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PROMOTING CORPORATE RESPONSIBILITY THROUGH THE REDUCTION OF DIVIDEND TAXES

HEARING

BEFORE THE

SUBCOMMITTEE ON CONSUMER AFFAIRS AND PRODUCT SAFETY

OF THE

COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

APRIL 8, 2003

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ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

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PROMOTING CORPORATE RESPONSIBILITY THROUGH THE REDUCTION OF DIVIDEND TAXES

TUESDAY, APRIL 8, 2003

U.S. SENATE,
SUBCOMMITTEE ON CONSUMER AFFAIRS AND PRODUCT SAFETY,
COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION,
Washington, DC.

The Subcommittee met, pursuant to notice, at 10:08 a.m. in room SR–253, Russell Senate Office Building, Hon. Peter G. Fitzgerald, Chairman of the Subcommittee, presiding.

OPENING STATEMENT OF HON. PETER G. FITZGERALD, U.S. SENATOR FROM ILLINOIS

Senator FITZGERALD. I will call this Subcommittee meeting to order.

I want to thank all the witnesses, Secretary Fisher for being here and all the others who are here. I understand that Professor Elson wants to be out of here by 11 o'clock, and we are going to try to accommodate the professor and keep this Subcommittee meeting moving. I want to thank all of you for agreeing to testify today. I appreciate that it takes a lot of time to prepare congressional testimony and make yourselves available, and I certainly appreciate it.

I wanted to call this hearing because we have had a great debate in this country about the propriety of cutting taxes or providing tax relief at this point in our Nation's history, and there has been a lot of debate especially about cutting the level of taxation or eliminating the double taxation of corporate dividends. It seems to me that the debate has centered almost entirely around the tax policy involved, and there has not been enough discussion out there about how corporate behavior might change or be modified if the double taxation on dividends were eliminated.

Now, last year at about this time we had several executives from Enron testifying right at that very same table there, and we got a real lesson in how earnings reports of corporations can be very misleading, even earnings reports that may well, in fact, comply with the strictest interpretations of GAAP accounting rules.

In fact, I remember when Jeffrey Skilling testified, sitting right where Peter Fisher is right now, I thought I was going to trap him and find stuff that was not disclosed in their financial statements, hidden liabilities that I was certain were not ever disclosed to investors. And Mr. Skilling surprised me by pointing to specific pages

and footnotes in the annual reports or annual filings with the SEC where they had disclosed hidden liabilities that had analysts picked up on, there would have been a whole different interpretation of that company Enron in the late 1990s and early 2000 when its stock price was going up and up.

The bottom line is, it seems to me, that earnings figures can mislead. Earnings are not easily defined. There is a lot of play within what earnings are defined, but on the other hand, as Professor Siegel is going to testify—and I have read ahead to his testimony—dividends are very well defined and tangible and a very good way for investors to judge the profitability of companies.

Now, we have gotten away dramatically from corporations paying dividends in this country, and I do not know if my staff has some of the charts that we have prepared.

Back in the old days, investors really looked to the dividend returns on stocks, and in fact, if you go back to the twenties and thirties, we had very high yields on corporate stocks ranging from 4 percent or a little bit under 4 percent down in 1926 when the stock market was very high. Then when the stock market collapsed, of course, the dividend yield was up to 10 percent on stocks. People still did not want to own stocks. But all the way, as late as the fifties and sixties, you could probably expect a 3 or a 3.5 percent dividend yield on most stocks. And then even in the late seventies and early eighties you were seeing 5, almost 6 percent yields as being common.

But then in the early eighties, the SEC made it easier for companies to buy back their own shares, and that is a way in my judgment of doing a tax-advantaged dividend to your shareholders. If you pay a corporate dividend, it is going to get taxed twice, but if you buy back your shares, make them more scarce, drive up their value, you can more easily return capital gains to your shareholders. So the SEC, doing that in the early eighties—and I think Professor Siegel points that out in his written testimony—caused some changes.

And then in the late eighties, early nineties and especially in the late nineties, we had a vast proliferation of stock option grants in corporate America. Stock options used to be fairly rare in this country. I know my grandfather had a stock option in the twenties that he could only exercise after running the company for 25 years, and he did exercise it in the fifties. But they were much longer-term in those days, and now we have stock option grants that grant very rapidly. Companies can get a tax deduction for stock option compensation paid to management, but they do not have to expense the compensation on their earnings report. So it is like manna from heaven for corporations.

In 1993–1994, FASB was going to require companies to expense stock options, but at that time Senator Lieberman introduced a resolution in the Senate which passed with 88 votes condemning FASB for having the audacity to require corporate America to expense stock option compensation on their earnings reports. In fact, Senator Lieberman also introduced a side bill that if FASB did not back down on their Rule 123, he would have put FASB out of business. In the face of that congressional pressure, FASB backed down and stock option grants took off with abandon.

Then by the late 1990s, we had Enrons, Global Crossings, WorldCom, all sorts of corporations, high-flying at the time, where the insiders were getting very rich on their stock option grants. Now, in the case of Enron, the top 29 insiders in the 3 years before the company's demise cashed in $1.1 billion worth of stock options. Now, with such proliferation in stock options, that is a further incentive for managers not to pay a dividend to the shareholders, but to focus all their attention on trying to lift the share prices because that is how those with stock options will benefit if they can cash in their options.

In the case of Enron, it appeared to me, after really delving into this for many months and many different hearings and after personally examining the documents, that all of the top insiders had to know they were running a house of cards, but they all had an incentive not to blow the whistle because they were getting very rich very quickly on their options. Finally, it was someone who did not have options, Sherry Watkins, who was in the CFO's office for just a few weeks, who figured the whole thing out in a matter of weeks and she did blow the whistle. And there are many other companies that have similar patterns.

Now, it strikes me that President Bush's proposal to eliminate the double taxation of dividends is the best possible answer to the corporate governance problems that we have seen in recent years in this country, and that is why I wanted to hold this hearing to delve into what the likely effect on corporate behavior would be. While I think we could continue to tighten the accounting rules and SEC rules, as we began with Sarbanes-Oxley, no matter how hard you tighten those rules, I think the earnings figures can always mislead. There are always going to be assumptions, and I think Professor Siegel points out in his testimony there are assumptions as to assumed future rates of return on your pension assets. You have to choose some depreciation schedules. There is always some play in GAAP accounting that always makes earnings numbers at the end of the day an opinion rather than a fact, whereas a dividend check is a fact.

Now, corporate executives can always take back a bad earnings forecast. We saw some examples in the late 1990s and the early part of this decade where companies were coming out with strong earnings forecasts. Then a bunch of insiders would cash out their stock options when the price was high, and then later the earnings forecast would be taken back.

Well, how do we protect investors in this kind of an environment? I think a return to dividends is a great way of starting because that corporate CEO cannot take back a dividend check. He can take back an earnings forecast and say, oh, sorry, I was wrong, but they cannot take back that dividend check.

The other thing I think clearly that we would do is probably lower the level of corporate debt in America. Companies have a huge incentive to use debt financing instead of equity financing because you get a tax deduction on your interest payments on corporate debt. You do not get that treatment with equity when you pay a dividend on your equity. So I would expect that corporate behavior would be modified in the direction of having less debt, and I think that would be helpful in corporate America. Look what hap-

pens to industries that are over-leveraged. Certainly, Peter Fisher, you have had to deal a lot with the airline industry. That is a very good example of an over-leveraged industry. When there is a downturn, they are not in a strong position to handle that.

The other thing is we have been dealing with the problem of corporate inversions, companies going off incorporating offshore in Bermuda to avoid taxes altogether. Well, I submit that under President Bush's proposal we would put a stop to a lot of that behavior because companies would not be able to deliver a tax-free dividend to their shareholders if the money had not first been taxed at the corporate level.

So we talk about double taxation of corporate dividends, for some corporations they are not paying any taxes at all at the corporate level. They may be reporting tax losses to the IRS but reporting huge earnings to their shareholders. And a red flag will be raised under President Bush's proposal, the Treasury Department's proposal, if you have a company that is paying dividends on earnings that were never taxed because people will start to ask questions how that could be. And I think John Rowe in his testimony is going to talk about that issue.

Finally, I think there would be, in addition to cutting down on stock options abuse and cutting down on lowering the level of corporate debt, discouraging corporate inversions or bizarre attempts to avoid corporate taxation, I think you just have less of an incentive for corporations to hoard cash. There have been a lot of celebrated examples in recent years of companies just building up enormous cash hoards because it is foolish under the current tax code to pay that money out a second time. Better to use it for a stock buy-back, better even probably to use it for corporate art because you get a tax deduction on that. But you would see less purchases of corporate art or lavish yachts or the kind of abuses we saw in the case of Tyco, buying a lot of perks and benefits for the CEO to the disadvantage and prejudice of the shareholders with this proposal from the Administration.

So with that very favorable comment from me on the Treasury Department and the Administration's proposal, I want to open this up to Peter Fisher. Peter Fisher is the Under Secretary for Domestic Finance at the Treasury Department. He was involved with the Federal Reserve in New York, I believe it was, and also he has been on the Airline Stabilization Board.

If I could deviate at the very start by asking Secretary Fisher a question about Hawaiian Airlines. I do not know whether you picked this up, but I picked it up because I represent Chicago where Boeing is headquartered. And I noted that Boeing has a suit in Bankruptcy Court against Hawaiian Airlines. Apparently this is a small airline that is owned 80 percent, roughly, by inside shareholders, insiders. I think the Chairman owns about 50 percent. They got $30 million as their share of the $5 billion cash payout to airlines. According to the allegations in Boeing's lawsuit, they used roughly $25 million of those proceeds to do a tender offer for their own shares and bought back about $25 million of their own shares, of course, to the great benefit of the insiders who run the company. And then they waited a period of time and filed bank-

ruptcy. Of course, they are trying to give a hair cut to their creditors at this point, and Boeing apparently is seeking to undo that.

