CUTTING THE DIVIDENDS TAX...AND CORPORATE GOVERNANCE TOO?*

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Abstract

Economists tend to agree that the recent cutting of US dividends taxes will encourage investment and reduce financial distress. In addition to creating these "benefits," however, the tax cut can also increase governance costs. For example, by removing a bias for leveraged capital structures, the tax cut foregoes debt's superiority on at least three dimensions: Evaluating and monitoring demanders of financial capital; Constraining managerial agents' from opportunistically employing capital market proceeds; and Encouraging non-financial stakeholders (e.g., employees, suppliers) to make firm-specific investments.

Keywords: Dividends Tax, Corporate Governance

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1. Introduction

Economists tend to agree that the US's recent cutting of dividends taxes maintains considerable expansionary potential. By treating dividends as taxable distributions and interest payments as deductible expenses, the pre-cut code biased capital structures towards debt. This bias arguably reduced the economy's productive capacity by distorting investment decisions and increasing financial distress costs. Federal Reserve Board chair Alan Greenspan thus "spoke warmly" in congressional testimony "about the benefits of eliminating the double taxation of dividends" (The Economist 2003).[1] But these benefits may be offset (at least partially) by an increase in associated governance costs.[2] Our objective for the present article is to highlight several channels through which cutting the dividends tax can create unintended consequences in this regard.[3] One such channel concerns the relatively rich set of information that emerges from debt-holders' relationship with financial capital demanders. Holders of privately placed debt (e.g., banks) can face a lesser free-rider problem than do those of publicly placed equity when attempting to produce evaluation and monitoring services. By removing a bias toward debt-heavy capital structures, the dividends tax cut can thus exacerbate information asymmetries between suppliers and demanders of loanable funds, thereby foreclosing at the margin otherwise mutually beneficial capital market trades. Information asymmetries may grow even further if, in the face of a tax cut, dividends distributions do not fully offset associated interest payment reductions. Debt contracts create a relatively strong incentive for managers to disburse "free cash flows," and can thus check even loosely monitored managers' capacity to employ residual earnings in a manner that opposes shareholders' interests. Finally, cutting the dividends tax can magnify the potential for owners to play morally hazardous actions. By expanding the capacity for residual claimants to expropriate returns from "firm-specific" investments,[4] removing a policy-bias for debt finance can discourage non-equity stakeholders (e.g., employees, suppliers) from optimally employing their efforts. Relative to equity claim holders, debt holders pose little threat here since their contracts essentially cap the residual earnings

[1] Debate over whether to cut dividends taxes took place largely on efficiency versus equity dimensions.

[2] Throughout our note, we employ the term "governance" in reference to institutions that help "overcome the incentive problems between an entrepreneur or manager and outside financiers" (Vives 2000, p. 4).

[3] Morck (2003) investigates how cutting the tax on *intercorporate* dividends can exacerbate governance costs. We depart from Morck by investigating how tax treatments of *individual* dividends can influence governance.

[4] Those whose productivity is especially sensitive to the environment in which they are undertaken.

that can feasibly be extracted from firms. In other words, debt holders' potential to opportunistically expropriate the product of firm specific investments may be smaller than that of associated equity holders. By removing the bias for firms to finance projects via debt obligations, and thus increasing (non-owner) stakeholders' exposure to opportunistic expropriation, cutting the dividends tax can again discourage productive economic activity. Debates over how the dividends tax cut might affect such activity tend to focus on the technical merits of removing capital structure distortions. In doing so, however, they ignore how these same distortions can influence the economy's stock of governance services. Ultimately, this ignorance may prove innocuous. Indeed, benefits from reduced distortions and financial distress may very well overwhelm any associated governance costs. If they do not, however, then the cut's welfare consequences may rest on how strongly private governance production responds. Here, we recognize the incentive for firms to substitute for governance services that were produced via biased capital structures. We are less impressed, however, about this incentive's magnitude. First, to the extent that firm-level governance influences others' financial market credibility (a public good),[5] decentralized forces will not push firms to replace governance services that are lost to less-leveraged capital structures. Second, private organizational mechanisms may be relatively high cost producers of substitute governance services. This potential appears especially important in the short run where, in the tax cut's immediate wake, firms must learn to produce substitutes via extra-capital structure factors.

