Statement of
David R. Malpass before the
Subcommittee on Taxation
Senate Finance Committee
June 30, 2005

Chairman Kyl, Senator Jeffords, members of the Sub-Committee, thank you for the invitation to testify on the dividend and capital gains tax rates. The views I express today are my own and are not necessarily those of my employer.

The 2003 tax cut was a critical part of the recovery from the 2001 recession. One of the bill's most important features was the reduction in the tax rate on dividends and capital gains. This reduction in the cost of capital is a key to the economy's fast growth since then. When you tax something less, you get more of it – in this case more dividends, capital, capital gains and the associated jobs and economic growth. The cuts in the dividend and capital gains rates are also a structural improvement in the economy, allowing an improved allocation of capital which will provide increasing growth benefits over time.

S&P 500 Equity Price Index

Source: Haver; Bear, Stearns & Co. Inc.

If the existing rates are allowed to increase, I would expect a large negative reaction in the economy and equity market, reversing some or all of the gains from the tax cut. Higher dividend and capital gains taxes would unwind the improvement in the capital structure. It would likely lead to less economic growth, slower job creation and stock market losses. In my view, this impact would not drag out over a 10 year budget horizon, but would hit the economy and markets immediately.

As Congress considers extending the existing dividend and capital gains rates, I hope it will also consider the flaws in the 2003 tax scoring process. It completely ignored the growth and asset price benefits of the tax cut, leaving Congress to make a major tax decision based on extensive cost data (the federal government's assumed revenue loss), but no information on the benefits to the government and the private sector.

Positive Expected Impact of the 2003 Tax Cut

I supported the 2003 tax cut on the view that it would materially improve the economy by encouraging employment, investment, a more efficient use of capital, and higher equity prices.

From my May 22, 2003 research piece, *Tax Cut - Three-Quarter Loaf* (attached):

> "Our rough estimate is that the tax cut would add $600 billion (5% of market capitalization). This includes the added after-tax value of current dividends, the likelihood of an increase in the dividend payout, and some improvement in the capital structure. Congress estimates the 10-year deficit cost at $350 billion, not counting any economic benefits from the tax cut. Two important factors in the ultimate value of the tax cut will be: 1) when and how Congress clarifies whether tax rates will actually go back up at the end of the tax cut provision; 2) whether this tax cut is used as a step in broader tax or scoring reform. We note once again the unwieldiness of the Congressional budget and tax process and the extreme complexity of the outcome."

From my June 2, 2003 research piece, *Tax Cut Gains $750 Billion, ROI Already 150%* (also attached):

- "The tax cut is still being underestimated. The top marginal rate on federal income will decline from 38.6% to 35%, meaning taxpayers keep 65% of additional income, up from 61.4%. This is a 6% increase, not the widely cited 3.6% benefit. Those receiving dividends will keep 85%, up from 61.4%, <u>a 38% increase in after-tax dividend income</u>. Those earning capital gains will keep 85%, up from 80%, a 6% increase.
- "Since the tax cut suddenly became a reality beginning May 21, U.S. equities have gained some $750 billion. Comparing the $750 billion equity gain to the $300 billion net present value of the ten-year cost (5% discount rate), the gain is 2.5 times – a 150% ROI. *This doesn't count any GDP growth impact from the tax cut, which we expect to become material as the reduced obstacles to labor, capital and innovation spur the economy.*
- "Why didn't equity markets price in the tax cut earlier? Until the end, there was skepticism about the Senate finding the 50 votes needed to pass a growth-oriented bill. The surprisingly powerful solution was a tax cut that was bigger, more growth-oriented, and earlier than almost any expectations."

From my April 30, 2003 testimony to the House Committee on Financial Services:

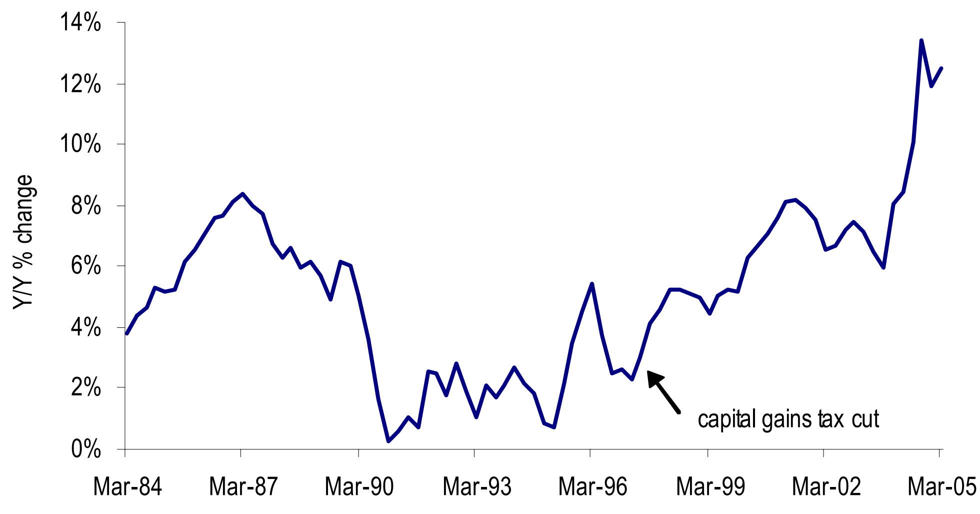
- We have a recent example of the impact of lower asset taxes on the value of assets and the related economic impact. In 1997, the government cut the capital gains tax rate on houses, losing a small amount of revenues but creating a tremendous gain in the national wealth. (By my rough estimate, the U.S. housing stock has increased roughly $4 trillion since the 1997 tax cut, though not all of that is attributable to the tax cut.) Jobs in residential construction surged.

- I would expect the same type of reaction to a dividend tax cut – a massive increase in national wealth and a surge in economic activity -- at a relatively small cost to the federal government.

- The current dividend tax distorts the capital structure. It creates an expensive wedge or toll gate between retained earnings and the shareholder, plus it encourages debt and unproductive acquisitions over equity capital and dividends. Its elimination would improve the allocation of capital, adding substantially to near-term and long-term U.S. economic prospects.

- A dividend tax cut offers a major, near-term addition to the value of equities due to: an increase in the after-tax value of current dividends; an increased dividend payout; faster dividend growth due to the reduction in the corporate cost of capital; and a pro-entrepreneur improvement in the corporate capital structure.

U.S. House Prices (OFHEO)



Source: Haver; Bear, Stearns & Co. Inc.

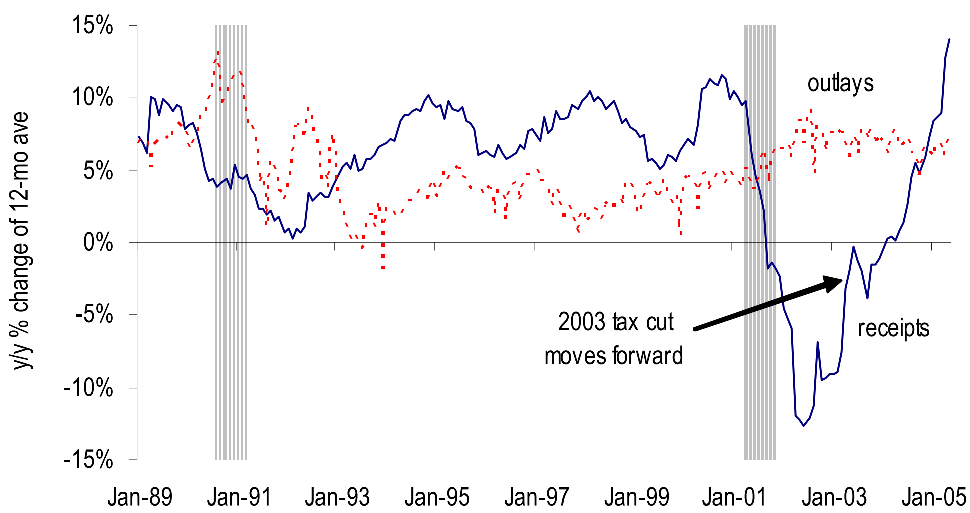
Positive Results of the 2003 Tax Cut

- **Faster growth.** On June 6, 2003, the Bloomberg consensus for third quarter 2003 economic growth was 3.2%, while the actual came in at 7.4%. For the two subsequent quarters, the June 2003 consensus was 3.5% while the actual growth averaged 4.4%. In total, GDP in the three quarters following the tax cut reached $11.47 trillion (annual rate) versus the June 2003 expectation of $11.31 trillion, an annualized gain of $160 billion in the immediate aftermath of the tax cut. Many of the tax cut's benefits accrue over time (in terms of capital formation, work incentives, entrepreneurship), helping U.S. GDP growth remain fast to date (an average 3.9% from the third quarter of 2003 through the first quarter of 2005.)