I was just wondering if the Under Secretary was aware of that situation and whether it is possible for the Treasury Department to look into that or would the legislation Congress passed last year give the Administration anything that they could do if the allegations in that complaint were true.

Mr. FISHER. Mr. Chairman, I only know about the allegations from Boeing from what I have read in the newspapers. So I do not know anything beyond that.

I think going back to September of 2001 when the original Air Stabilization Act was passed, the idea of the $5 billion in grants was no strings attached. That was what came out of the Administration and it was a rather delicate compromise with the Administration. So there was no conditionality. There was simply an allocation of that money by miles flown I believe was the formula.

So I have not looked into it and I do not know, but if you would like, I can try. But I do not think we at the Treasury have any responsibilities here, but I would be happy to check.

Senator FITZGERALD. Well, thank you. I know you were concerned about protecting the taxpayers in that legislation, as was I. Just maybe if you can look into that. I think you are right. Congress had no strings attached. I think it might have been permissible for an airline to just dividend the money out to their shareholders and then wait 90 days and file bankruptcy. I think we should have put more safeguards in there.

But with that, Mr. Fisher, go ahead. We welcome your testimony here today. Thank you for being here.

STATEMENT OF PETER R. FISHER, UNDER SECRETARY FOR DOMESTIC FINANCE, DEPARTMENT OF THE TREASURY

Mr. FISHER. Thank you, Mr. Chairman. I have a written statement. I ask it be included in the record. I know in the interest of getting to the full panel, let me try to briefly summarize my testimony on behalf of the President's proposal to eliminate the double taxation of dividends.

As we see the proposal, it would strengthen our economy and create jobs, first, by improving corporate governance, and second, by retargeting investment to the most productive ventures.

First, on corporate governance. As you, Mr. Chairman, have said, I think you and I are having a heated agreement here. When I look back at the last 2 or 3 years here in Washington, I think of what has been of concern. Jobs destroyed by bankrupt firms that took on too much debt. Executives that managed earnings inflating their company's stock prices and pumping up the value of their own stock options, and as you have referred to, corporate inversions where companies move to tax havens abroad.

Clearly our tax code must share some of the burden for these events. By taxing dividends twice, our tax code encourages companies to retain earnings instead of paying them to shareholders, to raise excessive levels of debt, and dedicate some of our smartest people in this country to tax minimization devices rather than job creation.

Now, let us all be clear. There is nothing wrong with retained earnings or debt or even share buy-backs, but there is no reason that the tax code should favor them either. Eliminating the double taxation of dividends would reduce these biases against investing and creating jobs.

One of the reasons I think that this is such a—well, it is always a good idea to take a distortion like this out of the tax code. One reason why this is a particularly good time, as you have alluded to, Mr. Chairman, is I think that our corporate leadership and our capital markets are looking for some way to find some better MO than managed earnings as an MO of corporate behavior. Today only half of nonfinancial firms even pay dividends. Without periodic dividends, as you have said, and the unmistakable facts about cash flow, investors are basically left, as you said, Mr. Chairman, with earnings opinions. As Secretary Snow likes to say about this, you can fudge earnings, but you cannot fudge cash. The President's proposal would clear the barriers to companies that sought to mirror in their earnings reports with dividend checks in the mail.

Now, I feel very strongly that it is through the process of better corporate governance that the second benefit of the President's proposal will be realized for all Americans in boosting investment efficiency and job creation. Let us be clear about where jobs come from. New jobs come from investment, from the willingness of investors and entrepreneurs to put capital at risk in a business venture. And the President's proposal is focused precisely on that point.

Taxing dividends twice means that we tax investment more heavily than any other major industrial nation. We all know that is simply bad policy.

Senator FITZGERALD. More even than Japan?

Mr. FISHER. Yes. Actually after a recent hearing where Secretary Snow was speaking, I believe a Member of Congress—I am not recalling precisely—showed an OECD study that said Japan had the highest tax and we were second. One of my colleagues at the Treasury, during the hearing, received an e-mail from someone at the Japanese Embassy pointing out that there were some things that the OECD had not taken into account. So we actually have the dubious distinction of being number one.

I think the problem here is that by sort of slowing down the investment process, we lock up money inside the balance sheet of corporations, neither giving it back to shareholders for them to reinvest if they would like in other ventures, nor putting a high enough burden of proof on corporate leaders to have specific reinvestment plans.

Now, if you think about it, each year American firms invest over $1 trillion in fresh capital, and they generate $700 billion to $800 billion in corporate profits. If we think about just marginally improving the efficiency with which that sort of sum of money is invested in capital utilization and job creation, we are going to accelerate and retarget that entire investment process. That is really going to pay off for us over the coming decade which is where our concerns need to lie at this point. I think it is the nexus between job creation and capital formation over the coming decade where

we should be concentrating our attention. By taking this distortion out of our tax code, we know we will be doing the right thing.

So on behalf of the Administration, I thank you for holding this hearing and I urge that Congress take this opportunity to improve our tax code.

I would be happy to answer any questions, but I know you will look forward to talking to the whole panel, so I am at your service, Mr. Chairman.

[The prepared statement of Mr. Fisher follows:]

PREPARED STATEMENT OF PETER R. FISHER, UNDER SECRETARY FOR DOMESTIC FINANCE, DEPARTMENT OF THE TREASURY

Chairman Fitzgerald, Ranking Member Wyden, and distinguished Members of the Subcommittee, I am honored to testify before you in support of the President's proposal to eliminate the double taxation of dividends.

This proposal would strengthen our economy and create jobs by improving corporate governance and re-targeting investment to its most productive ventures. Corporate governance would improve because the proposal would better align executives' interests with shareholders' and encourage companies to disclose more clearly their cash earnings and taxes paid. Investment efficiency would rise because the proposal would reduce tax distortions to fundamental corporate decisions such as whether to repay shareholders or how much debt to raise.

The result would be more investment, higher productivity, more new jobs and faster economic growth. At a time when too many people who want jobs can't find them, and when economic growth around the world is slower than we should accept, the President's proposal would be a welcome shot in the arm.

In the past year, under Chairman Oxley's and Senator Sarbanes' leadership, Congress took a major step toward improving corporate governance in America. Investors have matched that with their own call for improved governance. Corporate executives, directors, auditors, and lawyers are already hearing and heeding the call for greater accountability. Better-run corporations make for more efficient capital markets and a healthier economy.

But there is more to be done in encouraging the best conduct from corporate executives. Think of the headlines of the past couple years. Jobs destroyed by bankrupt firms that took on too much debt. Executives that "managed" earnings, inflating their companies' stock prices and pumping up the value of their own stock options. "Corporate inversions" where companies moved to tax havens abroad.

There are many forces responsible for these problems, but our tax code shares some of the blame. By taxing dividends twice, our tax code encourages companies to retain earnings instead of paying them to shareholders; to raise excessive levels of debt; to repurchase shares, often on a one-off basis, instead of issuing dividend checks; to dedicate some of America's leading minds to tax minimization instead of job creation. There's nothing wrong with debt or retained earnings or share repurchases. But there's no reason our tax code should favor them, either.

Eliminating the double taxation of dividends would reduce these biases against investing and creating jobs. A shareholder would no longer pay a second layer of taxes on dividends if the corporation had already paid tax on that income. If the company retained that income and invested it again, the shareholder would get an equivalent credit.

This is a ripe moment to improve corporate governance by removing the tax bias toward debt and retained earnings. CEOs and capital markets are now acutely sensitive to the risks of managed earnings. Yet today, because of double taxation, only half of non-financial firms pay dividends. Without periodic dividends—unmistakable facts about cash flow—investors are basically left with earnings opinions. As Secretary Snow says, you can fudge earnings, but you can't fudge cash. The President's proposal would clear the barriers to companies that sought to mirror their earnings reports with dividend checks.

The President's proposal is bad news, too, for the attractiveness of corporate tax shelters, corporate inversions, and other tax minimization devices. The rationale for creating these devices would lessen, because an investor could only claim an exclusion on a dollar of dividends if the company had paid full tax on that dollar.

The proposal's second benefit would be boosting investment efficiency and thus job creation. Let's be clear where jobs come from. New jobs come from investment—the willingness of investors and entrepreneurs to put capital at risk in a business ven-

ture. The President's proposal is focused precisely on that point: at sharpening the incentives for investors and entrepreneurs to invest in the most productive ventures. And higher productivity means higher wages and a stronger economy for everyone.

Taxing dividends twice means that we tax investment more heavily than any other major industrial nation. If investment is the blood of new jobs and growth, this is bad policy.

The double taxation of dividends also distorts companies' decision to retain funds versus returning capital to shareholders. Even if shareholders have more promising investment opportunities elsewhere, the tax code locks those funds up inside the company. That's not good for shareholders, and it's certainly not good for the economy.

Each year American firms invest over $1 trillion in fresh capital and generate $700–800 billion in corporate profits. Think of the gains in capital utilization and job creation for everyone if we accelerate and re-target this entire investment process. The Council on Economic Advisors estimates that through 2004 the dividend tax cut alone would generate more than 400,000 new jobs, nearly a third of the total from the President's Jobs and Growth Package. The Business Roundtable says it's even higher, closer to half.

Taxing dividends once and only once would convert directly into higher share prices. Private sector economists estimate that the President's proposal could boost stock prices by 5 to 15 percent, delivering immediate wealth to a confidence-short market.

