The Effect of the May 2003 Dividend Tax Cut on Corporate Dividend Policy: Empirical and Survey Evidence

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Abstract *- We analyze the impact of the May 2003 dividend tax cut on corporate dividend policy. First, we find that while there was a temporary increase in dividend initiations, this increase was not long–lasting. While dividend payments were increased right after the tax change, there was a larger and more pronounced increase in repurchases during the same time period. Second, we survey 328 financial executives to determine the effects of the May 2003 dividend tax cut. We find that the tax cut led to initiations and dividend increases at some firms. However, executives say that among the factors that affect dividend policy, the tax rate reduction is less important than the stability of future cash flows, cash holdings, and the historic level of dividends. Tax effects have roughly the same importance as attracting institutional investors and the availability of profitable investments. We also find that press releases only occasionally mention the dividend tax cut as the reason for an initiation. Overall we conclude that the dividend tax reduction had only a second–order impact of payout policy.*

INTRODUCTION

In December 2002, the Bush administration floated a radical proposal to reduce the taxation on dividends to zero. The official motive behind the proposal was to give the economy a boost by increasing investors' disposable income. Andrews (2003) quotes R. Glenn Hubbard, Bush's economic adviser at the time, as stating that reducing dividend taxation could boost overall stock prices by 20 percent, increasing spending and consequently economic growth. Moreover, many argue that the dividend taxation should be eliminated for the simple reason that dividends are taxed twice: Once at the corporate level since companies pay dividends from after–tax earnings, and then again at the level of the investor, who must pay income tax on dividends received. Interest income on the other hand, is taxed only at the investor level (because debt interest is paid from before–tax corporate income). This disparity between dividends and interest taxation creates a tax advantage to debt financing. Proponents of the proposal, therefore, argue that reduction in dividend taxation will reduce the corporate bias towards using debt financing. Finally, it is argued that the reduction in dividend taxation will reduce the cost of capital and increase investment, providing another boost to economic growth.

Since the majority of dividends are received by very wealthy individuals, opponents of the proposal argue that the elimination of dividend taxation is a tax break to the rich, which they claim makes this proposal unfair and ineffective: unfair because the tax reduction will disproportionally benefit the rich and increase the income disparity in the US, and ineffective because the marginal propensity to consume among those wealthy individuals is rather low and, thus, a very significant portion of dividends will not be consumed but will instead be saved. Moreover, the estimated cost of the proposal is more than $300 billion over the first ten years of implementation. Finally some economists argue that the reduction in dividend taxation will increase the amount of dividends paid by corporations and will reduce corporate investment and, therefore, it might have a counter–productive impact on the economy (Auerbach, 1979).

After a period of negotiations between the White House, Senate and House, a modified version of the original proposal went into effect in May 2003. The dividend tax rate for individual investors fell dramatically but was not eliminated. The top statutory tax rate on dividend income dropped from more than 38 percent to 15 percent and the top rate on capital gains declined from 20 percent to 15 percent. According to theory, this tax cut should have led to greater dividend payout because it reduced the tax disadvantage of dividends relative to capital gains. (Capital gains are still somewhat tax–favored because they can be delayed until the investor sells the stock or avoided altogether at death.) In this paper, we use survey and other empirical evidence to explore how this large reduction in the tax cost of dividends affects corporate payout decisions.

Several recent empirical papers (described in the fifth section) argue that the May 2003 tax reduction led to increased dividend payments. We do not dispute this conclusion. Rather, we examine whether the tax reduction affected payout policy in a first–order or second–order manner. In the latter case, we could imagine that some firms were "on the fence" about paying a dividend, given the existing equilibrium. The tax cut might have led these firms to initiate dividends but, overall, the effects of the tax effect might still have been modest. It seems plausible that the tax effect was second–order because the May 2003 tax cut reduced tax rates for individual investors but not for taxable institutions, and individual investors are generally not thought to be of first–order importance.

To examine the relative importance of taxes to corporate payout decisions, we look at three types of evidence. In the first section we present summary information on dividend initiations and aggregate payout. This evidence indicates that there was a surge in initiations that peaked in the quarter after the tax cut and then returned to pre–cut levels. Moreover, the average age of an initiator also fell in the year after the tax cut, but has since returned to historic levels. We also find that aggregate repurchases have grown much more than aggregate dividends since May 2003. Taken together, these results are not consistent with the tax cut having had a long–lasting, first–order impact. If anything, the evidence is more consistent with a spike in dividend activity.

Second, in the third section we survey corporate decision–makers and ask them directly whether reduced dividend taxation caused their firms to initiate or increase dividends, and if so, how important the tax effect was. We also examine the relative importance of several non–tax factors. The surveyed executives indicate that investor tax rates affect corporate dividend decisions. We also find weak evidence of a differential effect of tax rates on firms for whom individual investors are most important. This finding is consistent with the theoretical tax prediction. However, the executives indicate that tax rates are a second–order concern, less important than several other factors.

One in 11 firms in our survey sample had initiated dividends during the previous three years, and these firms report that on average, the dividend tax cut had a small to moderate effect on their initiation decision. Among initiators, the long–term stability of cash flows and cash position of the firm are more important than tax considerations, and the reduced availability of profitable investments and the desire to attract institutional investors are on par with taxes. More than 40 percent of the firms in our sample have continuously paid dividends over the past several years. These dividend–payers report that the historic level of the dividend is more important than are tax considerations, as are the stability of cash flows, cash on hand, investment opportunities, and attracting institutional investors.

Third, in the fourth section, to document the explanations initiators give when they begin paying a dividend, we examine the press releases issued by 265 companies that initiated dividends between the first quarter of 2002 and the end of 2005. Out of the 76 firms that initiated dividends during the second half of 2003, 24 explicitly mention the dividend tax reduction in their press release explanation of why they began paying dividends, although taxes were not necessarily the primary reason cited. However, even though reduced dividend taxes are still in effect, starting in 2004 very few firms mention dividend tax rates as a reason for initiating. We argue that this pattern is consistent with the tax cut influencing on–the–fence firms to initiate a dividend, but for the majority of companies, dividend taxation remains second–order in importance.

