

**Testimony Before the Senate Finance Committee
Wednesday, February 12, 2003**

by

Phil Gramm

Vice Chairman, UBS Warburg

Mr. Chairman and Members of the Finance Committee, I am honored to have the opportunity to testify before you today on a subject of great importance to every American: How can we get the economy into high gear, how can we put our people back to work, and how can we rebuild confidence in our equity markets to strengthen the foundation of our retirement programs and our financial security?

The Downturn

In the 20th century, America experienced two basic types of recessions. In the second half of the century, we experienced inventory cycles. On a more or less regular basis, economic signals were mixed up and unsold inventories mounted. Orders were cut back, the economy retrenched, and over time the excess inventories were consumed. In time, orders would flow again and the economy would recover. In such an environment, it was literally true that the bigger the boom that built up the excess inventories, the bigger the bust that followed. The deeper the recession, the stronger the recovery would be when it took hold.

In the first part of the 20th century, America experienced a series of financial panics due to the difficulty of converting bank deposits into currency and variations in the demand for money generated by the seasonal nature of agriculture.

The downturn we suffer from today is quite different. It is largely the product of a speculative bubble in the equities market. In fact, it is only a small over-statement to say that the financial panics of the 19th and early 20th century were a by-product of an agricultural economy, and the inventory cycles of the middle and late 20th century were the by-product of an industrial economy. The current downturn can be categorized with only a slight exaggeration as the first post-industrial recession in American history.

This is relevant because while we know a great deal about financial panics and inventory cycles, we find ourselves today in less charted waters. Consumption spending has been largely unaffected by the downturn, and the housing boom continues largely unabated. Wage rates have continued to rise as have total wages, even as unemployment has gone up. The current downturn is almost exclusively a product of a collapse in investment.

All this suggests that since consumption has stayed strong throughout the downturn, traditional pump priming to stimulate consumption will probably be ineffective as an economic stimulant. Since weak investment spending is the problem, any effective stimulus plan should have stimulating investment as its primary goal.

The President's Stimulus Plan

By sheer fiscal size alone, the President's proposal will have a very modest impact, since over a ten-year period its aggregate value is less than 2.4% of projected current services federal spending. The strength of the President's proposal is largely in the incentives it creates for new investment spending -- investment funded by private funds that are not now being invested.

The elimination of the double taxation on dividends will have a positive and significant impact on private investment, raising the after-tax return on capital and increasing investment. The elimination of the double taxation on dividends in and of itself should produce a one-time increase in aggregate equity values in the range of up to 5%. The overall efficiency of investment expenditures in both the short and long-term will improve as the current distortions, which encourage corporations to reinvest earnings even when rates of return on investment outside the company exceed internal rates of return, are eliminated. Eliminating the current bias against the payment of dividends will increase dividend payments and make the internal condition of corporations more transparent. The elimination of the double taxation on dividends will help small businesses that are currently discouraged from adopting a corporate structure even if it would allow them greater access to capital. It will eliminate the current tax bias against equity investment, which has encouraged non-economic use of debt rather than equity and made many corporations more vulnerable during downturns. The elimination of the dual taxation on dividends is both an effective stimulant and sound economic policy, which will speed up the recovery and increase longer term growth.

The President's proposal to accelerate the tax cut scheduled to occur in 2004 and 2006 will not alter middle and long-term revenues but will stimulate the economy. The highest tax rate is, in reality, the small business tax rate since the earnings of proprietorships, partnerships and sub-chapter S corporations are taxed at the highest individual rate. Dollar for dollar, accelerating the reduction in the highest rate is probably the most effective stimulus in the President's plan.

Had Congress anticipated how sluggish the recovery would be, it almost certainly would have implemented the tax cut more rapidly, and I urge you to accelerate the entire tax cut and make it retroactive to January 1, 2003. In a static sense, revenues will fall this year, but the longer-term revenue picture, even in a static model, will remain unchanged since the tax cuts will occur anyway in 2004 and 2006. If the recovery can be strengthened, the mid-term revenue picture will be dramatically enhanced. With estimated revenue losses due to the recession this year projected to equal five times the average annual cost of the President's stimulus proposal, the potential gains to be derived from enhancing the recovery are obvious.

Tripling the level of investment expenditures by small business that can be expensed and charged against current earnings will encourage small businesses to retool and, in the process, help grow the economy now.

The uncertainty surrounding the current recovery and the lack of predictability of its behavior strongly argue for a more activist policy. If the recovery could be accelerated, net additional job creation over the next three years in the two million

range is not unachievable. Anything that helps to restore the \$6.7 trillion decline in equity values, which has occurred over the last three years, will greatly benefit the economy and the federal treasury. The sooner a stimulus package is passed the better. All of its provisions should be made retroactive to January 1, 2003 for maximum short-term effect. Finally, let me reiterate that lagging investment is the problem and those provisions that directly affect investment will have the greatest impact.