PAYING DIVIDENDS: HOW THE PRESIDENT'S TAX PLAN WILL BENEFIT INDIVIDUAL INVESTORS AND STRENGTHEN THE CAPITAL MARKETS

HEARING

BEFORE THE

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OVERSIGHT AND INVESTIGATIONS

OF THE

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U.S. HOUSE OF REPRESENTATIVES

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WITNESSES

TUESDAY, MARCH 18, 2003

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

PAYING DIVIDENDS: HOW THE PRESIDENT'S TAX PLAN WILL BENEFIT INDIVIDUAL INVESTORS AND STRENGTHEN THE CAPITAL MARKETS

Tuesday, March 18, 2003

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON OVERSIGHT, AND INVESTIGATION
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to call, at 3:10 p.m., in Room 2128, Rayburn House Office Building, Hon. Sue Kelly [chairman of the subcommittee] presiding.

Present: Representatives Kelly, Hensarling, Garrett, Murphy, Brown-Waite, Barrett, Oxley (ex officio), Inslee, Moore, Crowley, Hinojosa and Sherman.

Chairwoman KELLY. [Presiding.] The hearing will come to order please.

The September 11 terrorist attacks and the end of the telecom and Internet bubbles, the corporate accounting scandals, and now the uncertainties accompanying war have left Americans feeling uncertain about their economic future. Business investment has been flat or down for about two years now. Only consumer spending has kept the economy afloat. Now, there are signs that consumer confidence is down to the 1992 levels.

President Bush's plan to eliminate the dividend tax is a sound, common sense approach to growing this economy. Cutting taxes and encouraging consumer spending and investment is the way to go. We want to create jobs. We need to spur growth. That will only happen by letting American investors keep more of their own money and giving them incentives to invest it in this economy.

For millions of individual Americans, encouraging investment means encouraging the purchase of stock, which has been the best long-term return of any investment. Half of all American households, more than 84 million individual investors, already own stock directly or through mutual funds. Today, millions of Americans of all income levels receive dividends from stock. In fact, 45 percent of all dividend recipients make under $50,000 per year. I am going to repeat that, because that is important for people to understand—45 percent of all dividend recipients make under $50,000 per year. Three-fourths make less than $100,000 per year.

The problem is that America has the second highest dividend tax rates among the 26 most developed nations in the world, second only to Japan. So it only stands to reason that if we need more corporate investment, we need to reduce the tax rate on the dividends which we receive from corporate stock. Those dividends are already taxed when the corporation earns income. It is fundamentally unfair for us to pay more taxes on that income.

Another reason we need to end double taxation is to help our seniors live more independent lives. More than half of all dividend income goes to America's seniors, many of whom rely on these checks as a steady source of retirement income. More than nine million seniors would receive an average of $991 in tax relief in 2003 if they did not have to pay income tax on those dividends. Maybe there was a day when ending double taxation would have helped a small handful of rich, privileged Americans, but with 84 million individual investors owning stock, those days are over and it is time to bring economic thinking into the 21st century.

Our witnesses today will discuss the increases in corporate investment, the hundreds of thousands of new jobs, and the improvement in the quality of life for seniors and all individual investors that will result from passing President Bush's proposal to end the double taxation on dividends. But there is yet another reason for ending double taxation of corporate dividends. On December 12, 2001, I co-chaired the first congressional hearing examining corporate fraud and mismanagement at Enron.

Investigations by law enforcement and by this and other congressional committees found that senior Enron management intentionally twisted its corporate finances to hide billions of dollars in debt from investors.

A massive and detailed report released last month by the bipartisan Joint Committee on Taxation shines a special light on Enron management's sordid actions. Part of the report lays out how Enron raised over $800 million through hybrid financial instruments called tiered preferred securities, which were specifically designed to be treated as debt for income tax purposes and as equity on their books. So Enron could deduct corporate interest payments on its tax returns without revealing its debt service on consolidated financial returns. I have provided copies of this section of the report to the members and to our witnesses, and I invite your attention to the last two pages in which the Joint Economic Committee stated four recommendations for dealing with tiered preferred securities.

The very last recommendation states, and I quote, "reduce or eliminate the disparate taxation of interest and dividends for both insurers and holders of financial instruments that creates the market for hybrid financial instruments." By providing more equivalence in the tax consequences of debt and equity, this approach would eliminate tax considerations from the process by which corporate taxpayers decide to obtain financing.

Now, certainly the most important factor in Enron's demise was plain old greed, but the lesson from this bipartisan report, and it was hailed by members on both sides of the aisle and in both parties in both Houses, if we do not want anymore Enrons gaming the system to line their pockets, one step we can take is to end the double taxation on dividends. Ending double taxation is not a panacea for the stock market's ills, but it would add to this committee's record as the home of sound corporate governance on Capitol Hill.

Numerous Presidents as far back as Franklin Roosevelt have proposed ending the double taxation of dividends, but the proposal always seems to get caught up in outdated, tired class warfare arguments. For the sake of our economy, for the sake of our seniors, for the sake of our financial markets and our investors, Congress should support the President's plan to end double taxation of dividends.

Several members of the full committee who are not on this subcommittee have asked to give opening statements today. I am not sure that they are all here, but for those who are, I ask unanimous consent that all members participating today can give opening statements and insert them into the record.

With that, I turn to you, Mr. Sherman.

Mr. SHERMAN. As American troops head toward Iraq, it is a shame that when Americans should be coming together, we have these hearings which represent nothing more than something to divide America along class lines—a declaration of class warfare against American working families. Roughly 40 years ago, the corporate income tax, the alleged first of the two payments on corporate income, represented over 4 percent of our GDP. Now, it is below 1.5 percent because we should be in this Congress addressing the incredible loopholes that have made the corporate income tax a fiction, and have given the lie to the idea that corporate profits are taxed twice, for if this bill goes forward they will be taxed not even once.

Now, this sneak attack, this class warfare against American working families, is not being done under the cover of darkness. Rather, it is under the cover of saying that anyone who resists it is starting a class warfare division of Americans. We in America had reached some consensus as to dividing the burdens of government among the economic classes, until the President came forward with this weapon of mass destruction against that accommodation. You see, 70 percent of the benefits from this will flow to the top 5 percent of Americans. Stated another way, the top .02 percent of tax filers will receive nearly as much benefit from this cut as 95 percent of Americans, and do not tell me about the elderly without mentioning that 75 percent of the benefit goes to those seniors with incomes of over $75,000, while those seniors with incomes below $50,000 receive only 4 percent of the benefit.

This is class warfare covered by deft use of statistics; covered by an attempt to intimidate those who would shine a light on it by saying we are waging class warfare. Keep in mind, a lot of Americans own stock, but an awful lot of those own stock only through their 401(k) or IRA. They get no benefits.

This is also an attack on the American economy. It is an anti-investment proposal. It says if a corporation is thinking of building a new factory, hopefully in America, and instead they are pressured by their shareholders to distribute that money so that the shareholders can afford the new $350,000 Mercedes, that is an improvement to the American economy. It takes money available from corporate investment and moves it further away from corporate investment. A policy this bad could not stand the light of day. Fortunately, these hearings are basically stacked with witnesses that will present pretty much one side.

I yield back.

Chairwoman KELLY. Thank you.

We have three panels today, and I am hopeful that members will keep to the five-minute rule.

Mr. Hensarling, have you an opening statement? Mr. Murphy? Mr. Garrett, have you an opening statement? Ms. Brown-Waite? Mr. Inslee, have you an opening statement? If there are no more opening statements, then I will introduce our first witness, Mr. Peter Fisher, Under Secretary for Domestic Finance at the Treasury Department.

We thank you for testifying before us today, and I welcome you on behalf of the committee. Without objection, your written statements and any attachments that you have will be made part of the record. You will now be recognized for a five-minute summary of your testimony. As you I am sure know, when the light changes color from green to amber, that is the time you need to put your own timer on, because when it blinks red, your time is over. Please begin, Mr. Fisher. We welcome you here today.

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

Mr. FISHER. Thank you for the opportunity to be here today to testify on the President's jobs and growth package.

Let me focus my summary on two issues and try to pick up a third. First, the President's overall package is the right prescription for the macroeconomic circumstances that we face today, because it would support consumption and promote investment on a balanced, enduring basis. Second, by enacting the President's proposal to tax corporate income once and only once, this Congress has the opportunity to make the single biggest improvement in the efficiency of capital investment in our economy.