In the fifth section we interpret our findings. The sixth section concludes the paper.

SOME EMPIRICAL EVIDENCE ON DIVIDENDS AND REPURCHASES SINCE 2000

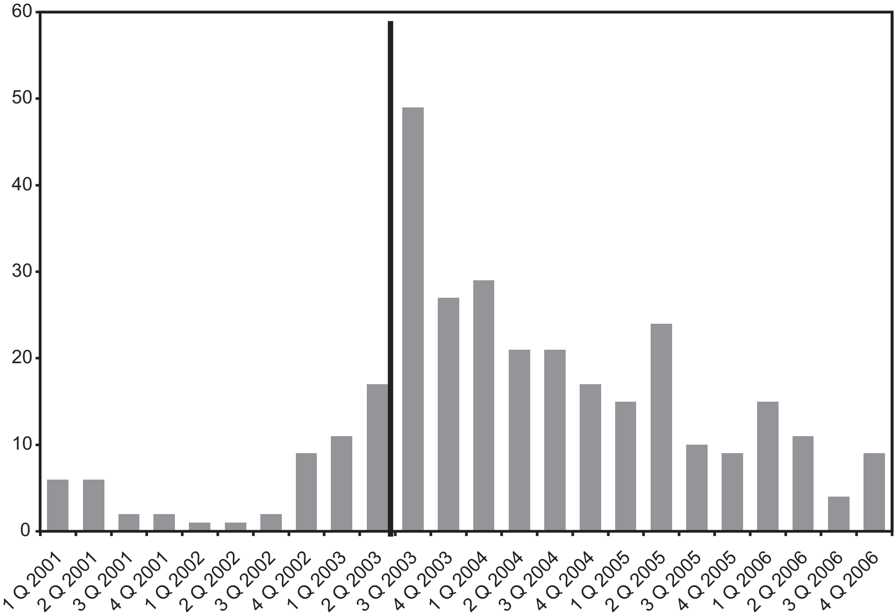
To put the effects of the 2003 tax cut in perspective, we present before–and–after information about dividend initiations and overall payout. (We define a dividend initiation as the payment of a regular dividend (i.e., not a special dividend) by a firm that has not paid a regular dividend in the past three years. We also separately consider special dividends below.) The initiation pattern provides evidence about whether the surge in dividends that followed the tax cut was temporary or permanent. Similarly, if dividend taxation of investors affects corporate decisions in important ways, then we would expect the relative share of payout attributable to dividends to increase at the expense of share repurchases.

Figure 1 presents the number of dividend initiations by quarter for the constant number of firms sample that Chetty and Saez (2005) use to document that a surge in dividend initiations occurred in the third quarter of 2003, immediately following the tax reduction. To reduce denominator effects in the analysis, the sample contains only the largest 3,582 non–utility, non–financial firms by market capitalization. Figure 1 shows that there was a spike in regular dividend initiations in the third quarter of 2003. Figure 2 shows the same pattern for regular plus special dividends.[1]

Given that dividend increases and initiations are approved by the board of directors prior to implementation, the third

[1] Julio and Ikenberry (2004) argue that the trend to initiate dividends was already in motion, at least to some degree, several quarters before the tax cut was announced (see our Figure 1). Chetty and Saez (2006) argue that Julio and Ikenberry's conclusion is driven by sample selection effects. We do not take a stand on this issue.

Figure 1. Regular Dividend Initiations



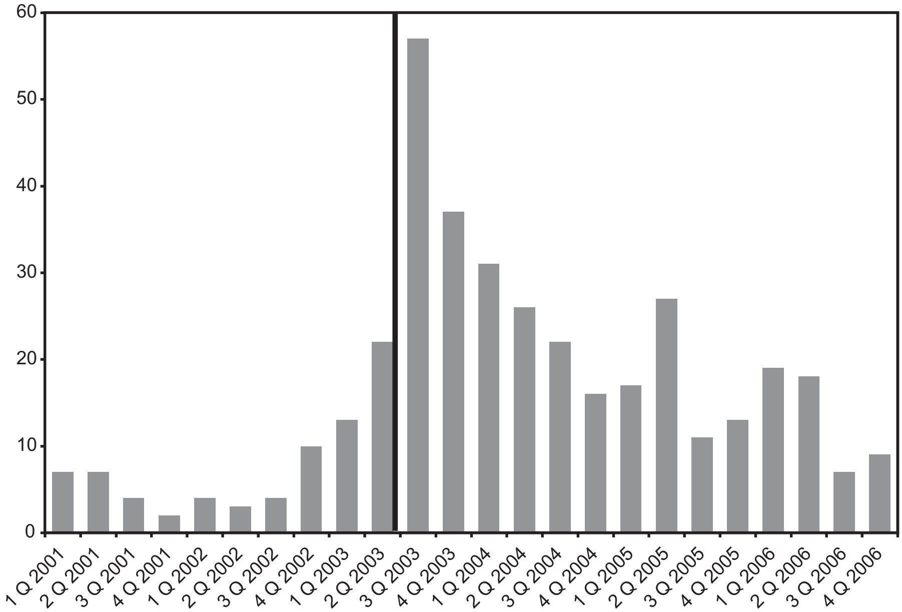
Notes: This figure shows the number of firms that initiated regular dividends in each quarter from January 2001 to December 2006. The sample of firms represents the largest 3,582 non–utility, non–financial firms by market capitalization examined by Chetty and Saez (2005) in their "constant number of firms" sample. The timing of the May, 2003 dividend tax cut is shown by the vertical line.

quarter spike indicates that some firms responded and paid their first dividend shortly after the tax cut went into effect. However, in the 13 quarters after that initial spike, dividend initiations gradually returned to the level found in the several quarters just preceding the tax cut.