Last, some ask why the President has not proposed eliminating the corporate income tax instead. The main reason is that doing so would violate the President's principle that the government tax dividends once and only once. If Congress eliminated corporate-level taxation, many billions in profits, headed to tax-free entities or abroad, would escape any taxation at all. Much more revenue would be foregone. And the way would be kept open for the same kind of tax minimization devices that today's tax code fosters and which the President's proposal would cut back.

On behalf of the Administration, I urge you to take this opportunity. Thank you.

Senator FITZGERALD. Well, if I could ask you a few questions before we bring up the other panel.

Mr. FISHER. Certainly.

Senator FITZGERALD. Some have suggested that the Administration should have gone about this differently. They agree that corporate profits should not be taxed twice, but they recommend that corporations be given a tax deduction for the dividends they pay to their shareholders, much as they are given a tax deduction for interest paid on corporate debt. Do you want to address that issue, why the Administration proposed providing the relief at the shareholder level rather than at the corporate level?

Mr. FISHER. Certainly, I would be pleased to. I think the important thing is to focus on the principle that the President has put forward, that corporate income be taxed once and only once. And structuring it the way we have is we think the right way to get at that. If the elimination of the double taxation of corporate dividends were done at the corporate level, much of the income which flows through corporations would not be taxed at all, given the high level of equity holdings in tax-preferred vehicles. It would have a much bigger revenue hit to the Federal Government, and it would create, if you will, a diversion in which corporate profits paid out as dividends would not be taxed at all in many cases. That would, if you think about it to the next step, create a powerful incentive for dividends as opposed to retained earnings.

And the other important principle that the President felt strongly about——

Senator FITZGERALD. Retained earnings that had been taxed at the corporate level would be added to a shareholder's basis. Is that correct? Because you did not want to give corporations a tax code

incentive to pay out a dividend. If they are better off, they have better opportunities to retain that.

Mr. FISHER. That is how we have proposed it. So the President's proposal works hard to be a level playing field between retained earnings and dividends. It is very important that we do not want to preference either one of those.

But most of the ways that I am aware of of structuring it at the corporate level effectively turns it into another tax management device for corporate leaders, which does not give you quite as many of the corporate governance benefits that we see flowing from the way the President has structured this.

Senator FITZGERALD. Now, there are many companies in America that report tax losses to the IRS, but report earnings to their shareholders. Is that not correct?

Mr. FISHER. Yes, I am aware that that does happen in common practice.

Senator FITZGERALD. A congressional study of Enron showed—I have to give my apologies to John Rowe, but in his statement, he is going to point out that between 1996 and 1999, Enron reported $2.3 billion in earnings to its shareholders, but to the IRS it reported $3 billion in tax losses. And during that period Enron paid out $1.5 billion in dividends.

Now, if the President's proposal had been in effect then, Enron would have had to notify its shareholders that its dividends, its $1.5 billion in dividends, were not excludable from taxation. Is that correct?

Mr. FISHER. That is my understanding. I have not done my own calculation of that, but that is my understanding from others.

Senator FITZGERALD. That itself would raise red flags in the shareholders' minds that they are getting this dividend, but for some reason it is not tax deductible because they would know then that the company is reporting tax losses to the IRS but earnings to them, and they would be wondering, well, is this company really profitable. That would kind of raise questions in investors' minds, would it not? It might have been a protection for——

Mr. FISHER. I think absolutely. I think there is a very powerful effect simply of the disclosures which will flow from the President's proposal that shareholders will routinely have the opportunity to see the taxes paid and the earnings and the dividends, all of those pieces put forward by corporate America for them to see. That alone will be a wonderful bit of sunshine.

Senator FITZGERALD. Now, we do have S corporations in America. I imagine we have a lot of S corporations. If I am correct, the current rule is if you have under 75 shareholders and meet some other requirements, you are eligible to have your profits taxed only once. It actually all gets taxed at the individual shareholder level. Would the President's proposal essentially make every corporation in America kind of like an S corporation? Although it would be different from the standpoint that the money would be taxed at the corporate level as opposed to the shareholder level in an S corporation.

Mr. FISHER. That is not how I have thought of it, but it is an effort to make sure that the choice at new business formation and small businesses, that they make a rational economic choice as to

what form they want of a partnership or an S corporation or other corporate forms, that they make that on economic grounds. So I have not quite thought of it in the way you phrased it, but I see what you are driving at. But I do think it is very important that we not limit the choice there. Our current tax code penalizes companies—maybe penalizes is too strong, but adds a burden if they want to move out of the partnership structure into a publicly traded vehicle.

Senator FITZGERALD. Now, what about a company that reports earnings to its shareholders but does not pay taxes to the IRS? It declares a tax loss to the IRS. But those earnings that it reports to its shareholders it retains as opposed to paying out in dividends. That money, I assume, would not get added to the shareholders' basis in their shares because it was never taxed. Is that correct?

Mr. FISHER. I believe that is right, although I would want to check back on that. I think the carry back/carry forward provisions of losses—I am not in a position to sing you chapter and verse on that, but we would be happy to clarify that for staff what our current proposal is.

Senator FITZGERALD. Okay. If you could look into what would happen in that case.

Also, I would be interested in any statistics the Treasury Department may have on S corporations in America. My sense is they are becoming much more common. I know I was in the banking business, but when I was in the banking business, banks could not be organized as subchapter S corporations. They now can be and that has changed a lot of things. I would imagine in certain areas there has been a big proliferation of S corporations. I know in Illinois some huge companies that are privately held and organized as S corporations, multibillion companies that are run by people in Chicago that are S corporations. I would be very interested in any statistics you might have on the growth of S corporations, the number of companies that are organized that way in America.

Mr. FISHER. We would be happy to look into that for you.

Senator FITZGERALD. Well, thank you very much, Secretary Fisher, for being here, and thank you for all the good work you are doing over at the Treasury Department. Keep up the good work. Thank you very much for being here.

Mr. FISHER. Thank you very much, Mr. Chairman.

Senator FITZGERALD. Now I would like to call the second panel. As I alluded to earlier, I want to give Professor Elson the opportunity to testify first. The second panel is Elizabeth Bull, Vice President and Treasurer of Texas Instruments; Professor Charles Elson, Chair of the Center for Corporate Governance, Lerner College of Business and Economics at the University of Delaware; John Rowe, the President and CEO of Exelon Corporation in Chicago; and Jeremy Siegel, the Russell E. Palmer Professor of Finance, at The Wharton School, University of Pennsylvania.

Mr. Elson, I want to make sure you make your commitment. You need to catch a plane or otherwise be out of here at 11 o'clock. So I want to thank you for coming here and invite you to fire away first, and then we will start with Ms. Bull and go my left to my right. Thank you. Mr. Elson.

STATEMENT OF CHARLES M. ELSON, CHAIRMAN, CENTER FOR CORPORATE GOVERNANCE, LERNER COLLEGE OF BUSINESS AND ECONOMICS, UNIVERSITY OF DELAWARE

Mr. ELSON. I appreciate your indulgence on the time. I had a commitment I agreed to in New York a long time ago, and to work it all out, this is great to let me go a little earlier.

I am going to be talking about strictly the corporate governance implications of the proposal. I teach corporate governance at the University of Delaware and have been involved in corporate governance activities for a long time. When I first heard of this proposal, I sort of went back to an earlier life as a law professor. I taught corporate law before I started teaching corporate governance.

Traditionally the tax on dividends with the resulting double taxation on profits was universally in the legal community considered an anomaly in the corporate law arena that created, it was felt, a distinctive bias against the use of dividends as a way to distribute earnings to shareholders. I think obviously this proposal will solve that problem.

But more importantly, from my own standpoint in the governance area, I think the idea has tremendous positive implications for corporate governance reform in the country and may create in the long run greater managerial accountability to shareholders and, frankly, as you pointed out earlier, lessen the likelihood of earnings manipulation that led to the numerous failures that unfortunately I guess a predecessor in this chair was talking about earlier. By removing I think a critical, and a lot of folks will say artificial barrier to dividend usage, you are going to see an increased distribution of corporate earnings to shareholders in the form of dividends and collaterally, I think, create five differing but really important improvements in corporate governance in this country and, frankly, the protection and expansion of investor capital. Let me just lay these five out because I think they are critical.

Number one. Dividends, I think, which require tangible cash outlays by the corporation, create the necessity to generate, as you pointed out, tangible real returns by companies which reduce management's ability and incentive to create fictitious earnings and returns based on the manipulation of accounting standards or, frankly, outright fraud. A reality check, if you will, on corporate earnings.

Second, the financial discipline within the organization itself that regular cash distributions to shareholders requires is going to aid in the creation, at least in my view, of a greater culture of managerial accountability to shareholder interests which in the end spur greater corporate productivity and real profitability. A very important point, internal point.

Third, regular cash dividend payments, by reducing the now dominant retention of earnings by most companies, I think will reduce the temptation presented by large cash positions, or awards some will say in companies, to management in mature businesses to, first of all, either misspend capital in poorly conceived projects or simply expropriate those earnings in the form of exorbitant salaries or benefits, which you also alluded to earlier. Additionally, the capital that is going to be returned to the investors I think will find

its way back into the investment pool and be directed to more meaningful and productive means. Investors traditionally have shown much greater wisdom than many managers in the efficient deployment of capital. And this is a point, frankly, that a lot of public pension funds have made in private conversations supporting this proposal, which I think is kind of interesting, that they do a better job reallocating capital than cash sitting in a corporation. A very important point.