First, our macroeconomic challenge. In my view, the United States is not just facing another swing of the business cycle, but the aftermath of the extraordinary events of the 1990s, as you, Madam Chairwoman, described. The Federal Reserve monetary policy, global economic integration, telecommunications advances combined to fuel real prosperity and higher productivity, but investors' overestimation of their impact contributed to a stock market bubble. We continue to live with the disinflationary consequences and the destruction of trillions of dollars in household wealth as the bubble burst.

Under these circumstances, using fiscal policy to deliver only a short-term stimulus would be a mistake. The American people are smart enough to distinguish between a one-off injection of cash and an enduring improvement in their disposable income. When consumers refinance their mortgages at lower rates, they gain an enduring improvement in household cash flow. The same would be true of bringing forward to this year the tax rate reductions the Congress has already approved that are scheduled to come in later in the decade. Together with eliminating double taxation of dividends, these acceleration proposals would put cash in people's pockets right away and in the future.

The scale of the President's package is central to accelerating growth and job creation. Over the next decade, U.S. economic output is projected to total $142 trillion, generating something on the order of $27 trillion or $28 trillion in federal revenues. The President's jobs and growth package would reduce taxes by $695 billion over that period, scored with static macroeconomic effects. To have an impact on our economy, fiscal policy needs to be large enough to move the needle on the economy.

In the past year, Congress, under Chairman Oxley's and Senator Sarbanes' leadership, took a major step toward improving our capital markets performance. Better run, better disclosing corporations make for better capital markets, but there is more to be done to provide the right incentives for corporate executives. By double taxing profits, but not interest, our tax code encourages executives to retain earnings instead of paying them to shareholders, to favor debt over equity finance, and to dedicate some of America's leading minds to tax alchemy instead of value creation.

By imposing a higher marginal rate on profit, our tax code thins the vital blood of economic growth, risk capital. No other major industrial nation taxes profits at such a punitive effective rate. We have learned since recent testimony that the Japanese have made some changes, so they are no longer number one. We are, according to information I was told about from the Japanese embassy. The President's proposal would reduce that bias.

A prime benefit would be to raise the burden of proof on corporate executives if they wish to retain profits instead of sending them to shareholders. Under the proposal, shareholders would be tax neutral between reinvesting profits in the best projects a company could offer versus the best projects that the market could offer. Today's tax code cordons off that choice inside the company. Some corporate executives may prefer today's tax code, which places a less onerous burden on them for justifying their decisions to retain earnings. Yet corporations exist to serve shareholders, and our tax code should reflect this.

The impact on capital efficiency of freeing this boxed-in capital may be huge. Each year, American firms invest over $1 trillion in fresh capital and generate $700 billion to $800 billion in corporate profits. Think of the capital gains utilization and job creation if we accelerate and re-target this investment. The financial and economic markets will reap huge collateral benefits.

Let me conclude by saying if dividends are suddenly a tax efficient way for paying shareholders, executives will have fewer arguments to justify cash mountains and share buy-backs, which a critic may be tempted to note, offer the insider benefit of boosting the value of executive stock options. Because the President believes that profits should be taxed once, but only once, the company's payment of tax actually accrues as an asset to shareholders. In such a world where corporations paying tax on dividends reduces shareholders' own tax liability, the rationale for corporate inversions would dissipate.

Thank you, Madam Chairman. I look forward to the committee's questions.

[The prepared statement of Hon. Peter R. Fisher can be found on page XX in the appendix.]

Chairwoman KELLY. Thank you very much, Mr. Fisher.

I have just a couple of questions for you. How many new jobs do you think would be created over the next five years by eliminating the double tax penalty on dividends? And how much economic growth do you see that as promoting?

Mr. FISHER. There are a number of different studies, the administration's numbers that the CEA has put out, that 1.5 million approximately new jobs, 1.4 million by the fourth quarter of next year. I know that there are studies by the Business Roundtable suggesting that perhaps 500,000 jobs will be added to total jobs over the coming years. There are a number of different estimates.

Let me, though, stick my neck out a little bit. Forecast models are very bad at dealing with changes in behavior. What we are trying to do is re-engineer a profound change in behavior on the part of corporate executives. When we do that, I am confident we are going to have a bigger impact on job creation than anyone's forecast, anyone's model is prepared to project. I think both in terms of job creation in our economy, the numbers we are looking at from static modeling, will understate it, and they will understate it because they do not take into account the break in habit from accelerating the investment process.

Chairwoman KELLY. If the tax penalty on dividends was removed, would it reduce the use of Enron-style accounting gimmicks and improve corporate governance, as it appears from the report by the Joint Committee on Taxation?

Mr. FISHER. Yes, I think it would have a profound impact, especially if we do it as designed by the President. If you go back to the mid-1960s, 75 percent of large companies paid dividends in America. Today, it is about 25 percent. If we can re-direct corporate America to cash-flow rather than managed earnings, that will be the biggest thing we can do to improve corporate governance and avoid a lot of the shenanigans, some legal, some illegal, which we know have gone on in corporate America.

I think that we also by leveling the playing field between debt and equity, we will increase equity in the system, reducing the risk of bankruptcy, and we will reduce the risk of what I call managed stock option plans. We know stock options are a legitimate tool of employee compensation, but where I think some companies have gone too far is using the stash of retained earnings to justify share buy-back programs, to engineer share prices higher to offset the dilutive effect of stock options they have granted. This became a self-justifying prophecy. We need to lean against that and make corporate management either justify their investment internally or pay the money out to shareholders.

Chairwoman KELLY. I have another question for you. I think I still have a little time here.

As I said in my opening statement, more than eight million seniors would get almost $1,000 in additional income a year if they did not have to pay income tax on the dividends. What impact do you think that would have on their lives? And do you think that corporations would be more likely to increase their dividend payouts or would it stop seniors from getting short-changed by the dividend penalty that they now pay? That is really a triple question.

Mr. FISHER. Yes, I am trying to keep track of all that. We know that 40 percent of tax filers, as you have said, a high number of them that receive dividend income have incomes under $40,000, and among seniors, 40 percent of dividend recipients have incomes below $30,000. Keeping the dividend income streams coming, and reducing the tax burden, is a very short-run effect which gives them a boost to their income.

Again, I want to go back to thinking about if we can unwind the clock either 10 or 20 or 30 years, and double or triple the number of dividend checks that are mailed, we will have a much greater impact than any of these static numbers we are looking at. While we do not expect that to happen in any one or two year scenario, over time as corporations have a reduced incentive to hang onto earnings, a greater incentive to pay dividends out, then there will be even more dividend checks flowing to seniors and other Americans.

Chairwoman KELLY. One more quick question. If we end the double taxation on dividends, how do you see that as changing the incentives on the pool of retained earnings? I think you talked about that—the incentives regarding the behavior with the pool of retained earnings. You talked about that in your testimony a little bit.

Mr. FISHER. I think that what it will do—I want to be very clear. The President's proposal is about leveling the playing field. We have taken some criticism from some quarters that it is complicated. One provision that I admit adds to the complexity is that we want it to be a level playing field between retained earnings and dividends. So I think it does not distort the incentive structure. It means management of companies should make economic judgments about whether they want to reinvest in their business or pay the money out to shareholders. But it equalizes the hurdle rate, if you will, on internal investment and external investment. That will speed up the investment process.

Let me just add, if I could, that one of the great strengths of our economy that the rest of the world is envious of is the efficiency of our investment process. Here, we have something which we know creates a huge distortion in that process. I know of no principled argument in favor of our current structure. There are arguments about transition costs, but I do not hear anyone arguing in favor of the current structure that we have. If we can eliminate this, we are going to accelerate investment, business formation, and job creation in America.

Chairwoman KELLY. Thank you. My time is up.

Mr. Inslee?

Mr. INSLEE. Thank you, Mr. Fisher.

When did you or your department determine that this was such a tremendous idea? When did you make that decision?

Mr. FISHER. I have been, about me personally, I have since the mid-1990s, and observing the acceleration of retained earnings inside corporate America, it then seemed to me most clear that this was creating a major distortion in our capital structure.