We also calculate the average age of initiator firms for the years leading up to and after May 2003 (i.e., 2001Q3 to 2002Q2, 2002Q3 to 2003Q2, 2003Q3 to 2004Q2, 2004Q3 to 2005Q2, and 2005Q3 to 2006Q2). We measure age as the number of years that the firm has been listed on Center for Research in Security Prices (CRSP). The average age of initiators in each of these five periods is 18.3, 15.4, 14 (in the four quarters following the tax cut), 16.2, and 16. Thus, the age of initiators fell in the year after the tax cut, but rebounded in years two and three after the tax cut. Overall, the pattern in initiations and the age of initiator firms is consistent with the tax cut accelerating the commitment to pay dividends at some firms but not having a long–lasting effect that dramatically changed the payout equilibrium.

Figure 3 presents aggregate dividends compared to aggregate repurchases for Compustat firms. There is a spike in dividends in 2003 that corresponds to the reduction in dividend taxation. However, there is an even greater increase in repurchases following the May 2003 tax act. Brown, Liang, and Weisbenner (2007) argue that the reaction to the tax cut at the firm level was a substitution away from repurchases at firms for which dividends increased. However, the aggregate numbers in Figure 3 indicate that repurchases

Figure 2. Regular Plus Special Dividend Initiations



Notes: This figure shows the number of firms that initiated regular or special dividends each quarter from January 2001 to December 2006. The sample of firms represents the largest 3,582 non–utility, non–financial firms by market capitalization examined by Chetty and Saez (2005) in their "constant number of firms" sample. The timing of the May, 2003 dividend tax cut is shown by the vertical line.

increased more dramatically than dividends, which implies that non–tax factors played an important role in recent payout decisions.[2] The 2003–2006 reduction in the share of aggregate payout attributable to dividends is hard to understand if dividend taxation is a first–order factor affecting payout decisions.

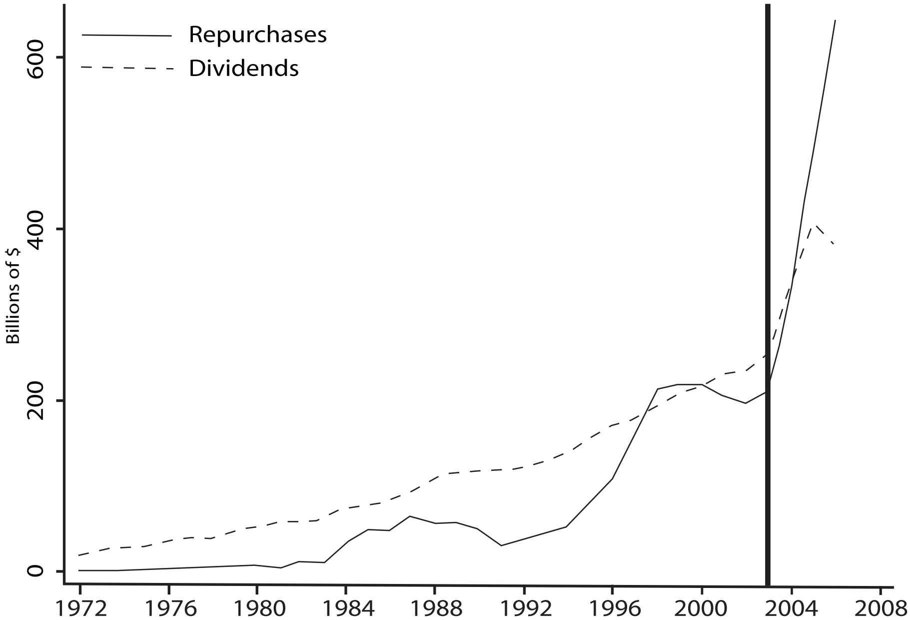
SURVEY SAMPLE AND SUMMARY STATISTICS

Our survey is part of an ongoing quarterly joint effort by Duke University and *CFO* magazine. Based on theoretical and empirical work about dividend decisions, we developed an initial set of questions to pose to chief financial officers (CFOs). Given the nature of the questions, we solicited feedback from academics on the initial version of the survey, incorporated their suggestions, and revised the survey. The questions are available at http://faculty.fuqua.duke.edu/cfosurvey/05q4/html/Duke–8–05_cookie_cutter.htm.

On August 23, 2005 we emailed a link to our Internet survey to approximately 7,000 financial decision–making execu-

[2] Annual aggregate dividend payments for each year from 1980 to 2006 are 53.7, 57.8, 59.8, 64.2, 72.8, 76.9, 86.9, 93.5, 109.2, 113.7, 117.3, 119.4, 121.1, 127.8, 139.4, 153.9, 171.9, 178.6, 195.4, 207.1, 214.4, 230.7, 232.8, 253.2, 335.6, 408.0, and 383.8 billion US dollars. Annual aggregate repurchases for each year from 1980 to 2006 are 7.2, 7.1, 11.5, 11.3, 33.8, 47.9, 49.8, 63.2, 57.8, 59.4, 50.5, 31.2, 39.6, 44.9, 52.8, 85.0, 109.3, 155.0, 212.6, 218.2, 219.4, 203.1, 197.9, 210.6, 332.5, 493.5, and 645.6 billion US dollars.

Figure 3. Dividends Versus Repurchases



Notes: This figure depicts aggregate nominal dividends and share repurchases for a sample of U.S. firms. The sample consists of all firm–year observations on Compustat over the period 1972–2006 that have available information on share repurchases and dividends. The timing of the May 2003 dividend tax cut is shown by the vertical line.

tives, most of whom were CFOs. The survey contained questions on important topical issues, including several questions related to the effects of dividend tax rates on payout decisions. The response rate for the survey was 5.3 percent (374 responses), which is approximately equal to the typical response rate for the Duke/*CFO* survey (see references in Graham and Harvey (2001), and Graham, Harvey, and Rajgopal (2005)). Of the 328 responses with information on public versus private ownership, there are 152 public companies, of which 106 paid dividends at some point during the three years just prior to the survey, and 176 private firms, of which 57 paid dividends at some point during the previous three years. The focus of our analysis is on public firms, although we separately analyze private companies.

