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Strategy to revive the stock market

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If the slide in the stock market is not addressed very quickly, a crisis in corporate and personal debt service may well occur, causing a rapid downward economic spiral.

The good news is that Congress and the administration can prevent a further meltdown. The bad news is that Congress seems bent on doing the wrong things, which drive the markets lower, and the administration is acquiescing. Specifically Congress, under the rubric of reform, is adding unnecessary costly new regulations that will make businesses less profitable and less able to compete with foreign competitors, hence lowering the market value of U.S. companies.

Many in the media and Congress seem to think the problem is that American corporate management suddenly became greedier. The fact is people have always been greedy — even those in the media and Congress. But additional pressures on management from past public policy mistakes have caused those with an insufficient moral compass to slide into corrupt behavior. The existing statutes and regulations, as well as the market discipline of lower stock prices, are adequate to punish those who have abused their trust.

Congress ought to be spending its time correcting its past mistakes.

Several years ago, Congress imposed a cap on the maximum tax-deductible salary for corporate managers. This caused a shift to incentive compensation, particularly stock options, which provided an excessive incentive for corporate executives to attempt to boost the stock price in the short run rather than long-run earnings. In addition, both the federal and many state governments have restricted the ability of those who are dissatisfied with the performance of a given company to engage in a hostile tender offer to take over the company. The threat of hostile tender offers served as a discipline on corrupt and incompetent management groups.

Corporate earnings are taxed multiple times — the corporate tax, the individual tax on dividends, the tax on capital gains — which, by increasing the cost of capital, decreases corporate investment, thus reducing job creation and economic growth. The tax structure also provides perverse incentives for corporations to increase debt relative to capital, hence increasing risk. The standard corporation is at a relative tax disadvantage to other forms of business organization such as the partnership, LLC and S Corp.

Ironically, upper-income individuals usually have more flexibility in organizing their affairs so they can take advantage of the nonpublic corporation alternatives, while middle- and lower-income people realistically can only invest in public corporations that suffer an additional level of taxation.

Also, corporations that have substantial foreign earnings have been moving their legal homes to foreign countries because they incur a large tax penalty by remaining in the U.S. This situation has arisen because most major countries have reduced their corporate tax rates below the U.S. rate.

The obvious solution is to reduce the corporate tax, the earnings cap limitation, and restrictions on hostile tender offers. Despite the economic benefits of reducing the corporate tax, it is a difficult economic sell given the economic ignorance and penchant for stoking class warfare in the political class.

As an alternative, the following is a proposal that could be sold politically and would achieve most of the goals of economic and political reform.

Allow corporations to deduct up to 90 percent of dividends paid, as is now done with interest payments. This would enable corporations to reduce their effective corporate tax by 90 percent while maintaining the same statutory corporate tax rate.

It is not an exemption, just a reduction in the double taxation of the same income. Many foreign countries allow part or all of dividend payments to be deducted by the corporation.

Critics of this proposal will complain about an apparent static revenue loss. The fact is, however, corporations have been reducing their dividend payouts, and many corporations pay nothing at all in dividends. Under this proposal, corporations will have an incentive to pay out much of their income in dividends on which individual investors will be paying income tax. In addition, foreigners pay a 30 percent withholding tax on dividends in the absence of a tax treaty, so Treasury is likely to obtain more revenue from foreign citizens.

When the additional individual tax on dividends is added in and the other shifts in behavior and the benefits from all of the new investment are considered, there should be little or no revenue loss over the long run.

The corporation should also be allowed (and encouraged) to pay a portion of compensation to managers, and even all other employees, in the form of tax-deferred stock grants. The stock grants would be put in separate individual accounts to be held by a trustee. No tax would be paid on the value of the shares and accumulated dividends in the accounts until withdrawals are made (like an IRA). The owner of the account would not be allowed to withdraw more than 10 percent of the value of the account in any given year.

Such a system would give managers and other employees a long-term interest in the economic health of the corporation, even extending beyond individual terms of service, thus converging the long-term interests of the managers/employees with the outside stockholders.

If the above suggestions were put into law, the stock market would likely surge, restoring the savings of the American people and enabling American business to create millions of new jobs. But there is also one constructive thing the Senate could do to greatly improve its new antifraud bill, which creates a new category of crime for any "scheme or artifice" to defraud shareholders. Add two words after shareholders, these are "or taxpayers" and make it apply to members of Congress and government executives.

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