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**COMMENTARY**

The Dividend Deficit

By **JEREMY J. SIEGEL**

The Enron scandal has brought hollers for practically every reform imaginable. Yes, we need separation between auditors and consultants. Yes, the Financial Accounting Standards Board must be freed from political pressure so it can standardize the way firms report earnings and off-balance-sheet transactions. And yes, anyone engaged in criminal concealment or other illegal activities must be prosecuted. But all of the discussions about Enron have so far ignored one significant culprit underlying these disturbing events: the U.S. tax system.

History provides us with important lessons about the sources of shareholder value. In the 19th century there was no Securities and Exchange Commission, FASB, or any of the other numerous agencies that oversee our securities markets today. A firm released whatever information it liked whenever it wanted and management didn't fret it would be taken to task for reporting a dubious number.

**The Old-Fashioned Way**

Given the total lack of standards back then, how did a firm signal that its earnings were real? The old-fashioned way, by paying dividends, an action that gave tangible evidence of the firm's profitability and proof that the firms' earnings were authentic. Dividends are crucial for pricing a firm since finance theory states emphatically that the price of a stock is not the discounted value of future earnings, but the discounted value of future dividends and other cash distributions. Earnings are only a means to an end, and that end is to maximize the future cash returns received by investors.

But the dividend yield, and thus the concrete evidence of real earnings, has declined dramatically in recent years. In the 19th century and first half of the 20th century the average dividend yield on stocks was 5.8%. It was not until 1958 that the dividend yield on stocks fell below the interest rate on long-term government bonds and even through the 1980s the dividend yield averaged 4.3%. But during the great bull market of the 1990s, dividends fell out of favor. The dividend yield sunk to 1.2% at the market peak in March 2000 and has subsequently risen to only 1.6%.

What contributed to this sharp fall in the dividend yield? Certainly faster economic growth in the 1990s has created more opportunities for firms to invest their earnings profitably. But our tax system has played a crucial role. Since realized capital gains are now taxed at a maximum 20% (half the top rate on dividends), shareholders prefer that companies use earnings to lift the price of their shares rather than pay taxes on dividends.

Employees who have been lavished with stock options also pressure firms to pursue capital-gains instead of paying dividends. Our tax system has also encouraged this practice. Under current accounting rules that FASB unsuccessfully sought to change in the face of congressional opposition, firms underreport the cost of such options, thus overstating their earnings. The tax benefits for the corporation issuing these options and for the employees receiving them can be very big.

The problems caused by the tax system do not end with the differential tax treatment between capital gains and dividends. Our tax rules also encourage debt financing, a major trouble spot for Enron, Tyco and other firms caught in the web of investor doubt.

Our tax laws allow firms to fully deduct interest costs, but dividends are not granted the same treatment. In effect, dividends face double taxation -- earnings are first taxed at the corporate level and then dividends paid from these earnings are taxed at the individual level. Firms would like to maximize tax deductions with interest costs, but investors and rating agencies do not look favorably upon companies with highly leveraged balanced sheets.

Enron's incentive to manipulate its balance sheet was brought to light by this newspaper on Feb. 4, in an article that showed how Enron employed a security devised by Goldman Sachs that, depending on who is looking, can be treated as either debt or equity. These securities, called Monthly Income Preferred Shares, tried to incorporate the best of both debt and equity. When Enron reported to the IRS, MIPS would be referred to as debt and Enron could deduct an interest expense. But for rating agencies and shareholders, MIPS were referred to as equity.

Is it surprising that Enron pioneered the use of these securities? Hardly. We now know that Enron went to some lengths to hide its debt from shareholders. Yet the use of MIPS was perfectly legal. In late 1995 the Treasury, which considered Enron's use of the securities an abusive accounting practice, tried to crack down. But after a three-year battle in the courts, an army of lobbyists forced the Treasury to admit defeat. Despite the department's persistence, almost \$200 billion of these MIPS, whose existence is solely to circumvent the unequal deductibility of interest and dividends, are currently outstanding.

The punitive taxation of dividends is not a policy pursued by most industrial economies. In a recent study by the American Council for Capital Formation, 62.5% of all countries provided complete or partial offsets to the double taxation of dividends on the corporate level. An additional 25% of those countries gave shareholders some break on dividend taxation. The U.S. itself used to give exemptions for dividend income. In 1954 there was a \$100 exemption per couple, which doubled to \$200 in 1964 and doubled again to \$400 in 1980 (almost \$1,000 in today's prices). The 1986 Tax Reform Act repealed this exemption, and it hasn't been restored.

Certainly there are some firms that are better off not paying dividends so that they can use their earnings to fund growth. But these firms must convince shareholders that their balance sheets and income statements are whistle-clean and that their retained earnings are being reinvested profitably.

Of course, Warren Buffett's Berkshire Hathaway has never paid a dividend and claims it never will. But Mr. Buffett is the exception to most rules and no other CEO reports all his firm's decisions and finances directly to shareholders in annual reports whose clarity and honesty have made them classics of financial reporting.

Throughout the 1990s, few investors questioned management's dubious accounting practices and unrealistic forecasts of earnings growth. But post-Enron, the market has become justifiably skeptical. If a firm as widely praised as General Electric can fall under suspicion, few can afford to ignore investors' cries for honest and straightforward accounting.

### **No Excuses**

Nothing could possibly excuse Enron, Arthur Andersen, or any other firms of deceptive and fraudulent practices. But cries for accounting reform, transparent earnings reports, and auditor independence will not amount to anything if our tax system encourages firms to do just the opposite. Why should we rail against accountants who do not provide investors with a clear view of their clients' earnings and balance sheets when many are also getting paid as consultants to minimize their clients' taxes and exploit loopholes in our Byzantine tax laws?