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IN THIS ISSUE

Lower Tax Rates Spurred Dividend Growth

In May 2003, President George W. Bush signed into law the Jobs and Growth Tax Relief Reconciliation Act. Among its main provisions, the Act cut the individual tax on dividend income to 15 percent; previously, dividend income was taxed according to the regular income tax schedule, with a maximum rate of 35 percent. In their recent paper, **Do Dividend Payments Respond to Taxes? Preliminary Evidence from the 2003 Dividend Tax Cut** (NBER Working Paper No. 10572), authors **Raj Chetty** and **Emmanuel Saez** assess whether the tax reform induced companies to pay out more dividends.

Chetty and Saez data come from the Center for Research in Security Prices (the CRSP tracks dividend, stock price, and share information for NYSE, AMEX, and NASDAQ companies). The authors examine quarterly data on corporate dividend payments spanning 1980 to the first quarter of 2004. Their core sample includes 431,379 firm-quarter observations, although they also examine a "selected sample" of 180,170 firm-quarter observations, taking into account only the firms listed in the 2004 CRSP.

The authors find that, after a continuous decline in dividend payments over more than two decades, total regular dividends have grown by nearly 20 percent since the beginning of 2003 — precisely the point at which the lower tax rate was proposed and subsequently applied retroactively. However, data on aggregate dividends are highly volatile and often driven by the behavior of just a handful of firms. Indeed, the authors find more than 100 cases when a lone firm changes the sample's total dividend payments by more than 5 percent. To deal with this "extreme values" problem, Chetty and Saez analyze three measures of dividend payments that are less sensitive to outliers: 1) number of initiations and terminations of regular dividend payments; 2) number of increases in payment amounts by firms already paying out dividends; and 3) number of "special dividends," that is, dividends intended to be one-time distributions.

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In 1980, the percentage of firms paying monthly, quarterly, semi-annual, or annual dividends stood at 60 percent. By the fourth quarter of 2002, this percentage had declined to 20 percent, only to rebound to nearly 25 percent in 2003. Of the 3,813 firms in the sample, 113 began paying regular dividends in 2003 — a large increase from the average of 22 new dividend payers in prior years. "The fact that the decline in the fraction of dividend payers stops precisely in 2003 constitutes strong evidence that the 2003 tax reform induced more firms to start paying regular dividends," the authors explain. Notably, the increase in dividend initiations occurred across firms of all sizes and industries. This is true even after the authors control for levels and lags of profits, assets and cash holdings, and firm age.

Among firms already paying dividends, Chetty and Saez find that an average of 65 firms increased their dividend payments by 20 percent or more in each of the quarters that followed the tax reform enactment — more than double the average of 31.7 firms in earlier years. The authors also find that the number of firms paying out special, one-time dividends rose substantially immediately after the tax reform, from an average of 11 firms per quarter in 2002 to 28 firms in each of the quarters following the tax reform.

Ultimately, the authors explain, their data "strongly suggest that the 2003 tax reform induced a large, widespread set of firms to initiate regular dividend payments or to raise the payments they were already making." This, they explain, is "unprecedented in the record of publicly traded U.S. corporations in the last three decades." However, Chetty and Saez caution that "it remains to be known whether the 2003 tax [reform] spurred investment and business activity."

— Carlos Lozada

Are Political Platforms Capitalized into Equity Prices?

Financial analysts have long argued that certain industries, such as defense and tobacco, fare better under Republican Administrations, while other industries, such as alternative energy, fare better under Democrats. In **Are Policy Platforms Capitalized into Equity Prices? Evidence from the Bush/Gore 2000 Presidential Election** (NBER Working Paper No. 10333), author **Brian Knight** systematically measures these ties between political parties and industries using evidence on equity returns during the six-month period before the 2000 U.S. Presidential election. He studies a sample of 70 firms favored under the policy platforms of either Bush (41 firms) or Gore (29 firms), as identified by financial analyst reports.

For this sample of 70 politically sensitive firms in the United States, Knight confirms that favorable policies play a key role in determining a firm's total value. During periods in 2000 when the prospects of a Bush victory were increasing, Bush-favored firms outperformed Gore-favored firms. Likewise, during periods in which prospects of a Gore victory were increasing, Gore-favored firms outperformed Bush-favored firms. All told, under the Bush administration, relative to a counterfactual Gore administration, Bush-favored firms were worth 3 percent more and Gore-favored firms were worth 6 percent less, representing a transfer of roughly $100 billion from Gore-favored firms to Bush-favored firms. The most sensitive economic sectors include: tobacco, worth 13 percent more under Bush; Microsoft competitors, worth 15 percent less under Bush; and alternative energy companies, worth 16 percent less under Bush.