Table 1 presents self–declared summary information for the firms in our sample. Considering all the firms in the sample, 38.4 percent had paid dividends continuously during the previous three years, 9.1 percent initiated dividends during these three years, and 2.2 percent had paid dividends but stopped doing so during the last three years. The remaining 50.3 percent of the population did not pay any dividends during the previous three years. The public–firm sample is similar, except that an additional 20.2 percent of firms paid dividends during the three years just prior to the survey.

Table 1 also contains information on sales revenue, number of employees, and industry composition. One–fourth of the respondents are manufacturers and one–fifth are tech firms. The respondents are relatively large; the public firms have an

TABLE 1
SUMMARY STATISTICS

	Public	Private	All Firms
N=	152	176	328
Dividend paid during last 3 years?			
Yes, each quarter	58.6%	21.0%	38.4%
Initiated during last 3 years	9.2%	9.1%	9.1%
Did pay but stopped	2.0%	2.3%	2.2%
No, did not pay	30.3%	67.6%	50.3%
Sales Revenue (Million)			
Mean	4,658	557	2,457
Median	3,000	300	300
Number of employees			
Mean	7,392	1,452	4,205
Median	7,500	300	1,750
Industry			
Manufacturing	21.2%	31.3%	26.6%
Tech	29.8%	14.2%	21.4%
Finance	5.3%	5.1%	5.2%
Other	43.7%	49.4%	46.8%

Notes: This table describes whether the 328 survey respondents pay or have paid dividends during the previous three years. The table also lists size and industry composition. Sales and Employees responses are restricted to discrete categories, leading to a maximum possible value (12,000 employees or $12 billion in sales), which reduces the means and medians relative to continuous numbers.

average of $4.7 billion in sales and an average of 7,400 employees. These numbers are understated, because the answers are categorical and we code the responses as the midpoint of each category. The exception is that the "more than $10 billion" ("more than 10,000") option is assigned sales (employees) of $12 billion (12,000). The private firms are smaller, averaging sales (employees) of $557 million (1,452).

DID THE MAY 2003 DIVIDEND TAX CUT AFFECT DIVIDEND DECISIONS?

The survey contained questions that focus on the effect of the tax cut, and more broadly, ascertain the most important payout factors.

The Incremental Effect of the May 2003 Dividend Tax Cut

We asked the CFOs how much the tax cut affected their decisions to initiate/increase dividends, relative to what their firms would have done in the absence of a tax reduction. We code their answers as zero if they say that there was no effect from the tax reduction, 0.33 if they say there was a small effect, 0.67 if they say a moderate effect, and one if they say that the dividend tax cut greatly affected their dividend decisions. Based on this coding, a mean response of 0.5 would indicate that the effect of the tax cut was somewhere between small and moderate. Table 2 presents the results of this analysis.

Among the public firms that had recently initiated a dividend, the CFOs rated the effect of the tax cut on their decisions as small to moderate, with a mean rating of 0.45. Among firms that had continuously paid a dividend, the tax reduction had only a small effect on their decisions to increase dividends (mean rating of 0.23). For private firms, the tax effect was small across the board (ratings smaller than one–fourth).

Table 2 also presents the data conditional on the importance of individual investors to a given firm. The May 2003 tax cut only reduced tax rates for direct

TABLE 2
INCREMENTAL EFFECT ON DIVIDEND INITIATIONS AND DIVIDENDS PAID OF THE MAY 2003 DIVIDEND TAX CUT

	Public	Private	All Firms
Dividend paid during last 3 years?			
Yes, each quarter	0.23	0.22	0.22
Initiated during last 3 years	0.45	0.21	0.32
No, did not pay	0.04	0.03	0.03
How important are retail investors?			
Not important	0.21	0.07	0.13
Somewhat important	0.17	0.18	0.18
Very important	0.23	0.17	0.20

Notes: This table summarizes 328 responses to the question "Relative to what your firm would have paid out if dividend tax rates had not fallen, how much did the 2003 reduction in dividend tax rates affect your firm's decision to increase/initiate dividend payments?" We code a response of "none" as zero, "a little" as 0.33, "moderately" as 0.67, and "greatly" as one. The table presents means.

individual investors and mutual funds held by individual investors. Therefore, finding that the tax cut mattered more for firms for which individual investors are important would be consistent with a tax effect. For public firms, the evidence on the importance of individual investors is weak. Firms for which individual investors are very important rate the tax cut as 0.23, while the average of all other public firms is about 0.19. The evidence is stronger for private firms. The private firm evidence affects the overall average such that when we consider all firms, the importance of the tax cut increases monotonically with the importance of individual traders. Although this pattern is consistent with individual–investor tax effects mattering, the level of the importance of tax effects is small (i.e., for all subgroups of investors, the average rating is less then 0.25).

Which Factors Most Affect Dividend Policy?