The fourth point, which is kind of a slightly different tangent, focuses on executive compensation, which has also been an issue of a little bit of controversy lately. Use of dividends to distribute earnings I think will have a big impact on the way compensation is run in this country. I think it will change dramatically compensation structure and practice. The use of option-based compensation I think will decline significantly as the incentive for its usage by management and will effectively disappear. Compensation would shift away from stock options, which many have argued have provided the incentive for earnings management and other forms of nefarious activities in some circumstances, towards restricted stock, which most in the corporate governance community at least believe to be a better shareholder alignment tool and more effective incentive for prudent and productive management. In other words, we will get out of the options culture. We will not have to have this debate over expensing, not expensing, how much to expense, how little to expense, but instead focus on——

Senator FITZGERALD. Restricted stock is expensed.

Mr. ELSON. Exactly, immediately.

Senator FITZGERALD. But options are not.

Mr. ELSON. Right. Restricted stock people feel is a better aligner and a real chunk of the company and frankly a better aligner both on the upside and on the downside. It would be a very important collateral benefit that I do not think has gotten much play, frankly, in the discussion of the tax repeal.

Finally, the fifth point is really kind of a fundamental point. Through regular cash distribution of corporate earnings, investors would gain greater liquidity, interestingly enough, in their investments, and they would not be forced to sell their holdings quite as regularly, in my view, to access their capital. And I think longer-term investment would end up resulting.

Additionally if the sale of stock is the only way to access the return of your investment, which is true under the current regime, one is totally dependent on the accuracy of the stock price to ensure an appropriate return. Unfortunately, as we know, stock price is sometimes affected by numerous factors, sometimes completely unrelated to a company's performance, making the sale of stock sometimes an imperfect way of return on capital. A greater reliance on the dividend as some way at least to access one's capital, to access one's return on an investment, I think would mitigate this problem.

Basically the corporate governance and investor protective aspects of this tax repeal proposal I think are really powerful and compelling reasons for its enactment. And you have not heard a lot about them, and I think you are absolutely right to hold this hearing on this point. It is one of these side benefits that people really

did not think about until they started to analyze the proposal. I think its positive impacts on the investing public far outweigh any kind of short-term revenue consequences that it is going to provide and, frankly, in the long run, is only going to lead to greater investment returns and greater consequent tax revenue in the form of greater revenues from the companies themselves in the future as corporate productivity and accountability are strengthened. You may have a short-term revenue issue, but frankly a much longer-term revenue productive issue. But more importantly, structurally you have got tremendous positive impacts that come out of this thing in my view.

Thank you.

[The prepared statement of Mr. Elson follows:]

PREPARED STATEMENT OF CHARLES M. ELSON, CHAIRMAN, CENTER FOR CORPORATE GOVERNANCE, LERNER COLLEGE OF BUSINESS AND ECONOMICS, UNIVERSITY OF DELAWARE

Traditionally, the tax on dividends with its resulting "double taxation" of corporate profits has been virtually universally considered an anomaly in the corporate law arena that created a distinctive bias against the use of the dividend as a way to distribute corporate earnings to shareholders. The present proposal to eliminate the dividend tax will certainly resolve this anomaly and eliminate the taxation barrier to dividend declarations. However, more importantly, the proposal has tremendous positive implications for corporate governance reform in this country and may act to create greater managerial accountability to shareholders and lessen the likelihood of the kinds of earnings manipulation that led to the numerous corporate failures of the past few years. By removing a critical, and some would argue artificial, barrier to dividend usage, this proposal will result in increased distribution of corporate earnings to shareholders in the form of dividends and collaterally create at least five differing, but significant improvements to U.S. corporate governance and the protection and expansion of investor capital.

1. Dividends, which require regular tangible cash outlays by the corporation, create the necessity to generate tangible returns by a company, reducing corporate management's ability and incentive to create fictitious earnings and returns based on the manipulation of accounting standards or outright fraud.
2. The financial discipline within the organization that regular cash distributions to shareholders requires will aid in the creation of a greater culture of managerial accountability to shareholder interests which will spur greater corporate productivity and real profitability.
3. Regular cash dividend payments, by reducing the now dominant retention of earnings by most companies, will remove the temptation presented by large cash positions to management in mature businesses to misspend capital in poorly conceived projects or simply expropriate those earnings in the form of exorbitant salaries. The capital that will be returned to the investors will find its way back into the investment pool and be directed to more meaningful and productive means. Investors have traditionally shown greater wisdom than most managers in the efficient deployment of capital.
4. Use of the dividend to distribute corporate earnings would dramatically change executive compensation structure and practice in the United States. The use of option-based compensation would decline significantly as the incentive for its usage by management would effectively disappear. Compensation would shift away from stock options, which have provided the incentive for earnings management and other forms of nefarious activity, towards restricted stock which most in the corporate governance community believe to be a better shareholder alignment tool and more effective incentive for prudent and productive management.
5. Through the regular cash distribution of corporate earnings, investors would gain greater liquidity in their investments and not be forced to sell their holdings as regularly to access their capital. Longer term investment would result. Additionally, if the sale of stock is the only way to access the return on one's investment as under the current regime, one is dependent on the accuracy of the stock price to ensure an appropriate return. Unfortunately, stock price is af-

fected by numerous factors, sometimes unrelated to a company's performance, making the sale of stock a sometimes imperfect way of return on capital. A greater reliance on the dividend as a way to access return on investment would mitigate this problem.

In summary, the corporate governance and investor protective aspects of the dividend tax repeal proposal are powerful and compelling reasons for its enactment. Its positive impact on the investing public far outweighs any short-term revenue consequences it may provide and will lead only to greater investment returns and greater consequent tax revenue in the future as corporate productivity and accountability are strengthened.

Senator FITZGERALD. Well, Professor Elson, thank you very much. You have still got about 15 minutes. We will try to get through the others. There may be some questions I want to ask you.

You clearly do not believe in the efficient market hypothesis of the University of Chicago if you think that a share price or selling your shares is not necessarily—you are not necessarily going to get the correct value for them.

Mr. ELSON. A softer form of efficiency.

Senator FITZGERALD. Okay.

[Laughter.]

Senator FITZGERALD. Ms. Bull, thank you very much for being here. I noted that Texas Instruments has been paying a dividend since 1962. And in the high tech world you stand out as a firm that actually manufactures something, has a product, and has a long history of profitability and paying dividends out to the shareholders. So, Ms. Bull, thank you very much for being here. We are delighted to have you.

STATEMENT OF ELIZABETH W. BULL, VICE PRESIDENT AND TREASURER, TEXAS INSTRUMENTS INCORPORATED

Ms. BULL. Thank you, Mr. Chairman. I appreciate you extending the invitation to Texas Instruments to address the President's economic growth proposals and soliciting our ideas on growing the economy.

As you know, the centerpiece of the President's proposal is the elimination of double taxation on dividends, and we strongly support that idea. We believe that ending this tax will promote consumer spending, but more importantly, it will stimulate business investment by companies, as well as personal investment by individuals, and ultimately it will serve to encourage good corporate governance and accountability.

And why better corporate governance? Well, the plan, we believe, will create more transparency, make corporate earnings easier to monitor, and place equity financing on more equal footing with debt financing, as you mentioned earlier. In doing so, it will reduce the opportunity for poorly managed companies to mislead their investors.

Although, as you note, the high tech industry in general has not traditionally paid dividends, TI has issued quarterly dividends since 1962, and our goal has always been to create value for our shareholders. We believe that paying a dividend requires financial discipline and accountability, and we believe it also sends a message to our shareholders about our financial health and the credibility, as well as the sustainability, of our earnings.

The deemed dividend provision of the President's plan means that the plan does not favor only companies that pay dividends. In fact, it benefits almost any company that is consistently profitable and, as you noted, pays taxes. Although it does not specifically penalize companies that choose not to pay a dividend, it does force those companies to make a better case to shareholders that the money is invested wisely within the company. So this is critical for many startup and high tech companies where significant capital must be invested in R&D as well as plant and equipment.

Indeed, dividends help investors keep track of companies in a way that I think has not always been generally appreciated or understood. Corporations, as it has been noted, have routinely been permitted to hold onto their earnings because of the widely acknowledged inefficiency of dividends due to the double taxation. However, stockholders who cannot realize value through dividends must depend on continued stock price appreciation for their investment to grow, and this increased pressure on the stock price has, in some cases, apparently led companies to engage in creative financial engineering and inappropriate managing of their earnings in order to manipulate the stock price.

And if this was not bad enough, the double taxation of dividends creates a bias toward debt on the part of the companies, as well as their shareholders. So the President's plan will even the playing field between debt and equity financing and ultimately result in lower levels of corporate debt. Companies with lighter debt burdens are better able to survive economic downturns.

In fact, we can go beyond prediction and actually look at some data points. A recent Money magazine article reported that when New Zealand repealed its dividend tax in 1988, debt-to-equity levels at 92 representative companies fell an average of 15 percent. Likewise, when Australia repealed its dividend tax in 1987, the use of dividend reinvestment plans grew from 2.5 percent of corporate capital raised to an almost unbelievable 33 percent within 5 years. So if we could achieve that in this country, I believe it would have a tremendous positive impact.

Under this proposal, companies will need to pay more attention to cash, how to manage it and how to invest it. Making companies better and more efficient at managing their money will have profound, long-term benefits that will transcend any short-term economic or stock market boost. Ending double taxation on dividends will ultimately lead to improved corporate governance and a restoration of confidence in American companies, and that I believe will lead directly to economic growth.

Market forces should be allowed to govern a company's decisions about dividend rather than a law which, at the moment, clearly discourages them. If I have a key message for you, it is this: The capitalist system is based on financial incentives. The Administration's proposal to eliminate disincentives for dividends and wealth creation and to embrace incentives which promote those objectives is right on target. Ultimately I believe this will transform behaviors for both companies and investors.

