

Giveth and then Taketh Away

By Peter Mork

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"In times like this, states usually get a little extra help from Washington, but instead they're going to give the money to me. I get the money," Clinton, who made \$9.2 million in speaking fees in 2001, said to hoots of laughter.

"As you can see, I can afford a nice suit and tie, but I need an income tax cut, a dividend tax cut," he said sarcastically.

Well I bet President could afford much more than a nice suit and tie with \$9.2 million in the bank. One thing I bet he doesn't have though is a copy of *The Joy of Freedom*, a new book by economist David R. Henderson. It includes some interesting facts about the former President and his wife, Sen. Hillary Rodham-Clinton, which I will touch on later in the paper. But first off, Clinton's remarks deserve a closer look all by themselves. It's scary that a well educated, intelligent, well connected guy like Clinton could make such statements. Scarier is the fact is that he probably knows exactly what he saying.

"THEY'RE GOING TO GIVE THE MONEY TO ME."

Well actually, no, they're not. You see they're not going to "give" the money to anyone. The government is not going to "give" money to Clinton; they are just not going to *take* as much away. That may seem like a minor point but it is actually quite important, especially when former President Clinton seems unable to make the connection.

How can Clinton not make this distinction with his own income? You see President Clinton earned his money. Most likely, Clinton earned his \$9.2 million and the federal government came along and *took* \$3.6 million of it, leaving him nearly \$6 million in the bank. That's of course in addition to his nice suit and tie in his closet.

If the tax rate were lowered to 35% instead of 39% the federal government would take about \$3.3 million instead of \$3.6. He in fact would then be in a position to do the giving. He could even make out a check for \$300,000 to the U.S. Treasury, but I doubt the former President would do so. Even he has to know that there are thousands of charities that would spend his money more effectively than Uncle Sam (that's assuming he would give the money to charity at all).

WOULD THE CLINTONS PAY HIGHER TAXES?







It seems Bill would prefer that the government not “give” him the money but history tells a different story. It is common practice for partners in law firms to take their entire income on the January 1st; the first day of the year. This way they can defer taxes for one year into the future. Interestingly, one particular lawyer did the exact opposite years ago by taking her entire salary in December of 1992 (*Joy of Freedom*, p. 213). She being Hillary Clinton, wife of President elect Bill Clinton, definitely had a motive behind this odd behavior. Could it be that knowing her family was in line to make \$200,000 the next year (Bill’s salary); she preferred not to have that whole amount taxed at the highest rate? Or could she have been privy to the fact that her husband was going to push through a massive tax increase in 1993, and she preferred to get taxed at a lower rate? I might not have got a 1600 on my SATs like Bill but I know tax evasion when I see it.

BESIDE THE POINT

Truthfully though, all this is beside the point. The beauty of this tax proposal is not that it takes less money from the poor or the rich. What it does is set up a system where businesses can make decisions based on what’s good for business, not on what’s the best way to avoid taxes.

Take a look at the table below:

Table 1
Tax Structure Pre-Bush Tax Plan

	Corporate Income	Taxes on Corporation		Earnings After Taxes	Taxes on Individual		Individual’s Income
Corporate Debt	\$100.00	0%		\$100.00	39%		\$61.00
Dividends	\$100.00	35%		\$65.00	39%		\$39.65
Retained Earnings	\$100.00	35%		\$65.00	20%		\$52.00

As you can see once a corporation makes \$100 dollars it can do three things with that money.

1. Pay it to its bondholders
2. Pay it to it’s stockholders
3. Keep the money for itself, by repurchasing it’s own stock or just keeping the cash

The only problem is that with today’s tax structure the corporation has a huge incentive towards debt. Since investors keep \$61.00 of a \$100 in earnings it is the preferred vehicle to deliver returns. But a corporation can only have so much debt, as too much will make the firm unstable. That leaves options two and three.

If you could keep 80% or 61% of the corporations \$65 which would you choose? Any rational investor would choose to keep more of their money which is exactly what has motivated corporations over the last several years. When Microsoft makes a billion dollars in profits, instead of handing the money out directly to its investors, it instead keeps the money, which in turn

increases the value of its shares. Then if investors want to realize their gains they are only taxed at a 20% *capital gains tax rate* rather than a 39% *personal income tax rate*.

It is precisely this behavior that helped lead to the accounting shenanigans of Enron and the like. Since investors preferred to have corporations retain their earnings, a select few firms (around 10 out of the largest 1000 companies in the U.S.) began to realize they could falsify their profits, and investors wouldn't know the difference. In other words, no one asked Enron for proof that they actually had the cash (by requesting dividends) so they took advantage of the situation by exaggerating their balance sheets.

THE BEAUTY OF EQUALITY

In essence, equality is the beauty of the Bush's plan. If the plan went through as proposed the top personal income tax rate would fall to 35%, while dividends paid and earnings retained would no longer be taxed at the individual level, leading to the following scenario:

Table 2

Tax Structure Post-Push Tax Plan

	Corporate Income	Taxes on Corporation		Earnings After Taxes	Taxes on Individual		Individual's Income
Corporate Debt	\$100.00	0%	→	\$100.00	35%	→	\$65.00
Dividends	\$100.00	35%	→	\$65.00	0%	→	\$65.00
Retained Earnings	\$100.00	35%	→	\$65.00	0%	→	\$65.00

By eliminating the double taxation on corporate income it doesn't matter if profits are distributed through debt payments, dividends, or retained earnings. You keep 65% anyway you look at it. Small companies that want to retain their earnings to grow will do so. Mid size companies who want to add debt as to not dilute their stock will not hesitate. And who doesn't love real money? Companies will once again begin paying more hard cash because investors will not be getting taxed twice at the highest rates.

Companies making decisions based on what's right for business would no doubt strengthen the U.S. economy. Remember that if the economy grows by only one-third of one percent faster, (0.33%) the dividend tax cut will pay for itself. Personally, I think that's a low number. A growing economy means more jobs, more income, and more stability. While Clinton may think that proposal will be giving a few more bucks to him and his country club friends to buy some extra suits and ties, it's far from the truth. The real gift will be given to the American people: a system that fosters prosperity for years to come.