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As a measure of the prospects of a Bush victory, Knight used prices of political futures contracts from the Iowa Electronic Market; prices of these contracts can be interpreted as the probability of a candidate's victory in the election. Data from that Market demonstrate that the 2000 race was extremely close throughout the six months preceding the election. In addition, the author shows that these futures contract prices moved in tandem with public opinion tracking polls.

As an alternative to the analyst reports identifying Bush and Gore stocks, the author also incorporated data on campaign contributions. During the 2000 campaign, corporations made both hard money contributions to candidates, through their political action committees (PACs), and soft money contributions, directly from their treasuries to political parties. Firms in traditionally Republican industries tended to give more to Bush, while firms in traditionally Democratic industries gave more to Gore. The results from this campaign contribution analysis are consistent with baseline results; firms giving more to Bush outperformed firms giving to Gore during periods in which the prospects of a Bush victory were increasing and under-performed during periods in which Gore's prospects improved.

The author's findings demonstrate that prospective future policies are reflected in equity prices during the electoral process. This result is surprising given that candidate platforms are not actually legislatively enacted until months, or even years, after the election of candidates to office.

— Les Picker

Work and Family Rise Among College Graduate Women

In **The Long Road to the Fast Track: Career and Family** (NBER Working Paper No. 10331), author **Claudia Goldin** examines the "long and winding road" that female college graduates took during the 20th century to reach the point where between 21 and 27 percent of those who graduated in the 1980s and 1990s achieved the goal of having both a career and a family. For mothers on the fast track, that percentage is about half the 45 to 55 percent of male college graduates with both a career and a family. For men, though, the proportion having both career and offspring is probably the lowest in history.

What has happened, Goldin explains, is that constraints on women's ability to work in fulfilling careers, first after marriage and later after bearing a child, have been loosened. Some changes were rooted in the labor market, including the growth of a wide variety of white-collar jobs, combined with the greater ability of women to hold certain professional jobs. Other changes were rooted in the schools, including the more labor-market relevant college majors taken by women — beginning in the 1970s — and their increased enrollment in professional schools.

Looking at various data sources, primarily for white women because proportionately fewer black women graduated from college, Goldin finds five distinct "cohorts" of women in the 20th century. Each cohort made choices about career and family subject to different constraints. Each generation built on the successes and frustrations of the previous cohort.

The first cohort, graduating from college at the beginning of the 20th century up to the close of World War I, had either "family or career." More than 30 percent of this cohort never married by age 50, a rate that was four times that for their female counterparts who attended no college at all. About half of female college graduates did not have children, leading some contemporaries to ruminate about "race suicide." Most of these college women were from upper-class families. Most of those who did marry did not choose to work in the labor force for long after marriage. Even at around age 45, only 20 percent were in the paid labor force. By far the most popular occupation of these educated women was teaching. Others were librarians, social workers, and nurses, sometimes ranked as "higher callings." Given the constraints of their day, it was not easy to have family and career, Goldin notes.

The second cohort graduated from college mainly during the period between World War I and World War II. The fraction of this cohort who had not married by 50 years of age was about 15 to 20 percent, a decrease from the earlier cohort. About 30 to 35 percent of the married women in this group never had a child, also less than in the earlier cohort. About 25 percent of those who married were in the labor force at age 30 or so. As a group, therefore, they had "job then family," Goldin notes. Although teaching remained the most likely job, some female grads embarked on careers ranging from journalist to veterinarian, giving their mothers some vicarious satisfaction.

The third cohort graduated from college during the era of the "baby boom" — from the end of World War II to the turbulent and socially transforming era of the mid-1960s. This cohort married and had children at exceptionally high rates. Just 8 percent never married, a rate almost as low as for women who did not attend college at all. Just 10 percent of those who married did not have a child. About 17 percent of all these female college graduates were childless.

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Further, Goldin continues, these women were married for the first time at an extremely young age by historical standards for college graduate women. Their median age at first marriage was less than 23. These college graduate women tended to have "family then job," putting priority and timing on having a family first. By age 45, 75 percent were in the labor force, considerably higher than for the previous cohort. But as a group, they became increasingly discontent with a labor market that offered college women little in the way of career advancement.

The fourth cohort, the "baby boom generation," graduated during the heady days of the late 1960s and early 1970s. A substantial fraction put off marriage for several years, resulting in an average age at first marriage of 25 for those born in 1957. Only 12 percent were still single by their mid-40s. About 19 percent of those who married had not had a child by age 40; about 28 percent of the entire cohort remained childless at age 40. About 80 percent of those married were in the labor force at age 45, and were employed in a variety of professions, including those at the top of any occupational prestige scale, and not primarily in teaching. So, Goldin finds, this cohort gained in careers but lost in family. Only 13 to 18 percent achieved career and family by age 40. Some of those putting careers first, putting children on "hold," never had children, perhaps running out the "biological clock."