Thank you again for this opportunity.

[The prepared statement of Ms. Bull follows:]

PREPARED STATEMENT OF ELIZABETH W. BULL, VICE PRESIDENT AND TREASURER, TEXAS INSTRUMENTS INCORPORATED

Mr. Chairman and Members of the Committee:

Thank you for extending an invitation to Texas Instruments to address the President's economic growth proposals and soliciting our ideas on growing the economy.

The centerpiece of the President's proposal is the elimination of double taxation on dividends and we strongly support that idea. We believe that ending this tax will promote consumer spending. More importantly, it will stimulate business investment by companies as well as personal investment by individuals, and ultimately, it will serve to encourage good corporate governance and accountability.

Why better corporate governance? The plan will create more transparency, make corporate earnings easier to monitor, and place equity financing on more equal footing with debt financing. In doing so, it will reduce the opportunity for poorly managed companies to mislead their investors.

Although the high tech industry in general has not traditionally paid dividends, Texas Instruments has issued quarterly dividends since 1962. Our goal has always been to create value for our shareholders. Paying a dividend requires financial discipline and accountability. We believe it sends a message to our shareholders about our financial health and the credibility and sustainability of our earnings.

The deemed dividend provision of the President's plan means that the plan does not favor only companies that pay dividends. In fact, it benefits almost any company that is consistently profitable and pays taxes. And, although it does not specifically penalize companies that choose not to pay a dividend, it forces those companies to make a better case to shareholders that any money not paid in dividends will be invested wisely within the company. It shines a strong light on corporate financial management and accountability. This is critical for many start-up and high tech companies where significant capital must be invested in R&D and plant and equipment.

Indeed, dividends help investors keep track of companies in a way that was not generally appreciated or understood during the dot com boom and collapse. Corporations have routinely been permitted to hold onto their earnings because of the widely acknowledged inefficiency of dividends, due to double taxation. However, stockholders who cannot realize value through dividends must depend on continued stock price appreciation for their investment to grow. This increased pressure on the stock price has, in some cases, apparently led companies to engage in creative financial engineering and inappropriate managing of their earnings in order to manipulate the stock price.

If this wasn't bad enough, the double taxation of dividends creates a bias toward debt on the part of companies and their shareholders. Simply put, the repayment of debt financing is taxed only once (to the payee) while the repayment of equity financing, the dividend, is taxable to the corporation as well as the shareholder. The President's plan will even the playing field between debt and equity financing, remove the bias, and ultimately result in lower levels of corporate debt. Companies with lighter debt burdens are better able to survive economic downturns.

Under this proposal, companies will need to pay more attention to cash, how to manage it and how to invest it. Making companies better and more efficient at managing their money will have profound long-term benefits that will transcend any short-term economic or stock market boost. Ending double taxation on dividends will ultimately lead to a restoration of confidence in American companies and that, I believe, will lead directly to economic growth.

Market forces should be allowed to govern a company's decision about dividends rather than a law which, at the moment, clearly discourages them. If I have a key message for you today, this is it: the capitalist system is based on financial incentives. The Administration's proposal to eliminate disincentives for dividends and wealth-creation and to embrace incentives which promote those objectives is right on target. Ultimately, this will transform behaviors for both companies and investors.

This plan also would promote better debt-equity ratios. In fact, we can go beyond predictions and actually have some data points. A recent *Money* magazine article reported that when New Zealand repealed its dividend tax in 1988, debt-to-equity levels at 92 representative companies fell an average of 15 percent. If we could achieve that in this country, it would have tremendous positive consequences for equity markets. Likewise, when Australia repealed its dividend tax in 1987, the use of dividend-reinvestment plans - or DRIPs - grew from 2.5 percent of corporate capital raised to an almost unbelievable 33 percent within five years. This proposal will powerfully change investor behavior.

With consumer spending accounting for two-thirds of U.S. Gross Domestic Product (GDP), it makes good sense to provide consumers with more purchasing power. Reducing their tax burden achieves this objective while also providing greater opportunity to make further investments. Likewise, robust business investment will drive economic recovery and job creation. Ending the double taxation of retained earnings and dividends will be a genuine incentive.

I would be happy to take any questions. Thank you very much for this opportunity.

Senator FITZGERALD. Well, Ms. Bull, thank you very much.

Mr. Rowe? John Rowe is the Chairman and CEO of Exelon Corporation in Chicago. This is one Illinois company that I am very proud of. Exelon was last month named the Best Performing Utility Energy Services Company for the second straight year by Business Week, and Forbes this year named Exelon Best in Breed among energy companies. Exelon is the former Unicom, the owner of Commonwealth Edison in Chicago. Unicom merged a couple of years ago with PECO based in Pennsylvania. They have done very well in the last few years. That coincides, not incidentally I think, with the tenure of Mr. Rowe at the company.

So, Mr. Rowe, I deeply appreciate your traveling all the way from Chicago to be here, and thank you very much for coming.

STATEMENT OF JOHN W. ROWE, CHAIRMAN AND CEO, EXELON CORPORATION

Mr. ROWE. Thank you, Mr. Chairman. In turn, we deeply appreciate your interest in this bill which is of the highest importance to our shareholders.

We are the largest provider of electricity in the country in terms of the number of customers we serve. As your remarks were kind enough to state, we have done well over the past several years, but we have managed to do well by improving our service to those customers, and we are very proud of that.

Last year we paid approximately 40 percent of our total income in dividends, or about half of the income of our regulated retail subsidiaries. We have an announced plan to increase those dividends by 4 to 5 percent per year. But if the bias that now exists against dividends were eliminated, we would increase those dividends even further which would provide immediate benefits to our shareholders.

As we look at the proposed legislation, we believe it is first important to note that it benefits Americans from all walks of life, not just a few.

Second, as the Chairman has discussed, this is legislation that would help promote corporate responsibility. It would also help restore investor confidence in at least part of the stock market, eliminate the bias in favor of retained earnings, as other witnesses have testified, and decrease incentives for companies to engage in transactions which are largely tax motivated.

As the Chairman knows, shareholding is not confined to a few who are wealthy. Over 84 million people representing over half of American households own shares in public companies. According to IRS data, over 15 million individuals who claimed under $50,000 in income received $27.2 billion in dividends.

As you might expect, investors in utilities have tended historically to be that kind of people. It is very difficult to know exact de-

mographics because many utility shares are held in mutual funds, and you have to go behind the initial owner. But studies that have been done by the Edison Electric Institute and the American Gas Association suggest that 70 percent of utility shareholders are 65 or older and the typical utility shareholder lives on a fixed income and has held that stock for over 9 years.

Now, we in our business are proud of having shareholders like that, and we look upon some others like hedge funds with some skepticism. Historically we have been able, by doing a job, to provide the kind of investment that is good for those kinds of people. But this is where the corporate responsibility factor comes in.

I know that the Chairman's earlier career was in banking. There is an old joke in banking that the worst thing that can happen to a good bank is to have a stupid bank for a competitor. Well, in the energy business, the worst thing that can happen to somebody trying to do an honest job is to have dishonest competitors.

We have suffered and suffered substantially as an industry over the past decade or so by some competitors, whose dishonesty is now widely known, and others who have tried to grab the brass ring of endless growth and, in doing so, have forfeited their real responsibilities for public service and steady cash flow.

The Chairman pointed out in his opening remarks that earnings sometimes can be manipulated and cash is harder to do. That is certainly correct, but I fear we are dealing with a phenomenon that is even more difficult than that. We are dealing with companies who are competing not on the basis of cash flow, not even on the basis of earnings, but on earnings forecasts. And sometimes the person with simply the rosiest glasses or the boldest willingness to take risks is the one who commands the highest P/E ratio. This is the kind of thing that emphasis on paying dividends will help correct. Companies will have to look for more cash to pay dividends.

It is only 2 years ago that people like me were laughed at for suggesting dividend increases as something our shareholders might want. Companies, as the witness from Texas Instruments suggested, will be forced to pay more attention to their quality of balance sheet. It is only 2 years ago that people like me were considered fuddy-duddys in the energy industry because we still thought having equity was a good thing. Companies will be forced to look for resilience in their operations and to explain to shareholders why we are not paying out more dividends and increasing dividends more.

This goes to one of the most powerful aspects of a market and economic democracy. This goes to the sense that why should shareholders not have more chances to decide how to reinvest because if we pay more dividends and we look at our expansion plans or our capital plans, we have to go back to those shareholders and ask for more money. And that is not a bad thing.

So, respectfully, Mr. Chairman, we ardently support this bill. The President's proposal is, of course, good for our company. We believe it is very good for our country and will help make the corporate community the stewards of capital we all want them to be.

Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Rowe follows:]

PREPARED STATEMENT OF JOHN W. ROWE, CHAIRMAN AND CEO, EXELON CORPORATION

Chairman Fitzgerald, Members of the Subcommittee:

I am John Rowe, Chairman and Chief Executive Officer of Exelon Corporation, a Chicago-based utility holding company. Our two utilities, Commonwealth Edison (ComEd) and PECO Energy, serve over 5.1 million customers in Northern Illinois and Southeastern Pennsylvania, respectively. Exelon also has one of the nation's largest generation portfolios, owning or controlling the output from over 40,000 megawatts of electric capacity. Exelon's Power Team affiliate markets the power from this generation in the 48 Continental United States and Canada.

It is a pleasure to appear before you today to discuss promoting corporate responsibility through the elimination of dividend taxation at the shareholder level.

Exelon's Dividend Philosophy

At Exelon, our core mission is "keeping the lights on" for our 5.1 million customers. At the same time, our Board of Directors has a fiduciary responsibility to grow the value of the company for our shareholders.