Mr. INSLEE. Just roughly, when did your administration propose this in the last year or so?

Mr. FISHER. The President proposed it the first week of January of this year. There were many discussions between our tax policy shop over the last year, working on different reform proposals.

Mr. INSLEE. And there have been some changes since then in our both world and economic conditions, haven't there?

Mr. FISHER. There continue to be a lot of uncertainties about the economic outlook.

Mr. INSLEE. Let me just mention a couple of them. Number one, we are starting a war in a couple of days and it is going to cost $100 billion just to start. And then it is going to on for years as we occupy Iraq—in the billions of dollars. We have had a recession which have reduced federal revenues dramatically, which since your department came up with this grand scheme, has left the U.S. economy in shambles because we have over a $300 billion deficit this year likely, in part because of the previous revenue reductions that your administration passed.

I want you to think about the fact that since you came up with this idea, we have had a war; we have got people from my district who got on the USS Rodney Davis, it is a frigate, last weekend to go steam into harm's way, and the 8th hospital unit of the Bangor Military Naval Hospital. They believe, like John F. Kennedy, that we should be willing to, "pay any price, bear any burden, meet any hardship, support any friend, oppose any foe, in order to assure the survival and the success of liberty."

But your administration believes that while we have a war overseas, it is okay to have a fiscal party at home. A lot of my constituents believe this is grossly irresponsible. It would be the first administration in American history to propose a major league tax cut in the middle of starting a war. I would like you to respond to their concerns as to how that is responsible, when we ask our men and women to go into harm's way next week, that you want to have this fiscal largesse at home.

Mr. FISHER. Sir, I do not think it is irresponsible. As I look back over the history of the last 50 years, I see that federal task revenues as a share of GDP in our economy peaked at 21 percent in 1944—the last year of the Second World War. From 1960 to 2000, through five Democratic and five Republican administrations, federal revenues as a share of GDP has oscillated in a corridor between 17 and 21 percent, with a very tight average around 18.5 percent.

Mr. INSLEE. So you think it is responsible even though we start a war, we increase our expenditures over $100 billion, we increase our deficit over $300 billion—it is still responsible, you believe, to grow our federal deficit at the same time you are handing out tax cuts? You believe that is responsible, to have deficits in the $300 billion range, at the same time you are increasing expenditures to a war; at the same time you want to increase these tax cuts? You believe that is responsible fiscal behavior?

Mr. FISHER. I think fiscal policy needs to focus on making sure our economy grows both now and over the coming 10 years.

Mr. INSLEE. So how do you explain it to our children? How do you explain it to our children?

Mr. FISHER. There is nothing more important to our children's financial success than that we grow this economy over the coming decades as rapidly on a sustainable basis as we can. That is where federal revenues come from, to pay for all of the priorities which Congress votes when you enact outlays.

Mr. INSLEE. Let me explain and convey to you my three children's belief. They are not happy that your administration is putting onto their shoulders a chronic debt burden. They are not happy that 14 percent of all the taxes they pay goes to pay the debt tax. Fourteen percent of all the taxes my son, who is a carpenter, pays goes to pay a debt tax to service the debt that you are increasing, you are exploding on his shoulders. He does not think it is responsible. I do not think it is responsible either, and if you want to go ahead and comment, go ahead.

Mr. FISHER. We disagree, I guess, sir.

Mr. INSLEE. We agree that we disagree. Thank you very much.

Chairwoman KELLY. Thank you.

Mr. Oxley?

Mr. OXLEY. Thank you, Madam Chairwoman.

It is good to have you here again, Mr. Fisher, and also I want to ask unanimous consent that my full statement be made part of the record, and also while I am at it, welcome our former colleague and friend, Senator Gramm, who will be on the next panel, as well as former member and a member of this committee, Rick Lazio, who will be on the third panel, along with some other distinguished members.

I am sorry my friend from Washington left. I was interested as to why he might oppose 431,000 jobs in the private sector, higher wages, I assume for his constituents, as well as mine; tax relief, particularly for senior citizens; a very positive impact on the stock market—as a matter of fact, probably a 10 percent increase minimum. I know that the gentleman from Washington state voted for the Sarbanes-Oxley proposals, which brought about better corporate governance. Clearly, as you indicated, Mr. Fisher, the impact on corporate governance would be a very positive one by eliminating the double taxation on dividends, creating a much better climate and a much better incentive within the corporate structure; and of course international competition, which means more exports for the United States.

So that is a pretty good record of what we can accomplish by eliminating the double taxation of dividends. I guess I would not want to be on the other side of that issue. I feel a lot more comfortable with a pro-growth package that would provide the kind of incentives and the kind of positive developments that would be brought about.

I asked Chairman Greenspan when he was here two or three weeks ago about his opinion on the elimination of double taxation of dividends. He was very positive—as a matter of fact, so positive that we did a "dear colleague" quoting directly from Chairman Greenspan. We may do the same with your testimony, and we appreciate the efforts.

Let me ask you, as you know, the telecom and high-tech sectors have been hit particularly hard. They are not making any money. Their earnings dropped precipitously in 2001 and 2002. As a result, they may not be able to take advantage of the dividend exclusion proposal, which would disincentivize their shareholders. Has there been some consideration given to expanding the proposal to permit companies in these circumstances to apply their average tax liability over, say, a five-year period to guide issuance of tax-free dividends to their shareholders?

It appears that of all of the sectors, perhaps, in our economy, the tech sector and telecom have been hit the hardest, and reflected certainly in their earnings and in their growth, and obviously a negative effect on their shareholders. Has Treasury given any thought to that proposal?

Mr. FISHER. I do not believe there has been work done on a five-year carry-back, carry-forward. I know there is some work going on there in the tax policy shop. I do not think, though, they have been looking at it on that long a horizon, but I would be happy to talk about it with them and get back to you.

Mr. OXLEY. There has been some discussion about something less than a five-year?

Mr. FISHER. We have heard from a lot of people wanting us to focus on that. There are discussions. I am not sure what the reaction is to the different proposals. I have not yet heard of any as long as five years, but I would be happy to get back to you, Mr. Chairman, after talking with our folks in tax policy.

Mr. OXLEY. Getting back to the issue of corporate governance, you and I were comrades-in-arms on some of these issues. As we look back on an Enron, for example, and as you know, this committee had the first hearing on Enron. It became quite evident, I think, to the committee that Enron was in a situation where they were desperately trying to bury and hide debt through SPEs—special purpose entities. To what extent do you think the tax code may have lent itself to some of the rather strange behavior that took place at Enron, particularly over the last year and a half?

Mr. FISHER. I think there are at least three different channels, I would say, of regrettable incentive structures that the tax code puts in play. One is simply the debt equity ratio issue of encouraging companies to be more levered than they might otherwise be, given the tax disadvantage currently in place. The remedy would address, if we unwound this, we would get companies and give them another incentive to focus on cash flow, rather than managed earnings. I think that that is now we are getting toward the heart of some of the issues that came up in Enron, where they went further and further off into the wilderness of managed earnings.

The third is managing tax liability as aggressively as they apparently did, is another sort of third dimension that this comes up. The remedy the President has put forward, this plan puts in place, as I was beginning to elaborate, is that it is really a fundamental change in thinking that corporate America would have to go through to think of the payment of corporate taxes as a shareholder asset. Instead of having every incentive to maximize tax shelters of every flavor and stripe, once we put in place what the President has proposed, the company has an incentive to think of the taxes they pay at the corporate level as offsetting taxes for the shareholder, and there as a shareholder asset.

So in those three different channels, I think we would be driving really at the heart of some of the behavioral problems that came up.

Mr. OXLEY. Thank you.

Thank you, Madam Chairwoman.

[The prepared statement of Hon. Michael G. Oxley can be found on page XX in the appendix.]

Chairwoman KELLY. Thank you.

In the absence of subcommittee Democrats, I am turning to Mr. Hensarling.

Mr. HENSARLING. Thank you, Madam Chair. I hope I am not supposed to give their side of the story.

[Laughter.]

Chairwoman KELLY. No, take your pick. You can do whatever you want. This is an educational forum, if you will.

Mr. HENSARLING. Mr. Fisher, one of my colleagues from across the aisle, who is absent now, spoke quite passionately about his children and future deficits. I, too, am a father. I have a one-year-old and another on the way, and I am very concerned about leaving them a legacy of debt, because I want to leave them a legacy of freedom and opportunity.

