-----BEGIN PGP SIGNED MESSAGE-----
Hash: SHA1

20 March 2003

Via Electronic Delivery

Henry M. Paulson, Jr.
Chairman and Cief Executive Officer
Goldman Sachs Group
c/o Linda.rabadi@gs.com

Mr. Paulson:

I enjoyed your recent commentary on the Administration's dividend plan. Eliminating the tax inefficiency of dividend payments will, as you note, remove one of the great inequities and structural biases in our current tax code. But, I have some criticisms of the President's plan and I also believe that the benefits of dividend tax reform are not fully appreciated.

Criticisms of the Administration's Proposal

As you correctly note, dividends are a cost of equity capital [1] and should be treated for tax purposes in the same way as interest, the cost of debt capital [2]. To accomplish equal treatment, both should be deductible from earnings before tax (EBT). The President's plan that would not allow deduction of dividends at the enterprise level, but would exclude dividends received from individual taxable income is flawed for several reasons.

- First, disallowing dividend deduction at the enterprise level will do nothing to discourage the misallocation of capital caused by over-weighting of debt in corporate capital structures [3].

- Second, and more importantly, it will continue the misallocation of equity capital by encouraging firms to retain cash earnings that should be returned to the shareholders [4].

[1] The current rules disfavoring dividends artificially increase the cost of equity capital. Precluded from demanding current payment of free cash flow as dividends, the rational investor seeks a level of share price appreciation that provides compensation for the dividends that are not paid as well as for the risks that the resulting retained earnings will not be profitably invested by the corporation, or that the share price will not appreciate due to general market conditions. The firm's cost of equity capital is, therefore, burdened with a "market risk" premium making the cost of equity capital higher than it would otherwise be.

[2] An artificially high cost of equity capital (see footnote 1) not only causes firms to overweight debt in their capital structures and to overpay for that debt capital, it also supports a higher cost of debt capital than would otherwise be the case. While this may not be a problem in the current interest rate environment, it might act as a constraint on growth and profitability as interest rates rise.

[3] In other words, firms would continue to prefer debt, where the cost – interest – is deductible from EBT over equity, where the cost – dividends – is not. Interest expense would reduce taxes, while dividends would have no effect on tax liability.

[4] Having paid the corporate income tax on profits, corporations will be disinclined to dividend out those profits, because doing so will not favorably affect the financial performance of the firm, however measured. Management, if not the shareholders, will be better off by retaining earnings and measuring rates of taxation over a larger base.

Incentives to artificially encourage retained earnings, such as those contained in the President's proposal, are economically inefficient and unnecessary. [5]

- Third, it is unfair to lower-income investors, because the lower-income investor is effectively paying tax on dividends at the corporate rate, which is likely to be materially higher than his or her marginal individual rate. Meanwhile, the higher-income taxpayer receives a small benefit, because the highest marginal corporate rate is slightly lower than the highest individual marginal rate.

- Finally, to some extent, excluding dividend payments from individual taxable income will cause dividend-paying stocks to compete with other tax-advantaged investments available to individuals, such as municipal bonds [6] (although this effect will be mitigated because, as discussed below, dividend payments based on ROE and free cash flow metrics are likely to be variable). [7]

Benefits of Dividend Tax Reform

The benefits of dividend tax reform are misunderstood by a static view of the role of dividends in corporate tax structures. Under the current system, dividends are paid by companies with relatively stable free cash flows and some constraints on growth (usually operating in industries with some oligopolistic characteristics). Utilities and oils are prime examples. If the rules disfavoring equity that pays dividends are eliminated, this should change drastically.

The rational investor purchases shares assuming that the firm will yield a higher risk-adjusted return on equity (ROE) than can be obtained by alternative investments. So long as the firm's risk-adjusted ROE meets or exceeds this threshold, the rational investor will cause the firm to retain earnings and not pay dividends, as by definition the firm is making best use of the investor's capital. [8] If, on the other hand, the firm does not meet the appropriate ROE hurdle, rational investors will – in the absence of tax inefficiency –

---

[5] Thus, it seems to me that it is unnecessary for government to adopt complex rules defining which dividends qualify for favorable tax treatment. Just as corporations cannot pay dividends, at least not over any period of time, in the absence of free cash flow, it is difficult to see how a corporation can generate free cash flow without at the same time generating taxable earnings. Again, this is an issue that has to be modeled, but I suspect that the potential for abuse is probably de minimis. Remember that stakeholders – particularly lenders – will have appropriate incentives to prohibit dividend payments in the absence of free cash flow.

[6] Contrast a system where both dividends and interest on certain fixed income investments are both not includible in the recipient's taxable income with a system in which dividends are includible in taxable income and interest on certain fixed income investments is not.