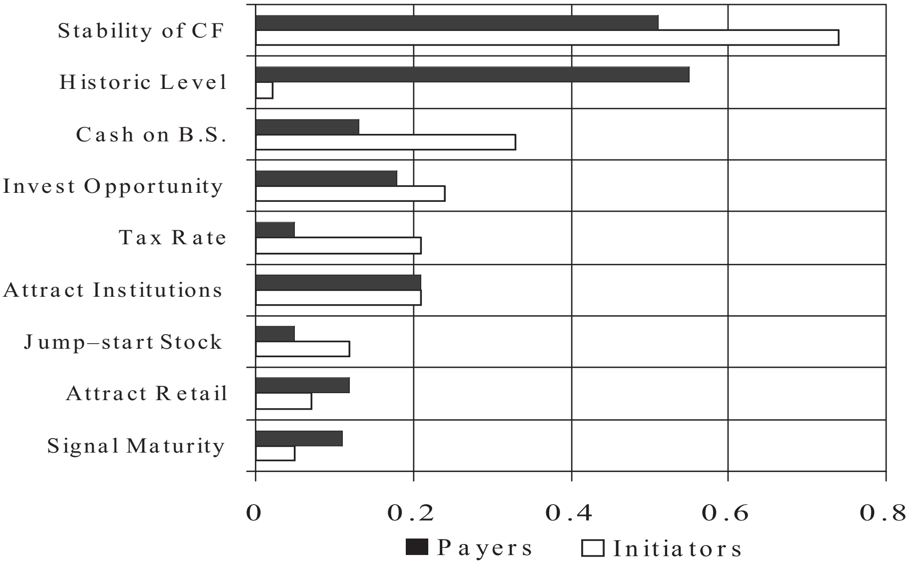
We asked CFOs to rank the three most important factors that affect their dividend decisions. The results from this inquiry helped us to put the importance of the tax cut in perspective, relative to support from survey responses for various explanations of dividend policy. Figure 4 presents the results.

For public firms that were already paying dividends, the most important explanations of dividend decisions were the historic level of the dividend and stability of future cash flow (see "payers" in Figure 4, Panel A). These factors were and are important because of the extreme aversion that executives have to cutting dividends (see Brav, Graham, Harvey, and Michaely (2005)). Several factors take second–order importance with payers, such as attracting institutional investors, lack of profitable investment opportunities, and cash on the balance sheet.

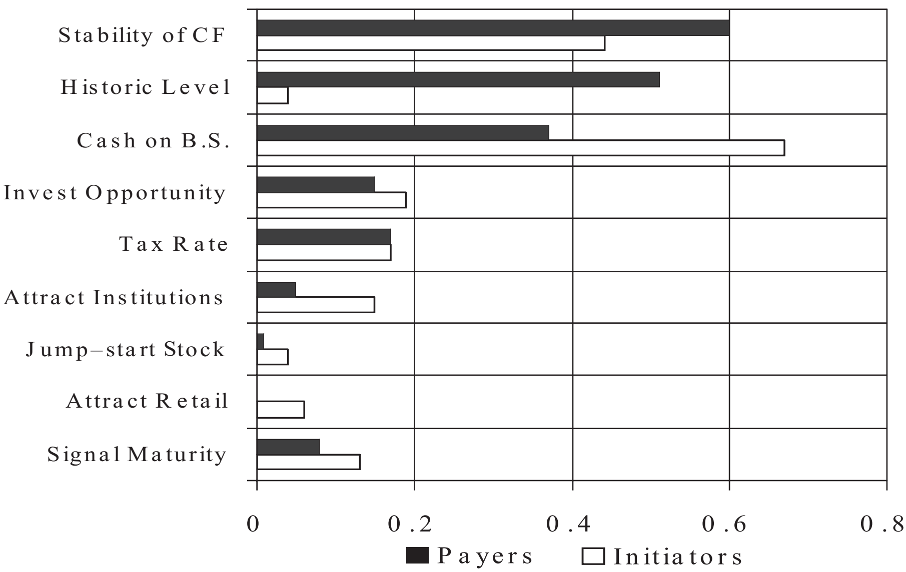
However, the most striking result for our paper is the relative unimportance of dividend tax rates to public firms that already pay dividends (Figure 4, Panel A). On a scale of zero to one, where zero indicates that not a single firm listed the factor as one of the three most important affecting its dividend decisions, dividend taxes rate at 0.05. Among private firms that had paid dividends continuously during the preceding three years, taxes found a little more support (a rating of 0.17 in Panel B). However, even among private firms, tax rates were less important than was the stability of cash flows and cash on hand, and of equal importance with several other factors. We find no evidence that the importance of tax rates as a factor increases with the perceived importance of individual investors among public firms (Figure 5).

Figure 4. Factors that Affect Dividend Policy

Panel A: Public Firms

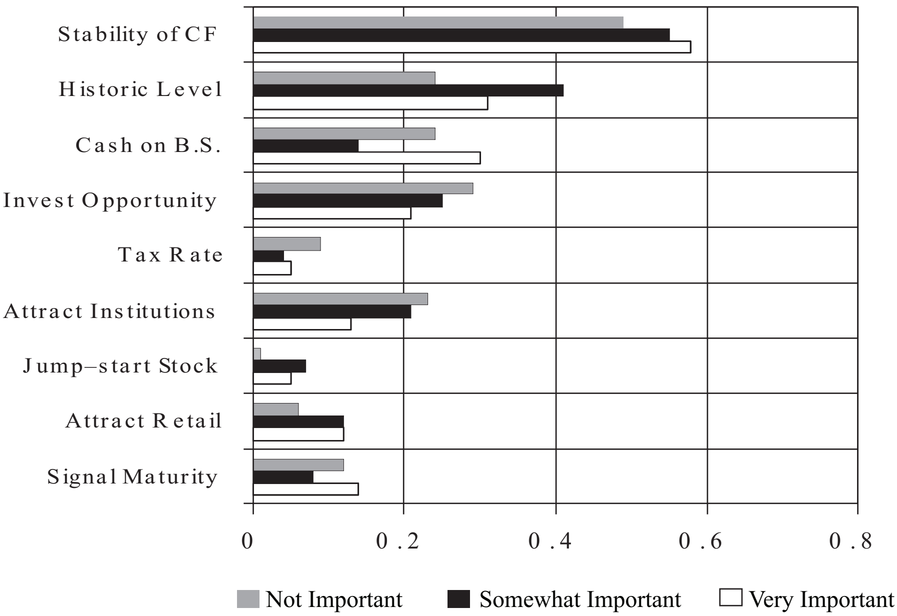


Panel B: Private Firms



Notes: We rate each factor as either the most important factor affecting dividend decisions (in which case it is assigned a 1.0), second most important (0.67), third most important (0.33), or not rated as one of the three most important factors (0). The mean ratings are presented in the figure. Therefore, a mean rating of one indicates that a factor is rated as most important by every respondent, and zero indicates that a factor is not rated by any firm as one of the three most important.