The gentleman spoke about deficits. Can you tell me how the tax relief in the President's package is scored for fiscal year 2004? Isn't it approximately $100 billion?

Mr. FISHER. Yes, it is about $100 billion. Yes, about $100 billion in terms of the jobs and growth package.

Mr. HENSARLING. And the administration has proposed roughly a $2.2 trillion budget for fiscal year 2004, is that correct?

Mr. FISHER. Yes. That is my understanding.

Mr. HENSARLING. So if I do the math correctly, is the tax relief less than 5 percent of the proposed spending?

Mr. FISHER. That sounds right. That sounds about right, but maybe even a tad less.

Mr. HENSARLING. Might it be a fair conclusion then that over 95 percent of the problem appears to be on the spending side and not the tax relief side?

Mr. FISHER. I would certainly share that view with you.

Mr. HENSARLING. The $100 billion is under static scoring, is that correct?

Mr. FISHER. Yes.

Mr. HENSARLING. Okay. The administration has not employed dynamic scoring, but I assume that you believe that your tax relief package will indeed have some consequences on human behavior.

Mr. FISHER. Yes.

Mr. HENSARLING. I assume the administration has looked at past tax relief, say, in the Reagan administration or the Kennedy administration, since we heard JFK's name mentioned earlier. If you look at the history of earlier tax relief packages, can you tell me what their impact was on economic growth and tax revenues?

Mr. FISHER. I do not have those figures on the top of my head. We know they were positive and they had a dynamic effect. I am confident this package will, too, but I do not have the figures from 1962, 1964 and the early 1980s in my head. But I think you and I agree, it is going to have a positive impact, lower the loss of federal revenues considerably, and increase the job creation.

Mr. HENSARLING. One last question, can you go into further detail about how we in the U.S. tax capital and savings vis-a-vis other industrialized nations, and what the consequences of that has been on the availability and cost of capital in the U.S.?

Mr. FISHER. I think all other OECD industrial countries have worked through different formulas to integrate—it is called tax integration—personal income tax and the corporate income tax, to avoid effects such as the double taxation we are looking at. So they have all been working at it, and it is just in the last few weeks we learned that Japan has actually moved ahead of us, so we are now taxing capital at the highest rate, as they have put through some credits to try to offset.

So we know it has a dampening effect on investment here, and all the perverse corporate incentives that we have been discussing, and other countries do not put this dampener in their investment process. We should take it out.

Mr. HENSARLING. Thank you, Mr. Fisher.

Mr. FISHER. Thank you.

Mr. HENSARLING. Madam Chair, I yield the balance of my time.

Chairwoman KELLY. Thank you.

Mr. Hinojosa?

Mr. HINOJOSA. Thank you, Chairwoman Kelly.

I want to ask for unanimous consent to let my opening remarks, statement be made a part of the record.

Chairwoman KELLY. So moved.

[The prepared statement of Hon. Rubén Hinojosa can be found on page XX in the appendix.]

Mr. HINOJOSA. Thank you.

Under Secretary Fisher, I apologize that I was unable to come in while you were making your statement. I was at another meeting and I just could not get out of it.

Mr. FISHER. I understand, sir.

Mr. HINOJOSA. Currently, the interest payments on many of the State and local government bonds are exempt from federal income taxes, while capital gains on stocks and securities are not. This system is in place to stimulate private investment in our communities and schools, and makes it easier to build roads, schools, and other projects. So that is something that is very important to us, especially who come from congressional districts with large rural areas and school districts that need to have the sale of these government bonds so that it can keep all these projects that I mentioned to you.

Will the elimination of taxation on capital gains and retained earnings for private securities harm these communities I mentioned, and result in more costly municipal and state construction projects? And will the reduction in taxation of dividends reduce the amount of funding available for community investment?

Mr. FISHER. Sir, I do not believe that it will. I think it is very important to understand the different characteristics of municipal bonds and municipal borrowing from equity securities. While in an absolute sense, we see a diminishing of their relative advantage in terms of tax advantage of munis vis-a-vis equity dividends, investors recognize the profound difference between the safety and stability of a government bond issued by a state and local government, and the risks of equity securities, particularly after the last few years we have been through with the wild swings in the equity markets.

So when investors approach this, they do not think of these as fungible instruments. They might think of a diversified portfolio where, in order to have a very safe and secure revenue stream, you might have some government bonds and municipal securities. A balanced portfolio might also include some equity investment, but it would be quite odd to think of those two instruments as comparable, given how different the risk characteristics of them are.

So while in some absolute mathematical sense, the tax advantage decreases for municipal securities, these are such profoundly different instruments I think it mistakes how investors approach them to think there would really be an increase in the cost of financing State and local projects.

Mr. HINOJOSA. Let me tell you why I am not very clear on the reason that you give. In talking to some of our friends in New York about this problem, their comment was that once you take out the capital gains, then you do not have the advantage of these tax exempt bonds that they are investing in and getting a high return, for comparing tax exempt bonds. By taking out the capital gains on those stocks, will they still be attractive to the investors in New York?

Mr. FISHER. Yes, I believe they will. It has to do with the risk to principle, is one issue, and therefore the volatility of the instruments. Someone who wants to hold a municipal security is looking for something that is very safe and secure, and in which the principle amount is not subject to fluctuation, and which gives them a regular income stream in the form of the interest. An equity instrument is subject to all the risks of the market going up and down, and to the risk the company does not declare a dividend. That is in the discretion of management.

So the two instruments have fundamentally different risk characteristics, which make it extremely unlikely that investors think of them in fungible terms.

Mr. HINOJOSA. Investors also want the highest return possible. It is not just the risk, it has got to be balanced.

Mr. FISHER. Investors are always struggling to find the highest risk-adjusted returns. That is, to simply say, I want an instrument that pays me the largest interest payment, that will turn out to be a very risk bond, for example, of some company that does not have a very good credit rating.

Mr. HINOJOSA. You and I both know that they are going to be low-risk, because in many cases they are guaranteed by somebody, especially in Texas where the State permanent school fund guarantees those bonds.

But let me go to another question. I do not believe that I am sure that there is going to be a high enough interest rate to still make it as attractive as you seem to be anticipating. In your written testimony, you said that the deficits projected are manageable and declining. At their peak, the immediate future, they are below U.S. historical experience. They compare favorably with fiscal conditions in other G-7 countries. Our debt remains modest by historical and international comparisons, and as a share of U.S. credit market it is at a 50-plus year low.

My research indicates just the opposite. In 2001, the U.S. enjoyed a $127 billion surplus. In 2002, our budget went into a $158 billion deficit. CBO forecasts that the President's new tax cuts and his other budget initiatives would produce deficits of $1.82 trillion over the next 10 years. The CBO projects a deficit of $287 billion in fiscal year 2003, that we are in, and a deficit of $338 billion in fiscal year 2004.

Chairwoman KELLY. Mr. Hinojosa?

Mr. HINOJOSA. Yes, ma'am.

Chairwoman KELLY. Can you please conclude as quickly as possible. Ask your question.

Mr. HINOJOSA. In conclusion, how can these deficits be characterized as manageable and declining?

Mr. FISHER. Looking at the 10-year forecasts that we are working with, that both CBO and OMB have done, we are looking at deficits as a share of our economy—that is the normal way we look at them; as a share of GDP—they are in a range inside our experience and consistent with other G-7 countries. So right now, we are looking at less than 3 percent of GDP. That is a very typical deficit-to-GDP ratio. The projections over the coming decade is that they are around here just a little beneath 3 percent, and then decline over the rest of the decade. That declining trend is one of the reasons that I think both financial markets and we at the Treasury responsible for debt management see these as entirely manageable. So I think that when we look at it scaled to our capital markets, as my testimony alluded to, scaled to our credit markets, we see these as entirely manageable.

Mr. HINOJOSA. I thank you for your response, and thank you, Chairwoman Kelly.

Mr. FISHER. Thank you.

Chairwoman KELLY. Thank you.

Mr. Murphy?

Mr. MURPHY. Thank you, Madam Chairman, and welcome here.

Mr. FISHER. Thank you.

