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COMMENTARY

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By HENRY M. PAULSON JR.

The president's dividend plan, submitted to Congress earlier this month, would remove one of the great inequities and structural biases in our current tax code. Some assail the plan for favoring affluent holders of equity over other Americans. Economists and other market experts who applaud the ideal of reforming dividend taxation have criticized the timing and affordability. I respectfully disagree.

The rationale for reforming tax policy on dividends is simple: Under the current system dividend income is taxed first at the corporate level when the income is earned and then again when it is paid out at the individual shareholder level. As these pages have noted, the tax falls disproportionately on older Americans, many of whom use dividend payments to supplement their retirement income. But aside from fairness issues, suggestions that the proposal will do little in the short term to stimulate our flagging economy while worsening our burgeoning long-term fiscal deficit are incorrect.

Let's start with short-term stimulus. Our economy is still reeling from the collapse of the high-tech/telecom bubble; investors have lost $7.3 trillion since the market's peak in March 2000. This "negative wealth effect" -- the tendency of consumers to retrench in the face of declining personal wealth -- has taken a heavy economic and psychological toll. Repeal of the dividend tax on individuals will not only place more money in taxpayers' pockets but immediately result in higher equity prices.

Estimates on the magnitude of this short-term boost range from 5% to 20%. Even a 5% increase in stock prices would result in a $500 billion increase in wealth at today's prices. The shift would help consumers become comfortable with spending again and help address a three-year erosion in equity values which has taken a toll on investor confidence.

Now let's turn to the deficit. As Federal Reserve Chairman Alan Greenspan noted last month, the long-term deficit picture is growing worrisome. But contrary to those who oppose this reform on these grounds, controlling the deficit will depend on greater discipline on the spending side of the fiscal ledger. The price tag on the proposal is roughly $39 billion a year over the next decade -- hardly a huge amount when measured against a $12 trillion economy.

This estimate is based on a purely static analysis. In reality, dividend reform will reduce the cost of capital to companies, spurring investment and growth. Conservative analyses indicate that higher growth should allow the Treasury to recapture half or more of the projected revenue loss from the tax cut. I believe that we will be surprised on the upside here because dividend tax reform will change corporate behavior to increase efficiency and promote growth.

The current double taxation of dividends can lead to astonishingly high effective tax rates. At Goldman Sachs, we paid a dividend of 48 cents per share in 2002. This dividend represented 74 cents in pre-tax earnings, of which our shareholders received as little as 29 cents after taxes. At marginal rates that can reach 60% -- the highest among developed countries. You don't have to be chairman of a Wall Street investment bank to grasp that higher taxes on capital lead to a lower level of investment and slower growth.

The high tax on dividends also increases the cost of equity capital and, at the margin, encourages companies to borrow rather than raise funds through equity financing. Under current tax law, there is relief for interest payments but not for dividends. This is at least partially responsible for the fact that many U.S. companies are too highly leveraged and their high debt burden makes them especially vulnerable to economic downturns and market volatility.

Dividend taxation also distorts the allocation of capital. It leads companies to hold artificially high uninvested cash balances or to invest in less efficient projects rather than return excess capital to their shareholders. Abolishing double taxation will, over time, release billions of dollars for more productive investment.

As we work to restore battered investor confidence, issuing more dividends would help ease the worries of investors. Nothing is more transparent than a dividend. It is a cash payment from the corporation to the stockholder. As investors receive a higher percentage of their return in this form, their risk premium should go down, the cost of equity capital should decrease and stock prices should get an additional boost over time.

The argument that the abolition of double dividend taxation somehow favors the wealthy at the expense of the poor harkens back to an earlier era when only the rich held equities. Today, of course, 84 million Americans own stock and stand to benefit. In the current environment of low growth, fiscal storm clouds, and likely war, we need dividend tax reform. It will benefit all Americans immediately by raising stock prices while laying the groundwork for sustained growth.

Mr. Paulson is the chairman and CEO of the Goldman Sachs Group.

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