Figure 5. Public Firms, Conditional on Importance of Individual Investors



Notes: This figure represents all public firms. (In contrast, Panel A in Figure 4 represents public firms, but only presents data for initiators and firms that continuously paid a dividend during the previous three years.) We group the means in this figure by whether firms answered the question "How important are individual (i.e., retail) investors to your company's value or stock price?" as "not important," "somewhat important," or "very important." A mean rating of one indicates that a factor is rated as most important by every respondent, and zero, that a factor is not rated as one of the three most important factors by any firm.

Taxes are somewhat more important among public firms that initiated dividends in the previous three years (a rating of 0.21 in Panel A of Figure 4). However, dividends were still of second–order importance relative to other factors. The same was true among private firms (Panel B), where the most important factors were cash on the balance sheet and stability of future cash flows.

Overall, the survey evidence indicates that although executives consider differential taxes when making payout decisions, taxes are not of first–order importance. On average, tax rates do not appear to be an important factor for dividend–increase decisions made by firms that were already paying dividends. Our results are more consistent with taxes affecting firms "sitting on the fence" than they are with dividend tax rates being a first–order consideration in payout policy decisions.

The second–order nature of the tax effects is consistent with an extension of a "new view" perspective in which young, high–growth firms do not pay dividends because they use available funds to pursue investment opportunities, while lower–growth firms with fewer investment opportunities are more likely to pay dividends. To dig deeper into this explanation, we split the sample into small (sales less than $1 billion) and large (sales $1 billion or larger) firms. In untabulated analysis, we find that the dividend tax cut was more important to small firms (vs. large firms) in terms of affecting the decision to initiate dividends. Assuming that small firms have better growth prospects than large firms, this evidence is consistent tax incentives interacting with growth prospects, and nudging small (high–growth) firms into becoming dividend payers sooner. At the same time, we note that the tax cut did not have a differential effect on small (vs. large) firms that already pay dividends, nor on any of the other key factors that affect dividend payout (in Figure 4).

ANALYSIS OF DIVIDEND–INITIATION PRESS RELEASES

To determine the factors that corporations mention when explaining their initial dividends, we gather information contained in dividend initiation press releases. Given the extensive press coverage of the tax cut and the appealing logic of paying more dividends after the applicable tax rate is more than halved, if taxes play a first–order payout role, we would expect companies to mention taxes in their initiation press releases. Moreover, the Brav et al. (2005) payout interviews indicate that executives understand and can easily exposit the tax incentives related to dividends. In general, "returning capital to investors in a tax efficient manner" is an easy story for companies to tell when justifying payout policy (Brav et al., 2005).

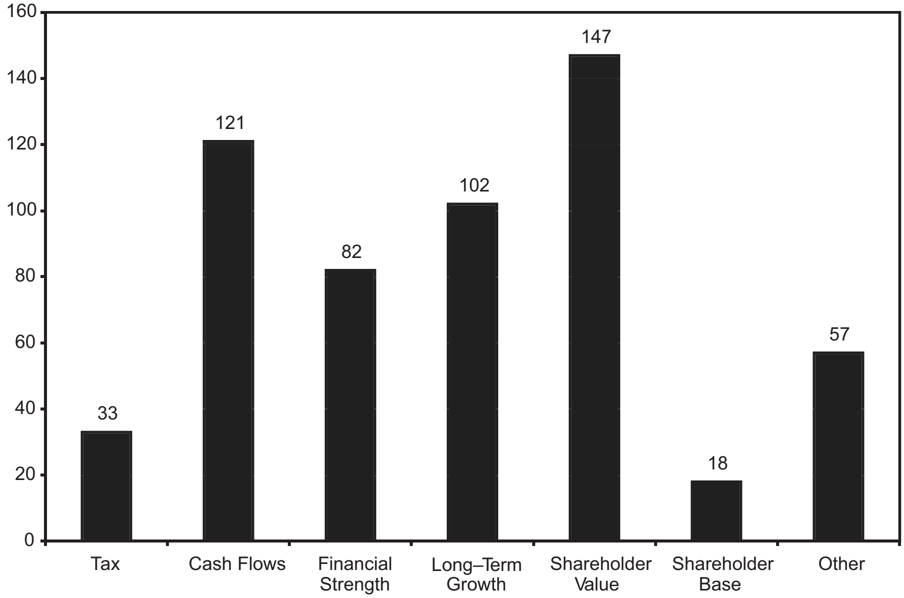
We use CRSP to identify 265 dividend initiations over the period 2002 to 2005, then use LexisNexis to search for words like "dividend" or "initiation" near the CRSP date of initiation. Doing so identifies 243 articles or press releases. (We are unable to locate any press information for the other 22 initiation events.) Of the 243 articles, 193 mention at least one reason for initiating dividends; the other 50 only declare the initiation and do not state any reason. The firms with press coverage have mean (median) sales revenues of \$4,641 million (\$1,255 million); the firms without coverage have mean (median) sales revenues of \$2,484 million (\$693 million).

Among these 193 press releases, only 33 mention the tax cut as an explanation for why their firm began to pay dividends (see Figure 6). Figure 7 shows that almost all of these 33 mentions of taxes occurred in the two quarters after the May 2003 dividend tax cut. Taxes were rarely mentioned as a justification for initiating dividends in 2004 or 2005.[3] This pattern is consistent with the firms that had been on the fence about initiating a dividend deciding to accelerate their first dividend payout once taxes were cut. It is also consistent with taxes being especially important to the small number of firms that initiated dividends in response to the tax cut, but not particularly important to most other firms.