Mr. MURPHY. I was talking with some folks on the street, and I agree oftentimes constituents, people around America know a heck of a lot more than we inside the Beltway give them credit for. This guy described himself this way. He said, I am just an average American Joe Sixpack that pounds nails and cuts wood during the day, mows my lawn in the summer, and cheers for the Steelers in the fall. He said, we are pretty tired of the Beltway bullfeathers, although he described it a little more colorfully. He said, all I want to know is this—with these plans, what is it going to do to my money in retirement? What is it going to do to my kids' college fund? What is it going to do for job opportunities for my kids? And what is it going to do to put food on my table and keep a roof over my head, for now and in the years to come?

How would you respond to him?

Mr. FISHER. I would say the single most important thing, both for his family finances and for our government's, is to get our economy growing and creating jobs over the next 10 years. As I said in my written statement and alluded to in my summary, I am concerned that we have a little more to confront here than just another swing of the business cycle. If I really thought we just were looking at sort of a normal business cycle issue then maybe we would not need to do something on the scale that the President has proposed. But I think we need to overcome some greater obstacles. So getting the growth rate up, and nothing over the coming 10 years will do a better job of that than speeding up the investment process.

Mr. MURPHY. In plain speak, do you believe this plan will essentially boost the value of what people have saved in whatever kind of market funds or something else they put away for college or their retirement? And how much do you think it will increase it by?

Mr. FISHER. There are estimates of the impact. We have not done one at the Treasury, but the estimates of impact on stock market valuations range from 5 percent to 15 percent positive impact.

Mr. MURPHY. Over how many years? Annually?

Mr. FISHER. No, that is a one-off effect of doing this, but that is a pretty substantial boost, even just a 5 percent boost. So I think it is going to raise equity valuations and the value of investment.

Mr. MURPHY. Does this translate also to you saying that you cannot affect the job market unless you affect the stock market?

Mr. FISHER. I think the effect comes back indirectly. What I would say is, businessmen and consumers want to see something that will be enduring support, so we need something that is going to drive investment higher so there are more jobs for his kids. We need something that is going to provide consumers with the confidence to buy something—a big ticket item—to keep their consumption on track. We need to do both of those things. That is what the President is trying to do.

Mr. MURPHY. Another avenue here—I heard someone say that those who oppose the President's plan are opposing a plan that forces corporations to pay their fair share of taxes. Could you respond to that? Does that sound about right? I guess they are referring to the way companies have, I think you were saying before, to keep money to finance buy-backs; they incur debts to falsely pay dividends to keep their stock value up, et cetera. They will find other loopholes to not pay taxes. Does this have any way of helping to keep companies more honest in what they are paying?

Mr. FISHER. Yes, as I have said, I think it does. I even know one commentator who thinks this will overall increase corporate tax payments because of the incentive effects that if they pay the taxes, then their shareholders do not have to. I think it has a powerful impact on just the other side of getting us away from tax shelters and corporate inversions and the like, reducing the incentives for gaming the system by corporations.

Mr. MURPHY. What do you mean by "gaming" the system?

Mr. FISHER. Aggressive tax shelters. We know there is a fine line between what the system permits and what then goes over the line—not tax avoidance, but tax evasion. Obviously, there are a lot of people out there who are trying to always push up against that line. We want to try to reduce the whole incentive to be playing that game to begin with.

Mr. MURPHY. Will this then lead to some job loss for attorneys and accountants whose whole job is to find ways to not pay taxes?

Mr. FISHER. Yes, if it is successful, it would do that.

Mr. MURPHY. I am for that. Thank you.

Chairwoman KELLY. Thank you, Mr. Murphy.

Mr. Garrett? Mr. Barrett, have you questions?

Mr. BARRETT. Thank you, Madam Chairwoman.

Mr. Fisher, just one quick question. I was reading an article in the Wall Street Journal that quoted Glenn Hubbard, of course, the head architect of the Bush tax package. It talks about urging people to invest more and pushing down the cost of capital. The part that intrigued me, that I really liked, he said a dividend tax cut is a way to raise wages. Tell me how that would work?

Mr. FISHER. By lowering the hurdle cost of investment, we make it easier for firms. Firms then have a choice of what to do with that additional capital, that additional expense. Now, over time—I think this is in the context Glenn would be discussing that—that drives us to higher productivity. We are going to get more investment, and it is really productivity that leads to enduring improvement in our incomes. It may not change it—if you think about just one person, are they going to get a raise the day this thing is passed—no, I do not see it that way. But this is the key to unlocking productivity gains to beget more investment in our economy, more productivity. That is what leads to a higher level of income for all of us.

Mr. BARRETT. Thank you, Mr. Fisher.

With that, Madam Chairwoman, I yield back the balance of my time.

Chairwoman KELLY. Thank you.

Ms. Brown-Waite?

Ms. BROWN-WAITE. Thank you very much.

One of the things when I got elected was I promised I would not fall in love with a place that people sent me to work at, namely D.C. So I go home every weekend, and I talk to people in the community, talk to seniors. I can just tell the rest of the panel and the rest of the members here that my seniors will appreciate having the dividend not be taxed. When you look at the figures, more than half of the dividend income goes to seniors, and that means about five million seniors nationwide would receive an average tax cut of somewhere around $900 in 2003. That is a substantial impact. That is money that they are going to use in the community. If you cannot see how these jobs are going to be created, how it stimulates the economy, then I do not think you understand Economics 101. It is when people have more money in their pocket that they actually spend it.

I was just wondering if you all have done a breakdown of State by State how much it would mean to seniors, to the residents in each State?

Mr. FISHER. I think we have done that. I do not have it with me. Let me double check that we have done that analysis and we will try to get it to you as quickly as we can. I do not have it with me or in my head.

Ms. BROWN-WAITE. Have you extended that to number of jobs created as a result of the tax break for each state? I saw some figures that came from a research organization, but I did not know if you all had official figures.

Mr. FISHER. I am going to have to double check. I think we may be able to do a State by State analysis, but I do not have it in my head or with me. So let me try to get back to you on that.

Ms. BROWN-WAITE. I can just tell you that the seniors in Florida are looking forward to paying lower taxes as a result of this. Thank you.

Mr. FISHER. Thank you, ma'am.

Chairwoman KELLY. Thank you.

If there are no more questions, the chair notes that some members may have additional questions for Under Secretary Fisher and they may wish to submit those in writing. So without objection, the hearing record will remain open for 30 days for members to submit written questions to him and place their responses in the record.

Mr. Fisher, there have been some requests by members of the committee for some additional information, so please feel free to— I will officially request that those figures get to us.

Mr. FISHER. Yes.

Chairwoman KELLY. We are very grateful that you were willing to be here with us today. You are excused with the committee's great appreciation for your time.

Mr. FISHER. Thank you very much. It was a pleasure.

Chairwoman KELLY. With the agreement of the members, I want to recognize Mr. Hensarling of Texas for the purpose of introducing our next witness.

Mr. HENSARLING. Thank you, Madam Chair.

It is indeed a distinct honor and privilege to introduce our next witness. In many respects, Madam Chair, we are getting three witnesses for the price of one, for there is Dr. Phil Gramm; there is Senator Phil Gramm; and there is Vice Chairman Phil Gramm. Dr. Phil Gramm was a professor of economics, who taught economics to thousands of students at Texas A&M University over 12 years. Thousands of students learned about supply, demand, money, banking, and Seays Law due to his inspiring teaching. I was honored to be one of those students.

He went on to have an almost quarter-century public service career in Congress, first as a Congressman and then as a Senator. He is indeed uniquely qualified to speak to us about economic growth, since he was the co-author of the Reagan economic program in the House, a program that cut marginal tax rates, increased government revenues, and caused one of the largest economic booms in American history to take place.

As a Senator, he was responsible for the Gramm-Rudman legislation, and was one of the last people in this city to actually put binding restraints on federal spending. I hope he explores in his testimony the relationship between economic growth and the growth in government spending. Once again, I was honored to be his aide for many years during these years.

Finally, there is now Vice Chairman Phil Gramm. Senator, we are very happy you finally decided to make an honest living.

[Laughter.]

Senator GRAMM. So am I.

Mr. HENSARLING. We have the perspective of an investment banker.