In determining how to optimize the investment for our shareholders, we must balance our desire for long-term growth in the terms of appreciation of the stock price with the desire of some investors for a shorter-term return through dividend income.

When Exelon was created in 2000 from the merger of Unicom, ComEd's parent company, and PECO Energy, the Board of Directors made a decision to focus on total return to shareholders. Exelon's dividend rate for 2002 represented about a 50 percent payout of the expected 2002 earnings per share from Exelon's regulated electricity delivery businesses. The Board has stated in regulatory filings that Exelon intends to grow the dividend to about a 60 percent payout of earnings from regulated operations based on cash flow and earnings growth prospects for Energy Delivery. Earlier this year, we stated in regulatory filings that Exelon intends to grow its dividend over time at a rate of approximately 4 to 5 percent, commensurate with long-term earnings growth.

While specific demographic data for Exelon Corporation shareholders is not available, 70 percent of individual utility shareholders are 65 or older, and that the typical utility shareholder lives on a fixed income and has held stock for more than 9 years, according to recent surveys by the American Gas Association and the Edison Electric Institute.

This shareholder profile is not surprising, since utilities have been viewed historically an attractive investment for investors interested in a stock with stable growth and a track record of issuing predictable dividends. As the industry has undergone deregulation over the last decade, that image has changed somewhat, with many companies focusing more on growth and less on issuing high levels of dividends. This change occurred not only as a result of the changes in our industry, but also as a result of the changing expectations of investors and the need for utilities to compete for capital with other industries which offered high-growth stocks but little return in the form of dividends.

Utilities have responded to these changing dynamics in a variety of ways: some utilities—mostly in states that did not fully deregulate their retail electric markets—have continued to provide relatively high levels of dividend income; other utilities have cut their dividend and invested their retained earnings in a variety of businesses; others—like Exelon—have taken a hybrid approach, pursuing unregulated business lines as a means of growth, while relying on regulated business units to provide a steady stream of income for dividends.

Our strategy for achieving the optimum balance for our shareholders was challenged during the late 1990s by individual investors and the investment community as a result of the tremendous run-up in the stock market. A handful of energy companies focused on aggressively pursuing growth in energy trading and non-core businesses as a means of driving up the price of their stock. While this strategy resulted in some truly spectacular results for some companies, the results were short-lived, and some of those same companies are currently in the midst of bankruptcy proceedings.

Meanwhile, Exelon's strategy has yielded impressive results that have been recognized by leading industry observers. Last month, *Business Week* named Exelon the best performing utility/energy services company for the second straight year. Exelon was also among the top 50 S&P Index companies for the second straight year in the *Business Week* survey, which rated companies based on growth in sales, profits and return to shareholders, performance over both one and three years, profit margins, and return on equity. Exelon was also recognized this year by Forbes, which named Exelon "Best in Breed" among energy companies.

Promoting Corporate Responsibility Through Elimination of the Dividend Tax

President Bush's proposal to eliminate the taxation of dividends would provide significant direct and indirect benefits to the nation's economy. The Council of Economic Advisors has estimated that eliminating the taxation of dividends would pump $52 billion into the economy annually.

The President's dividend proposal will not simply benefit the wealthy. Elimination of the dividend tax will benefit Americans from all walks of life. More Americans than ever—84 million people representing over 50 percent of American households—own shares in public companies. According to Internal Revenue Service data, over 15 million individuals who claimed under $50,000 in income in 2000 received over $27.2 billion in dividends.

In addition to the financial benefits, elimination of the dividend tax would have significant long-term economic benefits. Chief among these is the promotion of corporate responsibility, which will benefit investors—and all Americans—in a number of ways.

First, eliminating the dividend tax would help restore investor confidence in the volatile stock market and promote corporate responsibility by strengthening the degree to which dividends are viewed as an indicator of a company's financial health. Under the President's proposal, the dividends would be exempt from taxation only to the extent that the company's earnings have already been taxed.

Dividend payment has long been an indicator of a company's long-term stability. According to the *Wall Street Journal*, the price of dividend-paying stocks in the Standard & Poors 500 index fell 17 percent during first 9 months of 2002, while the price of non-dividend-paying stocks fell 39 percent. The President's proposal will make dividend payment an even stronger indicator of financial health and will promote corporate responsibility by making companies declare the extent to which their dividends are paid from taxable earnings.

Second, eliminating the double taxation of dividends will eliminate the current bias in favor of retained earnings and will require corporations to be more diligent in evaluating investments made with retained earnings.

Under current law, many investors prefer growth stocks to dividend-producing stocks since capital gains are generally taxed at a lower rate than dividends, which are treated as ordinary income. Most economists expect corporations to reduce the amount of retained earnings because this bias will be eliminated. Since companies will have less excess cash on hand, companies will have to be more selective when investing that cash in new projects. For projects requiring financing beyond that available from a company's retained earnings, the market will impose its own rigorous review of the venture, providing an added layer of scrutiny.

In effect, the bias is favor of retained earnings is also a bias against companies that pay dividends, since many investors prefer companies that retain a higher portion of their earnings. This has significant implications for electric and gas utilities, which are facing the prospect of raising hundreds of billions of dollars for infrastructure investment in the next decade.

It is important to note that the President's proposal also includes provisions to prevent the current bias against dividends from becoming a bias in favor of dividend distribution. Specifically, the proposal allows for the adjustment of a shareholder's stock basis to reflect retained earnings to the extent they have already been taxed. This provision ensures that the tax code is neutral in terms of dividends and retained earnings, allowing investment decisions to be guided by sound business principles rather than tax policy. It is essential that this provision be included in any legislation implementing the President's proposal.

Finally, since corporations must have taxable earnings for dividends to be tax-free, eliminating the taxation of dividends will decrease incentives for companies to engage in transactions whose only purpose is to minimize tax liability. This will shift the focus of both companies and investors to a corporation's cash earnings, rather than book earnings. Why is this important? Since dividends can only be paid on a tax-free basis from cash, the payment of dividends will provide investors with valuable insights into the financial health of the company. While companies can engage in various transactions to inflate book earnings, the ability to artificially inflate cash earnings is limited. Since dividend payments cannot continue without adequate cash earnings, investors will be better able to determine the true financial health of a corporation.

The President's proposal could help avert future tax shelter crises such as the one that is the subject of the Senate Finance Committee's hearing on Enron this morning. The Joint Committee on Taxation's "Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues" consists of three volumes totaling nearly 2,700 pages. Among the findings was the fact that while

Enron reported $2.3 billion in net earning from 1996 to 1999, the company reported tax losses of $3 billion during those years. During this same period, Enron paid out over $1.5 billion in dividends. Under the President's proposal, none of these dividends would have been tax-free. Clearly, this would have set off alarm bells for investors.

Conclusion

Mr. Chairman, I realize that Congress has a number of competing budget priorities, and that some members view tax cuts to be undesirable at this time. Nevertheless, the elimination of dividends will have significant benefits in both the short-term and the long-term.

One of the lessons of the last three years is that companies who put growth ahead of value ended up not getting either. The President's proposal will encourage companies to be more responsible by focusing on activities that result in value, not merely growth. I strongly urge Members of the Subcommittee to support it.

Thank you.

Senator FITZGERALD. Mr. Rowe, thank you.

Finally, we have Professor Siegel, and then we will go back to questions. Mr. Elson, you can feel free to leave when you have to.

Professor Siegel, I recalled a few weeks ago, when I was putting together this hearing, an op-ed by somebody that I could not remember their name about a year ago in the *Wall Street Journal* talking about how does one measure corporate performance before FASB, before the SEC, before publicly reported financial statements were out there. Well, you did it the old-fashioned way. You looked at dividends and what a company was able to fork over in cash to their shareholders. Remember, that is how investors did it for a very long time before the SEC.

I could not remember who wrote that, and I had my staff get a copy of the op-ed. I thought it was brilliant op-ed at the time. We tracked you down. I am honored that you would be here. I think that was a brilliant and prescient piece because that was long before the Administration proposed ending the double taxation of corporate dividends, and it was your answer over a year ago to correcting the corporate malfeasance that we had seen so much of in 2001 in the United States.

So, Professor Siegel, thank you for coming down from Wharton to testify before our humble Committee.

STATEMENT OF JEREMY J. SIEGEL, PROFESSOR OF FINANCE, THE WHARTON SCHOOL, UNIVERSITY OF PENNSYLVANIA

Mr. SIEGEL. Thank you, Mr. Chairman. Let me say I do feel somewhat at home. I was born and raised in Chicago, your State. I now live in Philadelphia and get excellent service from Exelon from Mr. Rowe on my right here.

[Laughter.]

Mr. SIEGEL. So even though I am in DC, I feel like I am at home.

Yes, it was my historical studies, when I went all the way back to the beginning of the 19th century and began to think we had 130 years without these regulatory agencies and the markets worked pretty well. When you look at the big difference, it was dividends.

Let me give you my prepared comments.

I strongly support legislation leading to the elimination of the double taxation of dividends. There is no question that this legislation will have profoundly favorable effects on corporate governance issues currently plaguing the markets. Ending this punitive tax-

ation will increase the credibility of firms' earnings, reduce the amount of debt on the balance sheet, and lower the number of options granted in lieu of cash compensation for employees. In short, this legislation will better align the interests of management with those of the shareholders.

The most effective way to encourage dividends in my opinion would be to make dividends deductible from corporate income. You spoke a little bit to Mr. Fisher about that just a few minutes ago, and I am sure we can talk about it more. This would make the treatment of dividends in computing corporate taxes no different than that of interest payments to bondholders. While deductibility at the corporate level in my opinion more directly incentivizes managers to pay dividends, President Bush's plan to exempt qualified dividends from personal taxes should also increase dividends and improve corporate governance.