We develop these arguments more carefully in our article's remainder. We begin in the following section by summarizing the distortion-reducing merits of a dividends tax cut – i.e., its capacity to increase investment and reduce financial distress. We then argue in Section 3 that a potentially important cost of creating these benefits is foregoing the relatively low level of moral hazard that debt-heavy capital structures can achieve. In Section 4, we address a "governance-counterargument" – namely, that the cut encourages firms to signal financial integrity by pursuing a more informative dividend policy. Here, we draw on a "money burning" argument from the literature to highlight how cutting the dividends tax might instead exacerbate adverse selection problems in this regard. Finally, we conclude in Section 5 by suggesting that, even holding distributional concerns aside, cutting the dividends tax may not be the dominant strategy that many economists understand it to be.[6]

[5] In light of *market* reactions to recent governance scandals (e.g., those associated with Enron, WorldCom, Tyco), this influence appears considerable.

[6] This conclusion does *not* imply that such tax cuts cannot create net benefits.

2. Dividends Taxes, Investment, and Financial Distress

Economists identify at least two channels through which taxing dividends can dampen productive activity: dividends taxes (i) weigh on investment and (ii) increase exposure to financial distress. Viewed in this light, cutting the dividends tax appears attractive. First, taxing residual earnings when firms report them as operating profits and distribute them as dividends makes equity a relatively costly mechanism for funding investment. This cost "artificially" reduces an economy's supply of loanable funds and thus increases equilibrium interest rates. Confronted with this increase, firms will optimally forego otherwise profitable projects.[7]

Second, by raising the relative cost of equity finance, dividends taxes encourage firms to bias their capital structures toward debt. And since default-risk increases with leverage, distorted reliance on debt financing can magnify the effects of economic shocks. To see this implication, notice that debt securities are "fixed price contracts" in that their promise of remuneration is independent of firm performance. But fixed price contracts entail relatively high renegotiation costs and are thus inferior to their cost-plus counterparts (e.g., equity contracts) in uncertain environments (Bajari, 2001).

3. Dividends Taxes can Reduce Moral Hazard

In this light, cutting the dividends tax might look like a dominant strategy. However, by removing a bias towards debt-heavy capital structures, this policy change can also reduce an economy's equilibrium level of governance services. And rather than being marginal, these forgone services may be considerable. After all, if the pre-cut tax code created only distortionary costs (e.g., those outlined in our Section 2), then why are US firms competitive against those who do not face such costs?[8]

Debt finance facilitates monitoring

One benefit from biasing the tax code for debt capital comes from encouraging firms to accept relatively high levels of monitored finance. Capital suppliers face an important free-rider problem when attempting to produce evaluation and monitoring services. Banks and other private lenders, however, face a relatively small problem in this regard because they largely internalize the benefits that their governance services produce (e.g., James 1987, Lummer, McConnell 1989). Suppliers of equity

[7] Moreover, dividends taxes can distort intertemporal and intersectoral capital allocations (Poterba, Summers 1984).

[8] Fama (1985) similarly motivates his search for bank loans' non-obvious benefits. In short, he argues that these benefits *must* exist since banks are competitive despite their regulation-inflated cost structure.

capital do not enjoy this comparative advantage. In spite of its distortionary costs, then, a tax code's bias toward debt financing can benefit an economy by encouraging private capital structures to mitigate public information asymmetries. The extent to which cutting the dividends tax diminishes governance through this channel depends, however, on whether it pushes equity financing to substitute for monitored (i.e., privately placed) or publicly placed debt (e.g., see Diamond 1991). If equity financing largely displaces public debt (for which it is a closer substitute), then cutting the dividends tax is unlikely to create a significant change in how firms' capital structures produce governance services. However, monitored debt constitutes an overwhelming share of even large firms' external funds (Houston and James 2001, Mayer 1990). In other words, even for firms where monitored debt's demand is relatively low, little or no replaceable public debt may actually exist. Here, "governance-poor" equity securities exhibit at least a marginal capacity to replace "governance-rich" private debt.

Debt finance limits discretion over cash flows

The dividends tax cut can also maintain more impervious channels through which to exacerbate governance difficulties. These difficulties may grow, for example, if increased dividend distributions do not offset reduced interest payments. Debt contracts force managers to disburse "free cash flows," and thereby check even loosely monitored managers' capacity to engage in self-indulgent behavior (Jensen 1986).[9] After all, managers must have resources available with which to fund morally hazardous actions. Dividend distributions, on the other hand, are more discretionary, and thus place a weaker constraint on manager-agents in this regard. If firm-level governance influences others' financial market credibility, then the tax cut can thus exhibit a more immediate potential to weaken corporate governance. This potential is especially interesting in light of the governance-benefits that some see in cutting the dividends tax. Proponents argue that the cut will limit public access to "free cash flows" and thus mitigate the agency problem between electoral constituencies and their political representatives. But the same type of principal-agent problem that makes constituency-representative relationships costly also makes shareholder-manager relationships costly. Hence, while potentially mitigating agency costs that emerge from constituency-representative relationships, cutting the dividends tax could increase agency costs by expanding managerial discretion over shareholder resources.