The final cohort considered, which graduated from college in the 1980s — the "decade of greed" — did try for both career and family. They achieved a slight decline in the fraction with no births — 26 percent by around age 40, rather than 28 percent for the previous cohort. Some 80 percent of those young and married women were working in diverse professions and occupations. So by age 40, about 21 to 27 percent had both work and a family, up from 13 to 18 percent for the previous cohort. Thus this most recent group, Goldin writes, "probably has had the greatest achievement in this regard among all cohorts of college graduate women in U.S. history."

— David R. Francis

Serial Default and Capital Flows

For some years now economists have been puzzled by the question of why, given the potential mutual benefits, rich countries do not invest more capital in poor countries. A number of explanations have been offered for the phenomenon of limited capital flow from rich to poor nations. Among these are the sense that investment is naturally drawn to environments that are already capital rich. Alternatively, a nation's reputation and debt history, its inflation history, the character of its domestic institutions, or its legal entanglements may inhibit investment. All of these may be interpreted as variants of expropriation risk. And, to a greater or lesser degree, there is evidence to support all of these explanations. But in **Serial Default and the "Paradox" of Rich to Poor Capital Flows** (NBER Working Paper No. 10296), authors **Carmen Reinhart** and **Kenneth Rogoff** maintain that the most compelling evidence lies in the area of serial default.

History shows that among debtor countries, serial default on debts in fact is the rule rather than the exception. Sovereign defaults — the failure of an obligor to meet a principal or interest payment in a timely manner — are difficult both to explain and to predict. But the fact remains that sovereign default tends to recur like clockwork in some countries, but not in others. And, the key explanation for why so little capital flows to poor countries, according to Reinhart and Rogoff, is simply that countries with a history of defaulting on debts find it difficult to borrow anew. So many poor countries are in default on their debts; so few funds are channeled through equity; and overall private lending rises more than proportionately with wealth. Therefore, credit markets and political risk are important reasons why less capital flows to developing countries. If credit market imperfections abate over time because of better institutions, then human capital externalities or other "new growth" elements may play a larger role. But as long as the odds of default are as high as 65 percent for some low-income countries, credit risk seems like a far more convincing reason for the paucity of rich-to-poor capital flows, at least for plausible underlying rate of return differentials.

Reinhart and Rogoff find support for this view by charting data on debt default among numerous nations throughout the modern era. A nation's debt history — and especially its record of defaulting on debt — provides a good measure of a country's capacity to bear future debt. Countries with "bad credit history" indeed can graduate from being serial defaulters, the authors note. They point to Greece as a recent example, and suggest that Chile is evidently in the process of graduating, in no small part by steadily reducing its external debt from 134 percent of GNP in 1985 to about 30 percent in 1997. But Reinhart and Rogoff add that full graduation for serial-defaulter status usually takes many years. More significantly, defaults exacerbate weak political institutions, laying the basis for further defaults. Hence, it is little surprise that capital fails to pour into such countries.

Reinhart and Rogoff's data strongly suggest that emerging market countries may need to aim for far lower levels of external debt-to-GDP ratios than has traditionally been considered prudent. Indeed, prudent external debt thresholds may be closer to 15-20 percent, a level seen in several emerging non-defaulting countries, as opposed to the much higher levels one sees today in countries like Turkey and Brazil, which have a history of serial default.

As far as emerging markets are concerned, comparisons to the lofty debt ratios borne by some richer countries are irrelevant. Governments that disregard this difference in debt tolerance, the researchers hypothesize, are likely to perpetuate the serial default syndrome. If anything, net external debt thresholds may have to become more conservative to accommodate the sharp rise seen in many countries' domestic public debt. For instance, domestic government debt as a percent of GDP in India, Korea, and Thailand was in single digits in the early 1980s, but by the late 1990s had risen to 86, 63, and 76 percent respectively, making these countries' reserve accumulation more understandable.

There is also a case for having rich countries make it more difficult, not less, to enforce debt contracts in rich-country courts. Though this would almost certainly reduce debt flows to many countries in the short run, say Reinhart and Rogoff, it would strengthen the international financial system in the long run by reducing reliance on debt and by helping to support the evolution of greater flows in equity and in direct foreign investment.

In short, Reinhart and Rogoff propose that rather than pondering the small flow of capital from rich to poor countries, the more productive concern should be preventing too much capital from flowing to serial defaulters — and especially to their governments — before they have "graduated" out of that status.

— Matt Nesvisky

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