In the last 20 years, we have seen a dramatic change in the composition of the real returns to stocks. From 1871 through 1980, the average dividend yield on stocks was 5 percent, constituting more than three-quarters of the total real return from equity. But starting in the 1980s and accelerating in the 1990s, the dividend yield plummeted. Currently, even with depressed stock market levels, the dividend yield on the S&P 500 Index is under 2 percent, a level that is less than 30 percent of the projected long-term real return on stocks.

The principal reason for the drop in the dividend yield is the double taxation of dividends. Double taxation encourages firms to distribute their profits by generating capital gains which are taxed at a much lower rate than dividends. Although this tax incentive was always present in the tax code, the shift away from cash dividends was accelerated by an SEC action taken in 1982 that made it easier for firms to use profits to buy back their own shares. This ruling, coupled with the double taxation of dividends, and the increase in management stock options, which I will talk about presently, created the perfect storm that drowned the dividend yield.

Cash dividends are tangible and very well defined, but earnings are not. Even if the firm applies the strictest GAAP conventions, there are arbitrary choices and assumptions such as depreciation schedules and pension return that firms make to come up with a single earnings number. Suffice it to say, that judging a firm's value on the basis of earnings alone has been subject to increasing error. Cash dividends are hard to fake. Earnings are not. With dividends down, stock investors must put increasing trust in earnings. Unfortunately, high profile earnings scandals have broken that trust.

Eliminating the double taxation of dividends is a tangible action that should restore that trust.

The incentive to use debt instead of equity has led to increasingly deceptive securities. Enron pioneered the use of MIPS, or monthly income preferred shares, that could be treated either as debt or as equity, depending on who was looking. When Enron reported to the IRS, MIPS were referred to as debt, and Enron deducted an interest expense. But in its earnings reports to shareholders, MIPS were referred to as equity. The U.S. Treasury concluded that this constituted abusive accounting practices and tried

to crack down on the use of MIPS. Unfortunately, the Treasury was not successful and the use of these securities has proliferated. If dividends were not tax-disadvantaged, MIPS would never have been invented, as there would be no incentive for firms to hide debt as equity or vice versa.

The unequal treatment of debt and equity also leads to excessive debt in firms' capital structures. Under these circumstances, if there is a negative shock to the demand for a firm's product, such as we see now with the airline industry, highly leveraged firms will experience financial distress and perhaps even bankruptcy. Tax deductibility of dividends would encourage more equity on the firm's balance sheet and lower the probability of this financial distress.

Finally, the shift from paying dividends to generating capital gains encouraged the proliferation of option-based compensation packages that are not accurately reflected in income statements and distort the decision of management. Options values are only based on the price of the stock, not on the dividend. If management holds substantial options, it is against their interest to pay dividends since the value of their options will only be enhanced by turning those profits into a higher price for their shares. Option holders also desire that the firm take on more risks than shareholders since the gain in option price from favorable developments outweigh those from unfavorable developments.

If the payment of dividends were not tax-disadvantaged, I believe option grants would become a far less popular form of compensation and would be replaced either by cash compensation or stock grants. Since the gains and losses realized in stock grants are identical to those of the shareholders, these grants better align the interests of management and investors.

In summary, corporate governance would be improved if this legislation is enacted. Investors would have more trust in earnings reports. Firms' capital structures would improve, and there would be better aligned incentives in the compensation packages for management. While I think that deducting dividend payments from corporate income best achieves these goals, the legislation we are discussing here today makes great strides towards those very same ends.

Thank you.

[The prepared statement of Mr. Siegel follows:]

PREPARED STATEMENT OF JEREMY J. SIEGEL, PROFESSOR OF FINANCE, THE WHARTON SCHOOL, UNIVERSITY OF PENNSYLVANIA

I strongly support legislation leading to the elimination of the double taxation of dividends. There is no question that this legislation will have profoundly favorable effects on the corporate governance issues currently plaguing the market. Ending the punitive taxation of dividends will increase the credibility of firms' earnings, reduce the amount of debt on balance sheets, and lower the number of options granted in lieu of cash compensation for employees. In short, this legislation will better align the interests of management with those of shareholders.

In order to encourage cash dividend payments, I prefer that dividends to shareholders be deductible from corporate income, just as interest payments to bondholders have always been deductible. I believe that deductibility at the corporate level more directly incentivizes managers to pay dividends than exemption at the personal level. However, President Bush's plan to exempt qualified dividends from personal taxes should also increase dividends and improve corporate governance.

The fall in dividend yield

In the United States, the after-inflation rate of return on stocks over all long-term periods has averaged between 6.5 percent and 7 percent. Yet there has been a dramatic change in the *composition* of this return over the past twenty years. From 1871 through 1980, the average dividend yield on stocks was 5 percent. This means that for over one hundred years, more than three-quarters of the total real returns on stocks came from cash dividends. But starting in the 1980s, and accelerating in the 1990s, the dividend yield plummeted. Currently, even with depressed stock market levels, the dividend yield on the S&P 500 Index is under 2 percent, a level that is less than 30 percent of the projected long-term real return on stocks.

The principal reason for the drop in dividend yield is the double taxation of dividends. This encourages firms to distribute their profits by generating capital gains, which are taxed at a much lower rate rather than dividends that are taxed at investors' highest marginal tax rate. Although this incentive to substitute capital gains for dividends was always present in the tax code, the shift away from cash dividends was accelerated by an SEC action in 1982 (Ruling 10b–18, amendment to the Securities Act of 1934) that made it easier for firms to use profits to buy back their own shares. This ruling, coupled with the double taxation of dividends and the increase in management stock options, described below, created the perfect storm that drowned the dividend yield.

The ambiguity of earnings

The shift to capital gains and away from dividends has led to a number of developments that hurts corporate governance and shareholders. Cash dividends are tangible and very well defined, but earnings are not. Although there are rules outlined in GAAP for computing "reported earnings," management often chooses a more generous accounting convention, called "operating earnings," that has no widely accepted definition. As a result, judging a firm's value on the basis of earnings alone has been subject to increased error.

Moreover, there are a tremendous amount of assumptions that go into calculating earnings. Even if the firm applies the strictest GAAP conventions, there are still arbitrary choices firms must make such as which schedules should be used to depreciate assets, what future return should be used to calculate pension plan assets, how fast and in what period revenue should be recognized, and what capital expenditures should be capitalized.

It is much harder, however for management to deceive shareholders about the true state of profitability of the firm when most of the profits are paid out as cash dividends. This is because accounting profits that are not backed by positive cash flows are much harder to turn into dividends. It is unlikely that Enron or Tyco could have deceived investors and analysts as long as they did if they were distributing a large share of their purported profits to stockholders.

It is well known that earnings numbers can be manipulated to show a brighter picture by tweaking a few assumptions. In the past, this was not such a problem since most of the real return was derived from cash dividend payments. But today, with returns relying on future earnings growth, trust in earnings is paramount. Unfortunately, the high profile earnings scandals have broken that trust. Eliminating the double taxation of dividends is one tangible action that could restore trust quickly.

Deceptive Securities and Excessive Debt

Since interest on debt is deductible, while dividends are not, it is in the interest of management to substitute debt for equity. Yet higher debt may harm a firm's credit rating. This had led to the issuance of deceptive securities that qualify as debt for the purpose of tax deductibility yet are viewed as equity by the rating agencies.

Enron's incentive to manipulate its balance sheet was brought to light by the *Wall Street Journal* on February 4, 2002 in an article titled "How the Treasury Department Lost a Battle against a Dubious Security." This expose showed how Enron employed a security devised by Goldman Sachs that, depending on who is looking, can be treated as either debt or equity. Goldman's securities, or MIPS (Monthly Income Preferred Shares), 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 took great strides to hide its debt from shareholders. Yet the use of MIPS was and still is perfectly legal. The U.S. Treasury disagreed with Enron's use of these securities, and in late 1995 tried to crack down on what it considered

to be abusive accounting practices. Unfortunately, an army of lobbyists successfully forced the Treasury to admit defeat in 1998 after a 3-year battle in the courts. And despite the U.S. Treasury's persistent attempt to shut this security down, almost $200 billion of these MIPS, whose existence is solely to circumvent the unequal deductibility of interest and dividends, are currently outstanding. If dividends were not tax-disadvantaged, MIPS would never have been invented as there would be no incentive for firms to hide debt as equity or vice versa.

Maintaining the tax deductibility of interest payments while denying it for dividends has also induced management to use excessive debt in their capital structure. This means that if there is a negative shock to demand for a firm's product (such as what is happening now to airlines), a highly leveraged firm will experience financial distress and possible bankruptcy. Tax deductibility of dividends would encourage more equity on the firm's balance sheet and lower the probability of financial distress.

Option Grants

Finally, the shift from paying dividends to generating capital gains encouraged the proliferation of option-based compensation packages that are not accurately reflected in income statements and distort the decisions of management. Option values are only based on the price of the stock, not on the dividend. If management holds substantial options, it is against their interest to pay dividends, since the value of their options will only be enhanced by turning those profits into a higher price for the shares. Option holders also desire that the firm take on more risks than shareholders, since the gains in option price of an upside surprise are far greater than the losses caused by a downside surprise.

If the payment of dividends were not tax-disadvantaged, I believe option grants would become a less popular form of compensation and would be replaced by either cash compensation or stock grants. The gains and losses realized in stock grants are identical to those of shareholders and help align the interests of management and investors.