[7] Robert Willens at Lehman Brothers suggested in correspondence to me that taxing dividend income to the recipient might be problematic for tax-exempt enterprises holding dividend-paying investments, and to some extent he is correct. But, rather than imposing the burden of determining the tax status of shareholders on the corporation, I suggested that rules governing tax-exempt enterprises could be adopted that would either require them to pay tax on dividend income at a specified rate, or hold investments paying dividends in taxable affiliates (as they are required to do now in other circumstances).

I believe that the "problem" of individuals receiving dividends in 401(K) and other tax-deferred accounts is a red herring; because these accounts are tax-deferred, not tax free. While models to evaluate the problem will have to be run, I suspect that individual tax liability for dividends received in a tax-deferred account will not be significantly lower – and may in fact be higher – than for dividends received directly. This is because tax-deferred accounts require withdrawals at specified rates and specified ages, and for many investors the assumption that their marginal rates of taxation in retirement will be lower than during their working years turns out to be false.

[8] Government tax policy does not have to – and should not – provide incentives for retained earnings such as are contained in the Administration's dividend tax proposal (adjustment of basis in amounts that could have been paid as dividends). Such incentives are an unnecessary subsidy for retained earnings.

want a dividend return of free cash flow that is as great as possible. [9] You make this point, but its significance is understated.

To date, because of the tax inefficiency, dividends have not been a significant component of investor return. Investors have, instead, relied on share price appreciation based on multiples of GAAP earnings. Consequently, firms have focused on maximizing GAAP earnings, not free cash flow or ROE.

Notice, however, that this will change if the tax treatment of dividends is normalized. Investors will focus financial performance measures primarily on ROE and free cash flow - ROE because it the measure that a rational investor will use to compare alternative investments and to determine whether a particular enterprise is performing acceptably, and free cash flow because dividends have to be paid in cash, and no company – no matter how profitable on a GAAP earnings basis – can consistently pay dividends in the absence of free cash flow (although some companies may, from time to time, borrow to pay dividends to adjust their weighted average cost of capital). [10]

Removing the tax disincentives to dividend payments will cause investors to demand return of capital from free cash flow, at least in those cases where the enterprise is not achieving an adequate risk-adjusted ROE and management has no other compelling basis to retain earnings. This means that dividend payments for many companies will increase dramatically and will fluctuate from quarter to quarter with free cash flow and ROE. This fluctuation should limit the extent to which dividends on equity will compete with tax-advantaged fixed income investments such as municipal bonds.

---

[9] I have thought about how the markets might set both ROE thresholds and the amount of free cash flow that can be returned as dividends where ROE is inadequate. Since the precision and accuracy of most financial performance data are limited, these measures are likely to be fairly crude.

An appropriate ROE threshold, for example, can be estimated by multiplying the short-term, risk-free rate by the beta of the share price. And, the ratio of the current ratio to share price beta suggests the percentage of free cash flow that can be appropriately paid as dividends. [This percentage, of course, cannot be more than 100%.]

These formulas suggest how the markets might set ROE thresholds and determine the appropriate amount to be paid as dividends. The actual determinations would be left to individual firms and their stakeholders (I suspect, for example, that lenders will establish limits on dividend payments in loan covenants.) There is no need for government to adopt regulations, or for the accounting profession to establish rules, on these issues.

In both formulas, share price beta is a crude surrogate for business risk. It serves a second role in connection with determining the appropriate ROE threshold by adjusting the ROE to account for risk to the underlying share price. The use of current ratio in determining the percentage of free cash flow to be paid as dividends addresses liquidity concerns and counters any incentive the firm might have to use debt to achieve a higher ROE. Investors and stakeholders (particularly lenders) will watch carefully to make sure that companies are not meeting ROE hurdles by taking on debt.

[10] I have thought about how the markets might set both ROE thresholds and determine the amount of free cash flow that can be returned as dividends where those thresholds are not met. Since the precision and accuracy of financial data for most firms is fairly limited, these measures are likely to be fairly crude. An appropriate ROE threshold, for example, can be estimated by multiplying the short-term, risk-free rate by the beta of the share price, and the percentage of free cash flow that can be returned as dividends can be estimated by the ratio of the current ratio to share price beta (but, of course, not more than 100%).

In both formulas, share price beta is a crude surrogate for business risk. It serves a second role in connection with determining the appropriate ROE threshold by adjusting the ROE to account for the risk to the base share price – the investor's "principal". The use of current ratio in determining the percentage of free cash flow to be paid as dividends addresses liquidity concerns and counters any incentive the firm might have to use debt to achieve a higher ROE. (A highly leveraged company will have a lower current ratio and will be unable to pay the same percentage of free cash flow as a firm with lower leverage.) Investors will watch carefully to make sure that companies are not meeting ROE hurdles by taking on debt, because the consequences of doing so will be that dividends will be limited if the hurdles are not met.