So Madam Chairman, I do think indeed we are getting three witnesses for the price of one, to the panel. We have an academician, we have a great public servant who is committed to principle, tenacity, courage; and finally we have an investment banker. But to me, he is a teacher, a friend, and a mentor. I am honored to introduce him, and one statement to the witness: Senator, for 25 years, I have answered your questions; turnabout is fair play.

[Laughter.]

Thank you, Madam Chair.

Chairwoman KELLY. Thank you.

STATEMENT OF HON. PHIL GRAMM, VICE CHAIRMAN AND MANAGING DIRECTOR, UBS WARBURG LLC

Senator GRAMM. Madam Chairwoman, members of the committee, Mr. Chairman, Congressman Hensarling, let me thank you for that wonderful introduction. If I had never done any of those things other than taught you, I would have had a life well spent, and I want to thank you very much.

I want to thank you for inviting me to come today. I cannot imagine what is more important than getting America back to work, than rebuilding confidence in our equity markets, than rebuilding the foundations of our retirement program. To the extent that I get to play a small role in advising you on that, I am very flattered and very grateful.

Let me start by defining the problem. In the 20th century, we had two different kinds of business downturns. In the middle and late part of the 20th century, we had a series of inventory cycles—seven of them—and they all worked basically the same way. Somewhere, signals got crossed between people that were selling things and people that were producing things. We would over-produce. There would be a buildup of inventories. It would be discovered. Orders would go back up the production chain to cut back on production. Businesses would re-trench. People would be laid off and we would have an economic downturn. Economists could never predict when they were going to happen, but we understood a lot about them once they started.

In the early part of the 20th century, we had a series of financial panics. They were generated by the fact that we had a very difficult time converting checking account demand deposits into currency, and we had an agricultural economy so you had huge seasonal variants in the demand for money.

I give you that little history lesson because one thing everybody should know in this debate is that the downturn that we are beginning to recover from is very different than anything we experienced in the 20th century. The downturn we suffer from was a speculative boom and a breaking of that speculative bubble. We do not know for sure whether all the gas is out of it. We do not have good precedents in recent history as to how post-speculative booms work in terms of recovery.

So the first point I want to make is that we are kind of in uncharted waters here. I would urge you to be cautious and forward-leaning in terms of addressing this downturn and guaranteeing a strong recovery.

Secondly, Madam Chairwoman, as you mentioned, this has been a very different kind of recession. Consumption has never declined. We are in the midst of a housing boom in the midst of a downturn. Our downturn has been produced by one thing and that has been a collapse in investment. Now, what I think that should tell us is if you want to get the economy growing again, you have got to affect investment. The old pump-priming where we give people money hoping they are going to spend it is not going to be very effective in a recession where consumption has never declined. The problem is investment, and if your policy does not affect investment, it is not going to have much of an impact.

Now, in terms of the President's stimulus package, despite all the media hype and all the politics, the plain truth is it is not very big—2.4 percent of projected current services spending, which means what you would spend if you created no new programs and did not change anything over the next 10 years. You could literally take 2.4 percent of projected current services spending and fly it over cities in airplanes and throw the money out and would have no substantial impact on this economy. If this stimulus package is going to affect anything, it has got to get people to invest not the money they get from your tax cut, but to invest money they have already got that they are not putting to work.

I think there are two things in the President's package that are very important in doing that. One of them you have talked a lot about, and that is the dual taxation on dividends. Eliminating the dual taxation on dividends will change the after-tax rate of return on investment and will, in and of itself, change the value of equities on the American market. The lowest figure that Secretary Fisher talked about was 5 percent. That does not sound very big until you realize that a 5 percent change in equity values is $350 billion. So we are talking about a substantial impact simply by eliminating a current bias in the tax code.

There are a couple of other things that I think are important. Number one, the current system basically encourages companies to invest internally even when the rate of return of investment in the market is greater than it is inside the company. That creates a wasting of capital and inefficiency, and eliminating this bias will go a long way toward correcting that, and ultimately will correct it.

By eliminating the bias against dividends, companies will pay more dividends and you will make the internal conditions of companies more transparent. I had an old accounting professor long ago who said, cash flow is real; profits are a fiction. Letting companies exhibit cash flow by paying dividends probably will do more for corporate transparency than any law you could pass.

Number four, the double taxation of dividends encourages businesses not to incorporate, even though they could get access to more capital; they could grow; they could create jobs. But by incorporating, they end up having to pay a dual taxation on dividends and they are disadvantaged. It cannot make sense to let tax policy dictate corporate structure.

Finally, the elimination of the dual taxation on dividends will eliminate the non-economic use of debt. How many companies that have had problems during the current downturn overused debt and underused equity because the cost of debt is tax deductible and the cost of equity is not?

Those are all sound reasons why this ought to be done. There is one other policy I wanted to touch on, Madam Chairwoman, and that is accelerating the reduction in rates. Let me just focus on one—the highest rate, 38.6 percent. That is in reality the small business tax rate in America, because 38.6 percent is the tax rate paid by proprietorships, partnerships and subchapter S corporations filing as individuals. That tax rate and the revenues collected from it generate revenues 85 percent of which come from small business.

Small businesses create most of the jobs in America. Probably dollar for dollar, the greatest stimulant in the President's package is accelerating those reductions in marginal rates, specifically the highest rate, from all four to the present, and from all six to the present. It does not change the long-term revenue stream of the government even in a static sense because it is going to go into effect anyway, and it ought to be made retroactive to January 1 and done now. There is no question about the fact that had Congress known how weak this recovery was going to be, how uncertain it was going to be, we would never have strung the tax cut out as we did.

So I want to urge this committee to move forward. And let me address just two other issues, if I may. First of all, the question about revenues, and I think at least when I was here that I had as good a record on being concerned about the deficit as anybody. But when you are losing five times as much revenue from a recession as the static cost of the stimulus package, I think it makes sense to act, not to sit passively by.

Secondly, if you take the Wilshire 5000, which is the broadest index of equity value in America, and you go back to the high water mark in 2001, and you compare that to today, we have lost $6.7 trillion in equity value; $6.7 trillion in equities that form the foundation of the life savings of our people; that form the foundation of our retirement programs. Whatever we can do to rebuild that equity value is going to produce many times more revenue than we are talking about in a static sense in this stimulus package.

So I think it is very important that we act on it. I think the figure that over the next three years that we would have the potential of creating an extra two million jobs is not out of reach. I think it might be achievable. And I think this stimulus package should be adopted.

Finally, in terms of this war, I did not see any evidence in 1991 that the war had any significant economic impact, and the economy is twice as big today as it was in 1991. I think the war is very important and I think it is something we ought to be concerned about. It is something we ought to be worried about and praying over. But this economic problem is something that is vitally important, and I do not think simply because we are staring a war in the face that we ought to forget the fact that unemployment is rising, that equity values have declined by $6.7 trillion, and that there is a lot of work to do economically. That is why I want to congratulate this subcommittee on holding this hearing, even when so much of our thought is on the war.

[The prepared statement of Hon. Phil Gramm can be found on page XX in the appendix.]

Chairwoman KELLY. Thank you so much, Mr. Gramm. Is it okay if I call you "Senator" still?

You have been one of the key players in all of the tax debates over the past 20-plus years. You have talked about some of the lessons that those debates have given you, about economic growth and federal revenues that we should apply to the debate over ending double taxation of dividends. Which fears that were raised by the President's opponents are not valid, based on past experience? You have heard some people earlier today talk about some of their fears. Which of those fears do you feel are not valid?

Senator GRAMM. Well, first of all, I think that our first fear ought to be about the economic recovery. Let me make it clear right now, I believe the economy is going to recover no matter what we do. I think the economy is going to recover. It is going to overcome the illness and the absurd prescription of the doctor. But it is going to recover slower if we do not try to do something to stimulate it. For the people who are going to be affected over the next three years, I think we can make their lives better and I think we can strengthen the economy dramatically. So it is not a question of, is America going to recover economically—we are. The question is the speed of the recovery and how it is going to be affected.

I would say this, Madam Chairwoman, and I do not want to get into a political debate. I have gotten out of political debates. But I would take the concern about the deficit more seriously if the people raising it had the same standard for spending money as they do reducing taxes. I think basically that is the test. In the end, I think that given the state of the economy and given the nature of this downturn we have, and how much uncertainty there is about it—and I can tell you, working today in New York, working with people who want to make investments, that have powerful economic ideas, there is still a great deal of uncertainty. And whatever we can do to allay some of that uncertainty, I think we should do.