In contrast to the relatively infrequent tax justifications of dividend initiations, several other explanations are often mentioned in the press. Of the 193 press releases that gave some reason justifying initiations, 121 (63 percent) of the announcements mention strong cash flows as a reason that the firm began paying dividends, 102 (53 percent) mention long–term confidence in the firm's prospects, and 82 (42 percent) mention financial strength. Enhancing shareholder value is generically mentioned in 147 (76 percent) of the announcements. Overall, the press release results are consistent with taxes affecting payout decisions, but

[3] One might wonder whether the temporary nature of the tax cut might have led firms to become less inclined as time passed to verbally link dividend increases to tax rates. We do not believe that this would be likely to cause the observed data pattern, however, because through 2005 or 2006 it was generally thought that the dividend tax cuts would be extended or perhaps eventually made permanent. (While they were not made permanent, recall that in 2006 the termination date of the dividend tax reduction was changed from December 31, 2008 to the end of the decade.)

Figure 6. Factors Mentioned in Press Releases to Justify Dividend Initiations



Notes: We obtain information from LexisNexis on dividend initiation press releases to determine the factors that corporations mention as reasons for initiating dividends. We identify 265 dividend initiations in the 16 quarters from 2002 to 2005. Of the 265 initiations, we identify 193 news articles that explain why a given firm decided to begin paying dividends. The graph shows the number of times each major factor is mentioned. More than one factor can be mentioned in any one press release, so the sum of factors mentioned exceeds 193.

not with taxes being first–order in importance relative to other driving factors.

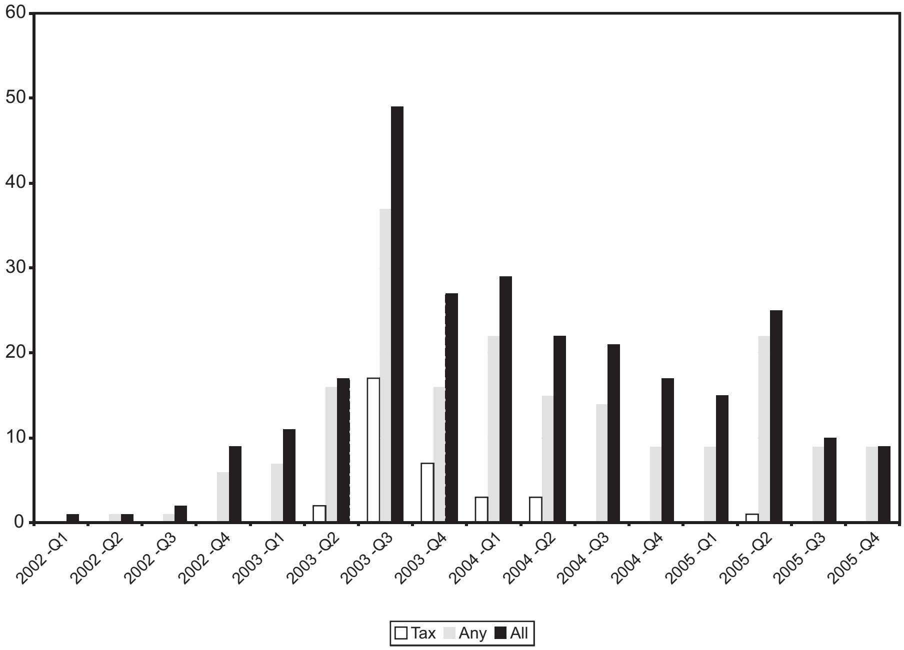
The spike in the mention of taxes in the press releases parallels the spike in dividend initiations (see Figure 1). Both of these trends are consistent with a long–term pattern in dividends caused by non–tax reasons, overlaid with a temporary surge in tax–driven initiations.

The dividend tax cut is due to expire at the end of the decade, which could justify the reduction in tax–linked dividend initiations in recent quarters (if firms are anticipating the eventual increase in dividend tax rates). However, considering all of our evidence (and noting that non–tax reasons are responsible for the increase in dividends prior to May 2003, as well as the level of initiations remaining higher during 2005 than they were during 2001–2002), we conclude that tax factors may have been responsible for a temporary surge in dividend initiations, but that the overall increase in initiations was part of a long–term trend attributable to factors other than dividend taxation. Said differently, to the extent that taxes affect payout, the marginal impact of taxes appears to be conditional on first–order factors, such as market and firm characteristics (profitability, cash on hand, etc.).

INTERPRETING OUR FINDINGS RELATIVE TO THE RELATED LITERATURE

Chetty and Saez (2005) argue that the May 2003 tax cut led to increased dividend initiations, helping to reverse the dramatic reduction in the proportion

Figure 7. Time-Series Pattern of Taxes Being Mentioned in Dividend Initiation Press Releases



Notes: This histogram counts the number of the times press releases mention taxes (leftmost bar in each group of three) or any specific reason including taxes (middle bar in each group) as the reason for initiation. The total number of initiations appears as the rightmost bar in each group of three. In quarters with only two bars, we find no instances in which taxes were mentioned in the press release. We consider initiations that occurred from the first quarter of 2002 through the fourth quarter of 2005.

of public firms paying dividends that were documented in Fama and French (2001). Julio and Ikenberry (2004) agree that the tax reduction contributed to the reappearance of dividend–paying firms. Other recent research shows that the tax cut led to increases in special dividends (Blouin, Raedy, and Shackelford, 2004), as well as to increases in dividend payments among those firms that were already paying dividends (Chetty and Saez, 2005). Moreover, these studies also find that the tax cut affected the firms that it should affect. For example, the tax cut reduced tax rates for individual investor taxable accounts, but reduced them much less, if at all, for accounts or institutions that were already tax–favored. Blouin et al. (2004) find that "dividend boosts were increasing in the percentage of the corporation held by individual investors," and Chetty and Saez (2005) show that dividend changes were smallest in stocks for which the largest investor was an institutional type that was not affected by the tax rate reduction.[4] As another example, stock options are not dividend–protected, leading Weisbenner (2004) and Fenn and Liang (2001) to argue that executives who receive ample stock options are less inclined to increase their

[4] Graham and Kumar (2006) find that low–income (i.e., low tax rate) individual investors hold high–dividend payout stock portfolios.

firms' dividend payments. Brown et al. (2007) and Chetty and Saez (2005) confirm this prediction empirically. Brown et al. also show that dividends increased disproportionately at firms in which executives own the most stock. These papers conclude that the dividend initiations and increases in late 2003 and 2004 were not merely a part of a time–trend of increasing dividends, but instead occurred at different rates at the companies that had the greatest net tax incentive to increase dividends.