GAAP earnings will continue to be important, but only as a secondary measure of financial performance. After all, if the firm's ROE is unacceptable the level of earnings will not matter. [11] While corporations will still report GAAP earnings as they do currently, investors will demand a comparable focus on free cash flow generation. Cash flow accounting is subject to fewer subjective accounting decisions than GAAP earnings. The mirror image of a focus on generation of free cash flow will be a reduction in the use of GAAP accounting to maximize reported earnings. This will result in somewhat greater transparency in corporate financial reporting and a reduction in related corporate governance problems.

Reforming the tax rules relating to dividend payment will favorably affect corporate governance in other ways.

Without the ability to tax efficiently pay dividends to shareholders, corporations retain earnings that must be reinvested. If the corporation is unable to make further investment in its core business, which is often the case, it is forced to diversify. Often these diversification investments do not perform as well as anticipated, but they inevitably increase the complexity of the corporate structure and organization. Ultimately, the enterprise becomes so large and complex that even management does not fully understand all of the businesses and their interrelationships. It is difficult to expect boards of directors or institutional shareholders to develop sufficient understanding of such complex businesses to perform a meaningful management oversight role. This is an additional benefit to the point you make on freeing up capital for more efficient investment.

Diversification is costly, both because of significant transaction costs and execution risks as well as general inflation in asset prices during periods when corporate earnings are generally high and many corporations need to make acquisitions to reinvest retained earnings. The excessive costs of diversification are yet another manifestation of inefficient capital allocation driven by a tax inefficient dividend policy.

Meanwhile, if dividends become a significant as a component of investor return, payment of quarterly dividends on restricted stock might replace stock options as a management incentive compensation vehicle. Management's incentives would coincide with those of shareholders - focus on either meeting the risk-adjusted ROE hurdle or generating free cash flow.

Opponents of dividend tax reform argue that it mainly benefits the wealthy. I agree with you that participation in the equity markets has increased in recent years. But, the current focus on GAAP earnings and appreciation of share price still discourages investment by small and lower-income investors to a significant extent. Given a choice, these investors would prefer current income to a potential for appreciation in share price, both because current income is likely to be more meaningful for them, and because they cannot bear the risks inherent in investing for long-term share price appreciation based on GAAP earnings. A change in dividend tax policy could provide new investment opportunities for small and lower-income investors who do not participate in the equity markets currently.

Changing dividend policy might make the Employee Stock Ownership Plan (ESOP) a viable organizational form. Historically, the ESOP has not been successful because the alignment of the workers' interests and financial performance measured by GAAP earnings is so poor. Workers can understand – and affect – free cash flow generation better than GAAP earnings, and a quarterly significant dividend payout might provide an efficient incentive for workers as owners. I have suggested this in correspondence to Robert Reich, former Labor Secretary, but have not yet received a substantive response (other than an acknowledgment that my ideas are "thoughtful").

---

[11] While ROE ties to net income (GAAP earnings), any rational investor is going to get nervous if the non-cash portion of net income gets too large - even if the ROE is acceptable - because without cash the firm may have limited ability to pay dividends.

Finally, the common wisdom is that dividend tax reform will adversely affect Treasury receipts and increase the federal budget deficit. There is no basis to accurately estimate the effects of a change in dividend policy on federal tax receipts, but there is no reason to assume that the effect would be negative.

For those companies that come to use dividends as a more significant component of investor return, share price appreciation will become less significant because the free cash flow component of current earnings will largely be paid out to shareholders and not retained. Thus, predicting the effects of a change in dividend policy on federal tax receipts is difficult. Investors will pay tax on dividends as ordinary income at a weighted average rate based on the marginal rates of the aggregate investor class (which might change if, as suggested above, a change in dividend tax policy induces greater participation by smaller and lower-income investors).

For the current cohort of equity investors, the weighted average marginal federal income tax rate exceeds the capital gains rate (particularly when the capital gains rates are reduced to present value at the risk-free rate – the Treasury's cost of capital – to take into account the delay inherent in the holding period qualifications for capital gains treatment), so unless the demographics of equity investors changes very dramatically, it is difficult to see how federal tax receipts will decline materially.

I very much enjoyed your article. Feel free to contact me with your comments on my views.

/s/
Michael D. Scott
MscottEsq@Yahoo.com
V: 317.598.1054
F: 888.546.9616

http://scott-juris.blogspot.com

-----BEGIN PGP SIGNATURE-----
Version: PGP Personal Privacy 6.0.2

iQA/AwUBPnnNwy6ZI3xbUAQYEQLH1QCeJ8YWyaJ6eXERAg2u7P+ueeQjbrwAn3/d
EajKri5Gk6cDp3ojkClBNgEC
=fB8H
-----END PGP SIGNATURE-----