Chairwoman KELLY. Thank you.

Mr. Hinojosa?

Mr. HINOJOSA. Thank you, Chairwoman Kelly.

Senator, it is a pleasure to see you again.

Senator GRAMM. Thank you.

Mr. HINOJOSA. Coming from Texas and seeing how you worked and worked so effectively, it is a pleasure to see you back on the Hill, and especially before this committee so that we can ask you some questions. Possibly the questions I am going to ask you may appear to be softball pitches because you come from Texas, but truly I want to ask you a question that is not very clear, and I certainly do not necessarily agree with the President's plan to stimulate the economy. Being the great economics instructor that you were at Texas A&M, I am going to focus my question on housing. Housing seems to be an industry that has created lots of jobs and continues in spite of the decrease of the GDP, which was projected to be at 3 percent and now will be 1.5 percent, according to some experts.

Nine national housing lobbies have expressed concern that President Bush's proposal to eliminate the taxation on individual dividends would undermine the country's most successful program producing and rehabilitating affordable housing. The low-income housing tax credit gives investors a dollar for dollar reduction in taxes in return for investing in such housing, which you and I know is greatly needed down in South Texas. The dividend exemption could make all tax credits less attractive to investors and could move investment from tax exempt government bonds to dividend-paying stocks, thus reducing the allure of the low-income housing tax credit and endangering affordable housing programs in the United States. What are your views on this contention?

Senator GRAMM. Let me say, Congressman Hinojosa, I thank you for your kind comments. I have always appreciated my friendship with you and with your family.

I have very strong views on this. Let me just begin with some history. When we cut taxes under President Reagan by 30 percent, these same arguments were raised in 1981; that by lowering the highest marginal rate from 70 percent to a 30 percent reduction from that rate, and ultimately with the 1986 Act, by lowering it all the way initially from 1981 at 70 percent to 28 percent, there was concern that the deductions you get for your mortgage interest would be lowered in value; there was concern about the marketability of municipal bonds—you raised that earlier. But let me say, in both those cases, both the 1981 tax cut and the 1986 more simplification—but in neither case was housing affected in a negative way and in neither case was there a perceivable impact on municipal bond sales and on the viability of that market.

The logic that you are quoting people as saying basically is the logic that if you wanted to make deductions more valuable, you would make the tax rate 100 percent. All I am saying is, in my career in 1981, in 1986, in 2001, when we cut taxes, we did not see any of these dire predictions come true. Remember this, the municipal bond market is a market that is driven by the fact that income is tax free. Even with the elimination of dual taxation on dividends, you are still talking about a 35 percent tax rate.

So it is a concern that I do not see any evidence to substantiate it. If you just ask yourself the logic, this logic is used every time we reduce taxes. All I am saying is, I cannot speak for all of the history of mankind, but from 1981 and 1986 and 2001, it just did not happen.

Chairwoman KELLY. But Senator——

Mr. HINOJOSA. I am going to finish my question. Is that Okay, Chairwoman Kelly?

Chairwoman KELLY. As long as it is a short one.

Mr. HINOJOSA. It is a short one.

I will come back in the next round and ask you, so be thinking about it. How could it be that from 1980 to 1996, when we had this huge gap between house ownership between minorities and the average American, and we started producing a lot more jobs and reducing the unemployment rate down to its lowest; produced the most millionaires in that period from 1990 to 2000, that national policies were to have taxes at about the rate that they are at now and to pay taxes on these dividends. So they must not have been too bad, because we paid off our deficit.

Senator GRAMM. That is right. We cut taxes in 1995, if you will remember on the budget summit agreement with the President. We cut taxes. We cut the capital gains tax rate. We controlled spending and we started moving, beginning in 1995 toward a balanced budget. You know, everybody wants to claim credit for what happened. Really, from 1982 until about 2001, we were living in a golden age. I do now know if people knew it then, but I tell you, looking back at it now, in terms of the quality of consumer goods, in terms of the economic development reaching people that had not been reached in 30 years under Democrat or Republican Presidents—in the 1990s, this economic expansion started reaching those people and you and I have seen it all over South Texas. Creating millionaires did not create enough, but it created a lot of them.

Mr. HINOJOSA. Madam Chair, I reserve the right to come back in the next round and continue my question and his answer.

Chairwoman KELLY. Mr. Hinojosa, there will not be a second round with this witness. However, if you would like to submit a question in writing, you certainly are able to do that.

Mr. HINOJOSA. Thank you.

Chairwoman KELLY. Mr. Oxley?

Mr. OXLEY. Thank you, Madam Chairwoman.

Senator Gramm, welcome. It is good to see you again and we hope this is the first of several appearances before the Financial Services Committee. Let me express my gratitude to you for your leadership, both in the House when we were colleagues here, and in the Senate, and particularly your work on what became known as the Sarbanes-Oxley bill, and your efforts working with me to make certain that we did not go too far in our efforts to seek more corporate accountability.

To that end, in your testimony you say that eliminating the current bias against the payment of dividends will make the internal condition of corporations more transparent. I am wondering if you could help us with some details and elaborate on how ending the tax penalty on dividends will improve corporate governance and reduce the use of gimmicky off-shore tax shelters. Do you share with me the belief that some of these problems that developed in Enron in particular and other corporations in general in some ways were brought about by the rather odd way that we deal with corporate taxation, and specifically the double taxation of dividends?

Senator GRAMM. Here is basically my point, that when you have the tax code discriminate against equity financing, and discriminate against dividend payment—let me just give you an example. If I am running a company and I earn a profit, and I pay it out to my shareholders, I have got to pay corporate income taxes on it and then they have got to pay individual income taxes on it, the effective tax rate pushes over 50 percent—up to 60 percent. But if I simply take it and repurchase my stock or if I take it and invest it internally, even though the rate of return inside my company may not be as high as my investors could get by investing somewhere else, they still can be better off economically. I think that when you have a policy that is biased against equity, then you get the instability that comes with these very heavy debt burdens; when you have a policy that discourages the payment of dividends, dividends give people information about companies. Companies cannot pay dividends unless they have got a positive cash flow. The ability to exhibit that tells you a lot about the health of the company.

I just think that there just is no intellectual argument in favor of the dual taxation on dividends. The only debate about it is that people would like to have the money to spend. I have never heard anybody say that it is a good, sound economic policy. I am not claiming that the dual taxation of dividends was the source of all of our problems in corporate governance, but I am saying that allowing dividends to be paid by eliminating the bias in the tax code has a lot of other positives, and a big one is increased transparency. If my company is paying me dividends, I know they have got money from somewhere. My old accounting professor was trying to make a point, and as most professors do, overstated the point, but profit has to do with all kinds of complicated calculations—write-offs, depreciations, et cetera. Cash flow has to do with money coming in, the money you are paying out, and the money you can then pay out in dividends. That is as real as real gets in the world we live in.

Mr. OXLEY. If that is the case, and you particularly make a strong point that it is very hard intellectually to argue against the elimination of double taxation, why has it never been seriously tried until now? I know that I think Charles Schwab really raised the issue with the President at the economic summit down in Texas. But obviously, this is the kind of issue that has been around for a long time. When Chairman Greenspan sat there where you are and testified two or three weeks ago and I asked him those same questions, I started out by saying I can remember studying Econ 101 in college, and that my professor at that point was talking about the double taxation of dividends and how inefficient it was and an odd situation. And yet, now 40 years later, we are still engaged in that debate.

Is it just that it is so difficult? You were on the Ways and Means Committee over here in the House. Is it just because it is there and the inertia is such that we just cannot move it?

Senator GRAMM. I think it is hard to do because it is an easy issue to demagogue. It is an easy issue to take yourself back to the 1950s where only rich people owned stock. I think it is important. A question was asked earlier about corporate taxes. Corporations do not pay taxes. Corporations collect taxes from consumers, but they do not pay them. This idea that corporations are paying this tax, ultimately it is their customers that pay it when it is passed to the consumer.

I think it is just a hard thing to eliminate and I think it would be good if we could work out a consensus to do something about it. You know, there is this age-old debate about how big should government be and how much of society's resources should go through government. I respect that. I have a strong opinion about it, but I respect other people's opinion. But the way we collect that revenue ought to be in a way that has the least damaging effect on the economy, because whether you want people to spend their money or whether you want the government to spend it, you want the pie to be as big as possible. So there ought to be some way to have this debate where everybody should end up on the same side of this particular issue.