- **Higher stock prices**. Taxes on capital are a critical factor in the valuation of equities in two ways: the direct effect of taxes on the after-tax value of earnings, dividends and capital gains; and the effect on economic growth (and future earnings) of changes in the cost of capital. Simply put, if you cut the taxes on capital, you get more of it. Equities surged in May and June of 2003 when the 2003 tax cuts moved forward in Congress and then continued their gains as extra economic growth materialized. In the three quarters following the May 2003 announcement by the President and Congress of the tax cut deal, U.S. equities gained 24% and $3 trillion in market value.

- **Higher tax receipts**. Well-designed tax cuts like the 2003 cut cause more economic growth which in turn causes tax receipts to grow. The growth and asset price effects of tax changes are substantial, yet they are generally not taken into account in Congress's scoring process. Due to faster growth and higher stock prices, the year-over-year growth in tax receipts has reached 15%. Adjusting for inflation, this is the fastest real growth in federal receipts in more than 32 years.

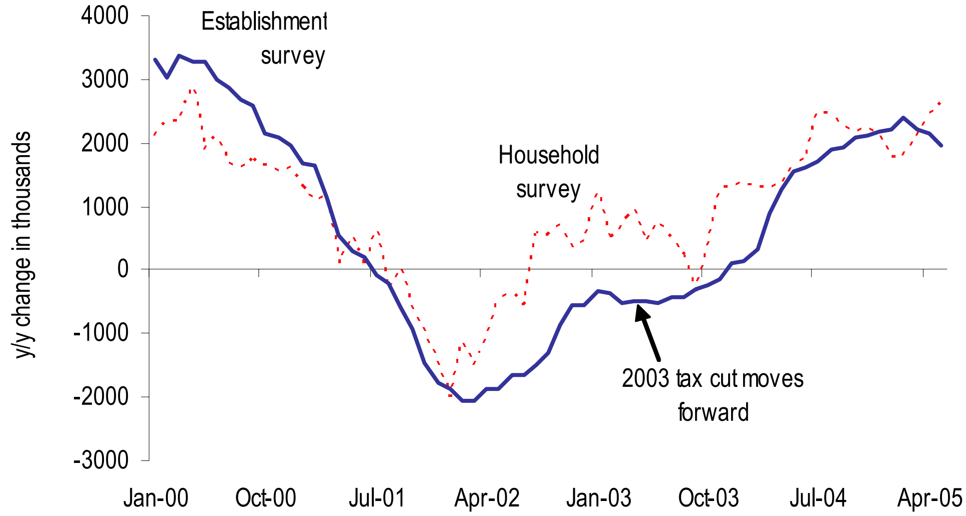
Growth in Government Receipts and Outlays



Source: Haver; Bear, Stearns & Co. Inc.

- **More jobs**. By helping re-energize the economy, the tax cuts also led to improved labor-market conditions. The pace of job growth picked up just after the enactment of the tax cuts.

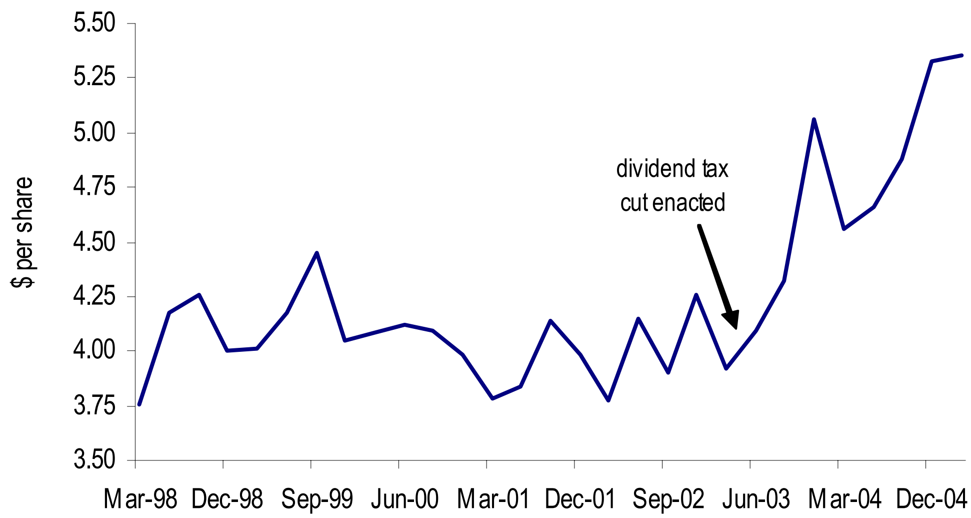
U.S. Employment Gains (000s)