Debt finance can encourage firm-specific investment

Finally, the dividends tax cut might reduce non-financial stakeholders' (e.g., employees, suppliers) incentive to make "specific investments." Specific investments confer disproportionate benefits onto the firm in which they are made – i.e., they are difficult to market externally. Once stakeholders sink resources into such investments, then, residual claimants (e.g., financiers) are tempted to expropriate associated returns.[10] Here, again, the dividends tax cut can exacerbate governance problems – this time by increasing productive investments' exposure to the prospect of opportunistic expropriation. To see this temptation more clearly, consider the case of equity shareholders accepting a hostile takeover bid. Contributors to both the academic and popular presses frequently interpret associated increases in target share prices as evidence that takeovers expand firms' production possibilities. Shleifer and Summers (1989) recognize, however, that the tendency for target share prices to increase with hostile bids may also reflect the capacity for takeover to redistribute (rather than increase) a firm's product. The post takeover firm may, for example, enjoy an expanded capacity to adjust wage contracts and thus redistribute residual earnings from employees to owners. This feature of equity financing can retard efficiency since, confronted with the prospect of opportunistic redistributions, employees, suppliers, and other non-capital stakeholders have relatively little incentive to make otherwise optimal firm-specific investments.[11] Debt capital, on the other hand, can shelter stakeholders from this exposure in a manner analogous to Burkart et al. (1997). By limiting themselves to fixed payments from residual earnings, debt holders pose relatively little threat to expropriating proceeds that are necessary for motivating specific investments.

4. Can Dividends Taxes Increase Asymmetric Information?

In each of these cases, cutting the dividends tax appears capable of diminishing private incentives to produce governance services. The cut's stronger proponents argue, however, that removing tax distortions can reduce information asymmetries that might otherwise keep loanable funds from finding their highest productivity application. In short, they argue that the tax cut's push for equity-financing strengthens governance by heightening firms' incentives to signal financial health via their

[9] Jensen suggests that debt can serve as an efficiency-enhancing commitment device. Committing free cash flows may be especially valuable in mature industries where investment opportunities can be sparse.

[10] Williamson (1985) highlights the importance of structuring governance mechanisms with an eye toward the gains from employing "specific" assets.

[11] That such an exposure can considerably retard firms' productivity is well documented (e.g., Miller 1991).

dividend policy. This argument ignores, however, a necessary condition for signals to be informative – i.e., the tax cut must increase the difference in costs that "good" and "bad" firms incur from distributing residual earnings as dividends. But, rather than exhibiting this type of asymmetry, the tax cut reduces distribution costs for all types of firms.

Moreover, cutting the dividends tax can arguably increase the cost that firms face when attempting to inform capital markets about their financial integrity. For example, suppose that paying dividends looks more like "money burning" when such distributions are taxed twice. Then, if the cost of distress financing does not vary with a firm's type, information that emerges from dividend distributions increases with the rate of double-taxation. This result obtains because common knowledge of a dividends tax reduces the potential for market participants to interpret associated payments as anything but a signal of quality (Bernheim and Redding 2001).

5. Conclusion

While the dividends tax cut's technical benefits are widely appreciated, its potential governance costs remain largely ignored. This ignorance is important since cutting the dividends tax can work against private capital structures producing governance services, and firms are unlikely to respond either fully or quickly to this negative force. First, if privately produced governance contributes to broader market integrity, then policies that bias capital structures toward producing governance services can facilitate superior levels of social welfare. Indeed, absent such a bias, firms face a reduced incentive to produce governance services at levels that exceed those that are privately optimal. Second, to the extent that firms substitute for foregone features of governance-rich capital structures, they are likely to do so slowly. An unbiased capital structure represents a new technology with which to produce governance services, and firms will recognize adjustment costs while learning to employ this alternative mechanism. Governance costs associated with the tax cut may thus be especially important in the short run. In either case, productivity changes associated with the tax cut can be less positive than those that are popularly reported.

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