Summary

In summary, corporate governance would be improved if this legislation is enacted. Investors would be better equipped to make investment decisions based on true profitability if firms were paying out more of their earnings as cash dividends. Firms' capital structure would improve, and there would be better aligned incentives in compensation packages for management. While I think deducting dividend payments from corporate income best achieves these goals, the legislation we are discussing here today makes great strides towards the same ends.

Senator FITZGERALD. Professor Siegel, thank you very much. I would like to start off with you right away to talk about your historical studies. Let us go back to the late 1800s before the Federal income tax and also before the SEC. Let us say the late 1890s when Standard Oil was going around. John D. Rockefeller used to offer his stock to small oil producers that he would be buying up. But he had no publicly available financial statements, in fact, did he at that time?

Mr. SIEGEL. No. Although there were accounting firms, there was no legislation on the New York Stock Exchange that really mandated more than a very cursory examination of what financial statements were——

Senator FITZGERALD. So the New York Stock Exchange may have required something?

Mr. SIEGEL. They may have required some of the firms on a yearly basis to report. I have not checked on the exact requirements of the firms. But clearly it was nowhere near what we have today and certainly what we have had since the establishment of the SEC in the 1930s.

Senator FITZGERALD. And it was only I believe, was it not, around the turn of the century that the New York Stock Exchange started recommending some reporting to shareholders? Of course,

there was no Federal law. Prior to that, the stock exchange would not have even had a rule, would it?

Mr. SIEGEL. No. Prior to that, there was not even a rule from the stock exchange. In other words, the firms themselves had to present credibility to the shareholders.

Senator FITZGERALD. And how did they do that?

Mr. SIEGEL. And they presented that credibility through saying these are the cash disbursements, the dividends, that we have been paying for years and that we hope to continue to pay and increase in our role as a firm listed on the New York Stock Exchange.

Senator FITZGERALD. That is interesting. Do you think the investors back then were less protected than they are today, now that we have the SEC?

Mr. SIEGEL. I would say we are more protected today because the shareholder population has increased so dramatically. We have more people that are not as sophisticated with understanding all of the ins and outs of holding shares. But there were advisors back then, there were brokers back then, and to my knowledge they pitched the shares on the basis of the dividend.

By the way, dividend yields back in the 19th century were not uncommon to be 7, 8, 9 percent. They were 2 to 3 percentage points above the bonds. They were saying these are riskier securities. You cannot count on capital gains. You are going to count on these dividends and these dividend yields, and that was it. If they could pay those dividends and had a good record at paying those dividends, then they were recommended and they were bought by investors.

Senator FITZGERALD. Back before the SEC, we of course had notable stock market collapses such as 1929 that led to the SEC, and prior to the crash in the late twenties we had many other crashes where investors were totally wiped out. But in the recent collapses in the stock market where several trillion dollars in market capitalization have evaporated, many companies, particularly high tech firms, that were once worth billions and billions of dollars, became worthless. Enron, which was I forget what its market cap was at the height, maybe $60 billion or something like that?

Mr. ROWE. $70 billion.

Mr. SIEGEL. $70 billion.

Senator FITZGERALD. $70 billion at the height. Worthless.

The collapse we have had in the last couple of years with the dotcoms and so forth, that has to rank as one of the most spectacular in our history, is that not correct, even though we have the SEC?

Mr. SIEGEL. Oh, yes, absolutely. The NASDAQ, going down by nearly 80 percent, just about rivals the great crash of 1929 to 1932 in the size. The S&P down 50 percent from the high. That just about equals 1972, but it does rank as one of the very few worst. SEC and all these regulatory agencies are really never going to be able to prevent bubbles. Bubbles are a result of psychology and similar phenomenon, and they will always exist as long as we have free markets.

Senator FITZGERALD. The greater fool theory, right? There is always going to be somebody coming along who——

Mr. SIEGEL. Psychology is often more persistent than some of the direct economic forces or, let me say, the lessons of history.

Senator FITZGERALD. Now, Ms. Bull, you discussed that it is harder to manipulate or manage cash flow than it is earnings. But did we not see in the case of Enron that they actually even managed to manipulate their cash flow reports? I mean, they knew. Skilling knew that, boy, you want to show good cash flow because the really sophisticated investors are not going to look at the earnings report. They are going to look at the cash flow to see what we are really earning. They managed, as I recall, to manipulate their cash flow statements. It was very involved. I do not recall the details. I did at one time know. The New York Times wrote some good pieces on how they manipulated their cash flow. But it is in fact possible, even complying with GAAP and SEC rules, to manipulate the appearance of your cash flow statement.

Ms. BULL. While it might be possible, I would say it is much more difficult now. Enron did take that to a new height or depth, I guess. But it is much more difficult to manipulate cash flow in my opinion.

Senator FITZGERALD. Mr. Rowe, it is good to see you have your day in the sun. I do remember a couple of years ago when firms that were perceived to be stodgy, particularly in the energy business that were not involved in trading, trading was going to be the way of the future, and so many of your competitors got all caught up in that. I think that you guys really look good at this point.

You mentioned that your payout now is about 40 percent and you have plans to increase that even more, possibly did you say as high as 60 percent?

Thank you, Professor Elson. Thank you for being here.

Mr. ROWE. Our current plans are to increase the dividend 4 to 5 percent a year, but if legislation like this proposal passed, I am certain we would increase the dividend more substantially.

Senator FITZGERALD. So that is a good barometer. There have to be a lot of other companies out there like that. You are in a mature industry where you feel it would make sense. Unless you feel you could deploy the cash somewhere and make a better return on it, you feel that you are better off returning it to the shareholders.

Mr. ROWE. Well, we keep hunting for ways to have more value added. But our shareholders send us pretty clear messages that they would prefer to have the choices about capital allocation themselves.

Senator FITZGERALD. Now, you believe, based on the Edison Electric Institute's studies, while it is very hard to determine, that most utility shareholders are senior citizens. Did you say an average age of 70 who would hold the——

Mr. ROWE. Those are the studies that EEI and the American Gas Association made several years ago, yes, Mr. Chairman.

Senator FITZGERALD. Do you know the percentage of institutional and individual shareholders that Exelon has?

Mr. ROWE. In our case it is about two-thirds institutional, one-third individual. But this is what makes giving you a really precise answer difficult. A great many of the people who hold the shares in the mutual funds are themselves senior citizens or other fixed-income people. There is, even in our institutional shareholdings, a strong tendency for utility shares to appeal to ordinary Americans as opposed to a more narrow class. As I indicated in my statement,

we always have hedge funds moving in and out and they may be in one day and out the next. But excepting that, our kinds of securities appeal to ordinary people and the President's proposal would make them even more appealing in that regard. I do think, however, given the confusions of the market, mutual funds are a very appealing way for regular folks to invest even in utilities.

Senator FITZGERALD. Now, what do you think about—Professor Siegel recommends he likes ending the double taxation of dividends, but thinks it should be done at the corporate level, giving a deduction to the corporation to make it on the same basis as debt.

Mr. ROWE. Well, I think that is literally more even-handed, but I am so delighted by this proposal to end double taxation basically that I find no fault with the one we have. I would rather bet on a very good proposal that has the kind of backing this does than look for something that may have one more notch theoretical elegance but has not generated this sort of support.

The way the President has done it has made it very clear that his concern is for the investors and the citizens rather than for the corporate management, and I think that is a good thing.

Senator FITZGERALD. And he would make sure the money is taxed at least once. It is possible to run a corporation so that you are reporting, as you pointed out, as Enron did. They reported $2.3 billion in earnings to shareholders between 1996 and 1999, but they reported a $3 billion tax loss, all the while paying $1.5 billion in dividends. My understanding is, under the President's proposal, you would not get a tax-advantaged dividend to your shareholders if you had not paid taxes on that in the first instance. Is that not correct?

Mr. ROWE. That is my understanding also. I suspect, as the Under Secretary suggested, you have to look at that over a period of 2 or 3 years, and that the tax provision does not work literally year to year. But I think it works over a period of 2 to 3 years to yield the result the Chairman suggests.

Senator FITZGERALD. Now, Professor Siegel, what do you think about that? I mean, one of the advantages, it seems to me the way the Administration has proposed this, is that we would cut down on the incentive for the corporate inversions or finding elaborate ways to avoid tax liability at the corporate level altogether. Enron could not get away with what it got away with in 1996 to 1999 the way the Administration has come up with their proposal. What do you think about that?

Mr. SIEGEL. I think what you say is certainly true. I also paid close attention to your comments about the S corporations which flow through to the individuals. That is what I think is really ideal, S corporations or REITs, as we all know, which are flow through as long as a certain percentage—they are not taxed as entities. That is what I think would be closest achieved by having the deductibility at the corporate level because you would probably then—the only tax would be on the retained earnings of the firm. And as you mentioned, a lot of times, when firms retain earnings and build up these cash hoards, it is not in the interest of shareholders. They spend it on acquisitions that do not always make sense.

Senator FITZGERALD. Then that would be a bias against retained earnings, would it not?

Mr. SIEGEL. It would be a bias against retained earnings, yes. And I think there is too much bias in favor of it. I want to redress that, and I think that if you paid it all out and then get it back, for instance, with dividend reinvestment plans, which are getting more popular, the firm would have to basically get it back from the shareholders on their plans or convince the lenders that this is a good project for them to do. I think it is too easy often when they have a big cash hoard and they do not always pursue those projects that are in the best interest of the shareholders. So, yes, it is a bias against retained earnings and I do not mind a little bias against retained earnings.

Senator FITZGERALD. Well, with that, I want to conclude this hearing. I thank all of you for coming here. Your testimony has been wonderful, and we really appreciate your making yourselves available and taking the time to prepare your testimony. So thank you all very much for coming.

This meeting is adjourned.

[Whereupon, at 11:22 a.m., the hearing was adjourned.]

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