Source: Haver; Bear, Stearns & Co. Inc.

- **More dividends**. Since dividend tax rates were lowered, the incentive to shelter earnings has been substantially reduced. Businesses have responded by adding to dividends, making more and lower-cost capital available for other businesses.

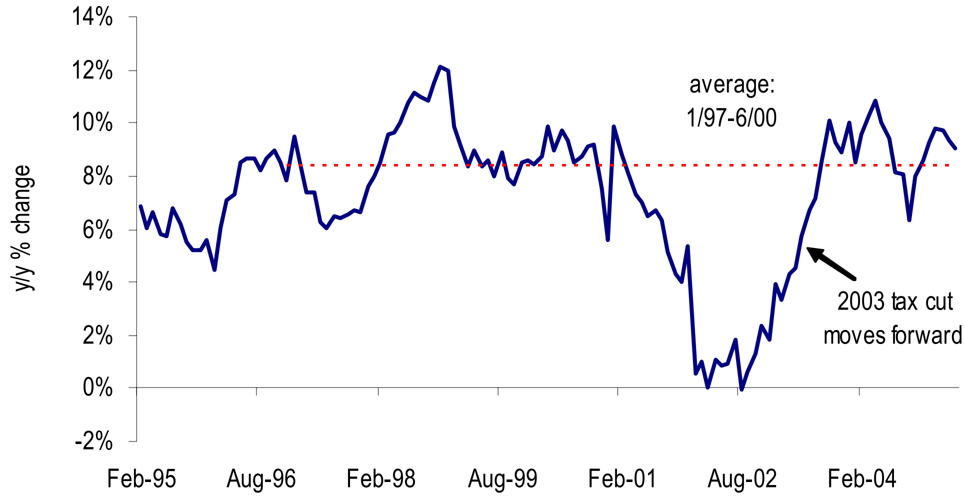
S&P 500 Dividends per Share



Source: Haver; Bear, Stearns & Co. Inc.

- **More small business income**. As expected, small businesses have been one of the big beneficiaries of the tax cut. Non-farm proprietors' income (a proxy for income of smaller, unincorporated businesses) grew to a record $955 billion annual rate in April, up 9.1% year-over-year, even faster than the average growth during the 1997-2000 boom.

U.S. Non-Farm Proprietors' Income



Source: Haver; Bear, Stearns & Co. Inc.

- **Adding it up.** In the three quarters following the 2003 tax cut, equities gained $3 trillion in market capitalization, GDP was $160 billion above the consensus expectation, employment grew by 1.3 million and dividends surged, helping free capital for smaller businesses. This compares favorably to the $350 billion scoring estimate for the ten-year cost to the federal government of the cut.

Risks of Allowing a Tax Hike on Capital

Financial markets assume a high probability that the 2008 expirations will be extended, so stocks would probably decline substantially if the dividend and capital gains rates were allowed to increase.

- Using the same modeling technique we used in 2003, we estimate that equities could decline some 7% (over $1 trillion in market capitalization at the market's current size) at the time an increase in the tax rates on dividends (to 35%) and capital gains (to 20%) became likely. This would reflect lower expectations for economic growth, the threat of higher taxes later, and the direct impact of the higher tax rates on asset prices.

- Additionally, a key strength of the US economy is its entrepreneurial nature. Allowing taxes on capital to rise would hurt small businesses, since a tax on capital is a tax on business formation and success.

- Over half of US households own equities in some form, so the benefits of rising equity valuation has had a far-reaching effect, and a reversal would too.

