 76:2, pp. 323–29.

- John, Kose and Joseph Williams.** 1985. "Dividends, Dilution, and Taxes: A Signaling Equilibrium." *Journal of Finance*. 40:4, pp. 1053–070.
- Joint Committee on Taxation.** 2003. "Summary of Conference Agreement on H.R. 2, 'The Jobs and Growth Tax Relief Reconciliation Act of 2003.'" JCX-54-03, May 22; Available at ([http://www.depreciationbonus.org/pdf/JCT\\_Summary.pdf](http://www.depreciationbonus.org/pdf/JCT_Summary.pdf)).
- Joint Economic Committee.** 2003. "Dividend Tax Relief and Capped Exclusions." May 13; Available at ([http://jec.senate.gov/\\_files/DividendTaxRelief.pdf](http://jec.senate.gov/_files/DividendTaxRelief.pdf)).
- Kahle, Kathleen.** 2002. "When a Buyback isn't a Buyback: Open-Market Repurchases and Employee Options." *Journal of Financial Economics*. 63:2, pp. 235–61.
- King, Mervyn.** 1977. *Public Policy and the Corporation*. London: Chapman and Hall.
- La Porta, Rafael, Florencio Lopez-de-Salines, Andrei Shleifer and Robert Vishny.** 1998. "Law and Finance." *Journal of Political Economy*. 106:6, pp. 1113–155.
- La Porta, Rafael, Florencio López-de-Silanes, Andrei Shleifer and Robert Vishny.** 1999. "Corporate Ownership Around the World." *Journal of Finance*. 54:2, pp. 471–520.
- La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny.** 2000. "Agency Problems and Dividend Policies around the World." *Journal of Finance*. 55:1, pp. 1–33.
- Lachmann, Michael, Szabolcs Szamado and Carl Bergstrom.** 2001. "Cost and Conflict in Animal Signals and Human Language." *Proceedings of the National Academy of Sciences United States*. 98:23, pp. 13189–3194.
- Lambert, Richard, William Lannen and David Larcker.** 1989. "Executive Stock Option Plans and Corporate Dividend Policy." *Journal of Financial Quantitative Analysis*. 24:4, pp. 409–25.
- Lang, Larry and Robert Litzenberger.** 1989. "Dividend Announcements: Cash Flow Signaling vs. Free Cash Flow Hypothesis?" *Journal of Financial Economics*. 24:1, pp. 181–92.
- Lie, Eric.** 2000. "Excess Funds and the Agency Problems: An Empirical Study of Incremental Disbursements." *Review of Financial Studies*. 13:1, pp. 219–48.
- Miller, Merton.** 1977. "Debt and Taxes." *Journal of Finance*. 32:2, pp. 261–75.
- Morck, Randall.** 2004. "How to Eliminate Pyramidal Business Groups—the Double Taxation of Inter-Corporate Dividends and other Incisive Uses of Tax Policy." NBER Working Paper No. 10944, December.
- Morck, Randall and Bernard Yeung.** 2003. "Agency Problems in Large Family Business Groups." *Entrepreneurship Theory and Practice*. 27:4, pp. 367–82.
- Morck, Randall and Bernard Yeung.** 2004. "Family Control and the Rent-Seeking Society." *Entrepreneurship: Theory and Practice*. 28:4, pp. 391–409.
- Morck, Randall, David Stangeland and Bernard Yeung.** 2000. "Inherited Wealth, Corporate Control, and Economic Growth," in *Concentrated Corporate Ownership*. Randall Morck, ed. Chicago, Ill.: University of Chicago Press, pp. 319–69.
- Morck, Randall, Daniel Wolfenzon and Bernard Yeung.** 2004. "Corporate Governance, Economic Entrenchment and Growth." *Journal of Economic Literature*. Forthcoming.
- Murphy, Kevin M., Andrei Shleifer and Robert W. Vishny.** 1993. "Why is Rent-Seeking Costly to Growth?" *American Economic Review*. 82:2, pp. 409–14.
- Murphy, Kevin J.** 1999. "Executive Compensation," in *Handbook of Labor Economics, Volume 3B*. Orley Ashenfelter and David Card, eds. North Holland, Amsterdam, chapter 38.
- Newman, Peter.** 2000. *Empire of the Bay: The Company of Adventurers that Seized a Continent*. New York: Penguin Books.
- Poterba, James.** 2004. "Taxation and Corporate Payout Policy." *American Economic Review*. 94:2, pp. 171–89.
- Poterba, James and Lawrence Summers.** 1984. "New Evidence that Taxes Affect the Valuation of Dividends." *Journal of Finance*. 39:5, pp. 1397–415.
- Roosevelt, Franklin D.** 1942. "Appendix A: Message from the President of the United States Transmitting Recommendations Relative to the Strengthening and Enforcement of Anti-trust Laws." *American Economic Review*. 32:2, pp. 119–28.
- Shleifer, Andrei and Robert W. Vishny.** 1986. "Large Shareholders and Corporate Control." *Journal of Political Economy*. 94:3, pp. 461–88.
- U.S. Department of the Treasury.** 2003. "General Explanations of the Administration's Fiscal Year 2004 Revenue Proposals." February; Available at (<http://www.treas.gov/offices/tax-policy/library/bluebk03.pdf>).
- Zahavi, Amotz.** 1975. "Mate Selection—A Selection for a Handicap." *Journal of Theoretical Biology*. 53, pp. 205–14.