In our study, we put this conclusion in perspective. We find that although taxes did affect corporate payout decisions, the effect was second–order. Moreover, the elasticity estimates in Chetty and Saez (2005) and other papers reflect the corporate economic conditions in place around 2003 (e.g., high corporate profits, substantial cash holdings) and document a marginal tax effect. Our results indicate that these non–tax conditions are likely the first–order factors that determine whether a particular firm is even at a margin where taxes would affect its payout decisions.[5]

Our results are also related to a recent paper by Brav, Graham, Harvey, and Michaely (2005). These authors conduct two surveys related to payout policy, and also interview nearly two dozen corporate executives. In their first survey, conducted before the dividend tax cut, Brav et al. find that most CFOs say that tax considerations matter, but are not a dominant factor, in their decisions about whether to pay or increase dividends, and in the choice between paying out as repurchases or dividends. Brav et al. confirm this conclusion in 23 face–to–face interviews with executives. This evidence indicates that in the economic setting before the dividend tax cut, taxes were a second–order concern for corporate executives.

A follow–up survey conducted by Brav et al. (2005) in June 2003, after dividend taxes had been reduced but before most corporate boards had had a chance to meet or act on the tax cut, reinforces the second–order importance of taxation. Although a minority of executives in that survey said that reduced dividend taxation would eventually lead to dividend increases at their firms, more than two–thirds said that the dividend tax reduction would either definitely not or probably not affect their dividend decisions. In terms of initiations, 13 percent of non–dividend payers in that survey said that the tax cut would result in their firm initiating dividends. This response is consistent with a result on our current survey: we find that 9 percent of firms that did not pay dividends in May 2003, but that survived for the two years after, initiated dividends. This response is also consistent with the percentage of June 2003 CRSP non–payers that initiated a dividend in the two years that followed the tax cut.

Our contribution relative to Brav et al. (2005) is threefold. First, rather than asking about conjectured plans as in Brav et al., we ask executives about their recent, actual actions in response to a major cut in the dividend tax rate.[6] We also add two types of analyses beyond the survey analysis in Brav et al. by investigating initiation and aggregate payout patterns and performing a press–release analysis. Triangulating the results across all three of our sources indicates that taxes do matter, but are second–order important.

As an example related to our conclusion, consider Microsoft's dividend initiation.

[5] Thanks to Raj Chetty for suggesting this interpretation. Future research should investigate whether tax elasticities vary with economic and corporate conditions.

[6] We note that the two surveys by Brav et al. (2005) and the current survey are not repeated samplings of the same executives. For example, only seven executives responded to both the June 2003 Brav et al. survey and the survey examined in this paper. Therefore, the moderate response to the dividend tax cut is a widespread view among executives.

Microsoft announced its first–ever dividend on January 16, 2003, just nine days after the administration first announced plans for a tax reduction. It seems to us unlikely that Microsoft decided to begin paying dividends just because of the announced plan to cut dividend tax rates (before the tax cut was even signed into law). Most likely a reduction in Microsoft's investment opportunities, in conjunction with investor pressure on the company to disgorge some of its tens of billions of dollars of accumulated cash, led Microsoft to plan an initiation even in the absence of reduced dividend taxes. At the margin, the tax cut may have solidified Microsoft's dividend initiation plans, and perhaps sped up their public announcement, but it seems unlikely that the tax cut was the primary impetus behind the initiation.

CONCLUSION

Given an equilibrium in which some firms pay dividends, an exogenous reduction in the cost of dividends, such as halving the dividend tax rate, makes dividends more attractive. Therefore, at the margin, the May 2003 dividend tax cut should have led to additional dividends being paid. Several papers document such tax effects. Our goal in this paper is to determine whether the dividend tax cut affected the payout equilibrium in a first–order manner or whether its effects were marginal, primarily affecting firms that were on the fence about initiating or increasing dividends.

By asking managers about the motives underlying their firms' payout policies, we provide a unique perspective on corporate payout decisions made in response to the May 2003 reduction in dividend tax rates. We find evidence that the tax cut did increase the propensity to initiate dividends. However, we do not find that aggregate dividends increased relative to repurchases.

The main contribution of our paper is to help gauge the relative importance of dividend tax rates on dividend decisions. We find that the tax rate reduction increased the likelihood of dividend initiation, but the effect was only second–order important. We also find that the tax cut had a smaller effect on increases in payout by long–time dividend payers. We corroborate these results by showing that firms only occasionally mention the dividend tax rate when publicly explaining why they initiate dividends. Combining these results with the observation that aggregate repurchases have increased more than dividends since the May 2003 tax cut, we conclude that taxes are second–order important in dividend decisions.

These results may have important policy implications because the reduction in dividend taxes is scheduled to expire late this decade. Our results suggest that the proportion of earnings paid out as dividends will not dramatically decrease if at the end of the decade dividend tax rates return to historic levels. Because individual investors are not perceived to be particularly important investors in stocks, we would not expect corporations to respond dramatically to an increase in the relative tax rates of individual investors. At the same time, if it becomes evident that tax rates will increase, we would not be surprised if a modest number of firms pay a one–time special dividend just before the increase in dividend tax rates.

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