- The sooner that Congress makes the 2003 tax cuts permanent (rather than the cumbersome and uncertain extension process), the better for the economy. As the expiration date draws near every two years or so, uncertainty about tax rates will act like a partial rate hike, costing the economy in terms of a less dynamic capital structure and a loss of productivity.

Scoring System a Major Problem

The huge economic and equity gains from the 2003 tax cut on capital underscores the importance of reforming Congress's scoring system as a key first step toward a growth-oriented reform of the tax code.

- The current scoring system blocks effective tax reform by assuming tax changes won't improve the economy or asset prices. It imposes that faulty assumption on House and Senate voting procedures.

- **By itself, a better scoring system, one which recognizes that major tax changes impact the economy and asset prices, would constitute a major pro-growth structural reform, leading immediately to higher equity prices and the related increases in jobs and investment.**

- The static calculation of costs overstates the costs of a tax cut and ignores the benefits. I don't think it's possible to do an exact cost/benefit analysis of tax reform, but we know that simply looking at the cost to the government (the current approach) is incomplete and highly misleading.

- Most of the "cost" to the government is a straight benefit to taxpayers. From the standpoint of national well-being, the first-order effect is a wash, not a "loss".

- Taxing dividends reduces the value of corporations and encourages debt. Lowering the rate causes higher stock prices, more capital gains, more capital gains taxes, a lower cost of equity capital, a more efficient allocation of capital and a faster growth rate. None of these benefits was reflected in the 2003 scoring process.

- The scoring process presents a particular difficulty for making permanent the lower tax rates on dividends and capital gains. A primary goal would be to increase economic growth, but the added growth and rise in equity markets would not be scored.

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GLOBAL COMMENTARY

Tax Cut - Three-Quarter Loaf

President Bush met with House and Senate leaders on Monday and urged them to finish the tax cut this week. Ways & Means and Finance worked out details and scoring on Tuesday. Final negotiations took place Wednesday with Vice President Cheney. We expect the full House to pass the compromise on Thursday or Friday, followed by Senate passage on Friday in time for the start of Congress's Memorial Day recess. In reaching 51 votes for passage, the 51 Senate Republicans would lose Senators McCain and Chafee, gain Democratic Senator Ben Nelson, and, if necessary, have Vice President Cheney add his vote.

We think the final bill will add to economic growth and equity values. The final deal reduces dividend taxes to 15% rather than 0%. As a result, we don't think it will be as beneficial to equity values or improve the U.S. corporate capital structure as much as the President's original proposal. Important growth provisions include the acceleration of the already-scheduled income tax cuts, a cut in the capital gains tax rate to 15%, a cut in the dividends tax rate to 15%, and expanded expensing of business equipment purchases.

Our rough estimate is that the tax cut would add $600 billion (5% of market capitalization). This includes the added after-tax value of current dividends, the likelihood of an increase in the dividend payout, and some improvement in the capital structure. Congress estimates the 10-year deficit cost at $350 billion, not counting any economic benefits from the tax cut. Two important factors in the ultimate value of the tax cut will be: 1) when and how Congress clarifies whether tax rates will actually go back up at the end of the tax cut provision; 2) whether this tax cut is used as a step in broader tax or scoring reform. We note once again the unwieldiness of the Congressional budget and tax process and the extreme complexity of the outcome.

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Tax Cut Gains $750 Billion, ROI Already 150%

We think the tax cut and its support for the ongoing reflation have been the driving force behind the recent $750 billion increase in U.S. equity market capitalization. It has helped extend the equity repricing that took place when Iraq uncertainty diminished, more than offsetting the damage from expensive oil.

Observations:

- For some time, reflation, the tax cut and Iraq repricing have been enough to lift equities. To sustain that process, we'd like to see lower oil prices, proof of future earnings growth, higher Treasury bond yields, and/or some improvement in the economic data. We expect all of these over time, as discussed in previous pieces. We note that the cost estimates done by Congress in evaluating tax cuts explicitly exclude any consideration of benefits from a tax cut, equity gains, added capital gains taxes, and faster economic growth due to the tax cut.

