BY ROBERT J. BARRO

# How Tax Reform Drives Growth and Investment

Not since 1986, during President Ronald Reagan's second term, has the atmosphere in Washington been so promising for basic income-tax reform. Proposals are likely to include making permanent the tax changes of 2001 and 2003, flattening the tax-rate structure, and moving toward taxing consumption rather than income. The 2003 law gave a taste of what is to come by advancing the effective date for the 2001 marginal tax-rate cuts and by reducing rates on dividends and capital gains. The 2003 tax cuts enhanced incentives for work effort, saving, and investment. So I think it is no accident that the U.S. has enjoyed rapid growth rates in gross domestic product, investment, and productivity since early 2003. Employment also grew, albeit with a lag.

Because the sharp cut in dividend taxation was a centerpiece of the 2003 law, it is particularly interesting to see how companies' dividend policies changed. The anecdotal evidence suggests a strong positive response, highlighted by Microsoft Corp.'s initiation of a regular dividend in 2003. Other large companies that started regular dividends in 2003-04 include Analog Devices, Best Buy, Clear Channel Communications, Costco, Guidant, Qualcomm, and Viacom.

**A BROADER PICTURE COMES FROM** the recent National Bureau of Economic Research working paper, "Dividend Taxes and Corporate Behavior: Evidence from the 2003 Dividend Tax Cut," by Raj Chetty and Emmanuel Saez, economics professors at the University of California at Berkeley. The Chetty-Saez study analyzes dividends paid by the universe of publicly listed corporations from the first quarter 1982 through the second quarter 2004. The sample, designed for statistical reasons to include the same number of companies in each period, comprises roughly the 4,000 largest companies by market capitalization in each quarter.

The study documents a surge in initiations of dividends after the dividend tax cut was proposed in January, 2003, and enacted in May, 2003. The percentage of companies in the sample that paid dividends increased from 20% in fourth quarter 2002 to 25% in second quarter 2004. This increased propensity to pay dividends reversed a long-term decline.

The 2003 reform was also followed by increases in payouts by dividend-paying companies. In the Chetty-Saez sample, the number of companies that raised regular dividends by at least 20% rose from 19 per quarter in the period before the tax reform was implemented to 50 in the postreform period. Another response was a surge in special, one-time dividends. This number rose from 7 per quarter pre-reform to 18 post-reform. The most celebrated special dividend was Microsoft's payout of $32 billion, announced in July, 2004.

The post-reform increases in dividends—new dividends, larger dividends, and special dividends—still apply when Chetty and Saez control for profits, assets, market capitalization, and cash holdings. In other words, the tax reform made companies more likely to pay a dividend and to pay a larger dividend.

In addition, dividend initiations did not increase among companies for which the largest institutional investor was a pension fund or other entity not affected by the tax change. Neither did dividend initiations rise for Canadian companies, which are not affected by U.S. tax changes.

> **The dividend tax cut worked well. Companies boosted payouts**

The study also revealed the relationship between the concentration of company ownership and the propensity to pay dividends. After the reforms, dividend initiations were more likely if share ownership was heavily concentrated among executives or taxable institutions. The desire of these players to have larger dividends when the tax rate falls is particularly likely to be translated into corporate dividend policy.

There's also evidence that the tax cut particularly heightened the propensity to pay dividends among companies with low forecasted earnings growth. So tax reform may have efficiently taken cash out of companies with below-average prospective returns on investment.

The dividend study shows that tax policy can have substantial and rapid effects on economic behavior. The data highlight the importance of the current deliberations on tax reform. The Bush Administration should seize the moment and deliver a tax system that promotes economic growth. ■

**Robert J. Barro** *is a professor of economics at Harvard University and a senior fellow of the Hoover Institution (rjbweek@harvard.edu)*

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