- The tax cut is still being underestimated. The top marginal rate on federal income will decline from 38.6% to 35%, meaning taxpayers keep 65% of additional income, up from 61.4%. <u>This is a 6% increase, not the widely cited 3.6% benefit</u>. Those receiving dividends will keep 85%, up from 61.4%, <u>a 38% increase in after-tax dividend income</u>. Those earning capital gains will keep 85%, up from 80%, a 6% increase. These figures don't take into account state and local taxes, which would subtract some, up to one-third, from the benefits. Our May 23 piece estimated an over 12% gain in disposable personal income over the next twelve months.

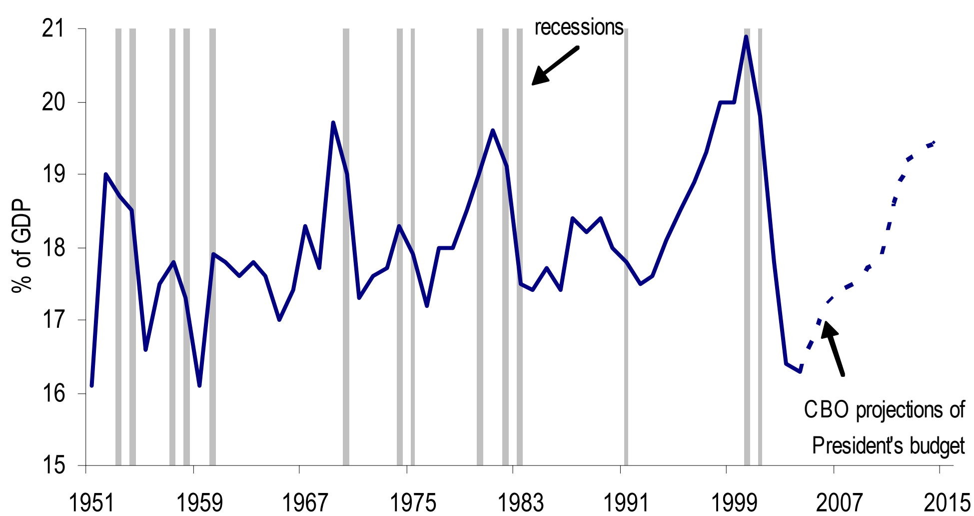
- Since the tax cut suddenly became a reality beginning May 21, U.S. equities have gained some $750 billion. Comparing the $750 billion equity gain to the $300 billion net present value of the ten-year cost (5% discount rate), the gain is 2.5 times – a 150% ROI. This doesn't count any GDP growth impact from the tax cut, which we expect to become material as the reduced obstacles to labor, capital and innovation spur the economy.

- Why didn't equity markets price in the tax cut earlier? Until the end, there was skepticism about the Senate finding the 50 votes needed to pass a growth-oriented bill. The surprisingly powerful solution was a tax cut that was bigger, more growth-oriented, and earlier than almost any expectations. It followed the same pattern as the Iraq war, depressing markets during the uncertainty phase and repricing them within weeks.

- In the past, we have emphasized the importance of oil prices in the growth outlook (for example, see *Oil Damage Mounts* on October 3, 2000). This still applies. However, the current damage from expensive oil is more than offset by the tax cut. U.S. oil usage (import and domestic) amounts to 7.1 billion barrels, $213 billion at $30 per barrel. A 30% decline would reduce that by $64 billion per year, about a quarter of the annual gain in disposable personal income from the tax cut. Expensive oil is also driving up the cost of other forms of energy. In addition, it is diverting investment to unproductive activities (i.e. Siberian exploration); however, the tax cut provides substantial incentives for new investment in the U.S., offsetting the oil price damage. We expect substantial additional stimulus to the economy if oil prices decline.

- In his June 1 New York Times piece critical of the tax cut, columnist Paul Krugman states that, as a share of GDP, "federal taxes will be lower than their average during the Eisenhower administration." This may be true for 2004, but is misleading. First, government receipts in 2004 will still suffer from unusually depressed capital gains, so it's not appropriate to compare 2004 to an *average* level in the 1950s. It's clear from the full data that tax receipts bubbled in the late 1990s and would only be brought back to normal by the three Bush tax cuts. Second, we're not sure federal tax receipts in this decade should be as high as in the Eisenhower administration. At that time, the U.S. was fighting the cold war, arguably more expensive than the war on terrorism. And state and local governments are bigger now, absorbing some of the federal burden for services.

Ratio of Federal Government Receipts to GDP



Source: Haver; Congressional Budget Office; Bear, Stearns & Co. Inc.

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