Mr. OXLEY. Thank you.

Chairwoman KELLY. Thank you.

Mr. Chairman, I am glad you brought up the name of Charles Schwab. I have here, and with unanimous consent, will enter into the record a copy of a March 11 Washington Post op/ed written by Charles Schwab, entitled, A Boon to Ordinary Investors: Eliminating the Dividend Tax is Just What the Economy Needs. So without objection, I will enter that into the record.

[The following information can be found on page XX in the appendix.]

Chairwoman KELLY. We go now to Mr. Moore.

Mr. MOORE. Thank you, Madam Chairwoman.

Senator Gramm, in January 2001 I believe the projected surplus by CBO was about $5.6 trillion. Does that sound about right, sir?

Senator GRAMM. For over a 10-year period, that is about right. My mind fades, but it was big.

Mr. MOORE. Right. I was speaking to a high school government class about the virtues of fiscal responsibility and balanced budgets and paying down debt last year. Even where I am on the other side of the aisle, I am not going where you may think I am going, because I voted for the President's tax cut. I thought it was the right thing to do and I still think it was the right thing to do two years ago. But at that time, we had a $5.6 billion projected surplus. I was talking to this group of high school students, and I said, how would you define "projected surplus?" This girl raised her hand and she said, "Maybe yes; maybe no." A pretty good definition, isn't it? Because as it turned out, what we hoped would happen, what we projected would happen, did not happen, did it? Over the 10 years, we did not have a $5.6 trillion surplus.

Senator GRAMM. It did not happen, and it did not happen really for several reasons. The economy got weaker.

Mr. MOORE. I understand.

Senator GRAMM. Number two, we spent a whole lot more money.

Mr. MOORE. My point is, when you project something, you hope it happens, but it will not necessarily happen. Isn't that correct?

Senator GRAMM. It is like an old woman once gave advice that when you are borrowing money, and you want a good analogy, write down on a handkerchief in indelible ink what you have to pay back, and then write down in fruit dye on the other part of it, where your revenues are coming from, and then wash it and see what is guaranteed.

Mr. MOORE. Fair enough.

Senator GRAMM. When you are predicting the future, you do not know.

Mr. MOORE. Exactly right. My point is, we were in surplus mode, and I am not blaming anybody for this. I am not blaming the President or the other party for this. I am just saying we were in surplus mode; now we are not. That is correct, isn't it?

Senator GRAMM. There is no question about it.

Mr. MOORE. And the President—and I am not blaming anybody for this; I am not making any political commentary on this—I am just saying we are or appear to be on the advent of a war right now, some sort of military action.

Senator GRAMM. The only thing I would say on that is——

Mr. MOORE. I have not asked the question yet. I am just asking. Thank you. With all respect, I do get to ask the questions here.

We appear to be ready for a military adventure of some sort, and we do not know what it is going to cost. I do not think you know, and I am not going to try to pin you down on that, because you cannot know, I do not think, or anybody. The President has even said we cannot really project what that is going to cost. Would you agree with that, in fairness?

Senator GRAMM. I do not think anybody knows what it is going to cost, but in 1991 it did not have any significant impact on the economy.

Mr. MOORE. Of course, this is 10 years later, and we still do not know what it is going to cost.

Senator GRAMM. Well, the economy is twice as big as it was 10 years ago.

Mr. MOORE. Right. We are in deficit mode. The President is proposing tax cuts, and I support some tax cuts, although I have some concerns about the size of the President's proposal. And we are, under the President's budget, at least $320-plus billion still in deficit, in his budget proposal. Isn't that correct?

Senator GRAMM. I do not think that—$320 billion sounds high to me, but it is too big to suit me.

Mr. MOORE. Okay. It is too big to suit me, too. I think we agree on that.

And I do not disagree either with your characterization of the taxation of dividends, in concept at least, because I do have this— I am from Kansas, sir, and I called the state department of revenue in Kansas when the President first proposed this dividend elimination. I talked to analyst there, and I said, do you have any idea what kind of impact this might have on collection of revenues in Kansas if this passed? He said, as a matter of fact, we just did an analysis of that and it is going to cost the state of Kansas $51 million. Well, Kansas is a relatively small state compared to Texas or California or others, and $51 million does not sound like a bunch of money. But when you are in a $750 million revenue shortfall, it is a lot of money to our new governor and to our legislature.

I submit that it is going to cost some other states a lot more money percentage-wise than it is Kansas in terms of this $51 million. Is that a concern or should it be a concern?

Senator GRAMM. Well, we have to believe that the elimination of dual taxation on dividends is going to create investment in America. Some of that will be in Kansas. How large it will be relative to the lost revenue I think is something you could speculate on. But let me make it clear that if we have this deficit and we did not have the current economic downturn that we are in, I would not be in favor of moving up these tax rate reductions. I think in that circumstance, we should be debating eliminating this inefficiency in the tax code and paying for it by either controlling or cutting spending, or by offsetting it somewhere else. I think the only reason it makes sense as a package is that we are in a downturn that is costing us five times as much as the revenues that we are talking about in terms of the economic growth package. That is the only reason it makes sense to me as a whole right now.

Mr. MOORE. Thank you, Senator.

Chairwoman KELLY. Thank you.

We go to Mr. Hensarling.

Mr. HENSARLING. Thank you, Madam Chair.

Senator Gramm, in your testimony I believe you said that the aggregate value of the President's proposed tax relief is less than 2.4 percent of the projected current services federal spending. There obviously continues to be great concern about deficits. In my own earlier math dealing only with fiscal year 2004, I came up with less than 5 percent. Can you tell us how you calculated the 2.4 percent?

Senator GRAMM. I took current services spending over the next decade. I took the value of the tax cut over the decade and divided. It is a little more front-end loaded because you are moving the rates forward to January 1, so in the first year it is more. In other years it is lower, but the average is 2.4 percent. I also would note that the deficit that comes from the increases in spending that the President has proposed is bigger than the deficit that comes from the tax cut the President has proposed, and yet many people who say the tax cut is too big say spending is too small. Yet if that is the case, how can the basis of concern be the deficit?

Mr. HENSARLING. I assume the 2.4 percent is based on static scoring?

Senator GRAMM. That is based on static scoring; how much it costs if no behavior changes; and of course it is based on how much government costs if no behavior changes, but we are in the midst this year of increasing government spending.

Mr. HENSARLING. I appreciate the fact that you are no longer in the politics business, but I do appreciate the fact also that you are still in the policy business. So let me put it this way, there appears to be at least one alternative economic growth package and it talks about targeting tax relief. Wearing any of your three hats, have you perhaps looked at the alternative economic plan or do you have an opinion about targeted tax relief?

Senator GRAMM. I think people are getting confused between a stimulus package and just trying to give money away. What we are trying to do here is to get people to invest. A lot of people have trouble accepting that if America is going to be saved, it is going to be saved at a profit; that if you want people to invest their money, you have got to provide them with incentives to do it. The strength of the President's proposal is not in its aggregate value, as I said during my testimony. If you took the amount of money the President is talking about and simply threw it out of airplanes over the major cities of this country, you would have a very modest impact.

The reason that I believe the two major parts of it will have a significant impact, and that is elimination of the dual taxation on dividends and accelerating these marginal tax rates, especially the highest rate, which is the small business rate—is that you are going to induce people that have got lots of money, that are not now investing it, to invest it. I think that is the hope we are talking about. I think it is a realistic hope. I do believe the stimulus package will help the economy and will stimulate investment if you pass it. Nobody knows by how much. So you know, there are uncertainties about it, but I think given the risk that we are facing, it is a risk you ought to take. At the same time, you ought to be very careful about the money you are spending.

Mr. HENSARLING. The same alternative growth package has tax relief in one year only it front-loads all the tax relief. Do you have an opinion on that impact on the economy and job creators?

Senator GRAMM. It is bigger in the first year than the President's, but again it is not aimed at investment. It is aimed at stimulating consumption, which has never declined to begin with. So you might very well get people to spend the money you give them, but that is not what the effort is. The effort is to get people to spend money they already have that they are not spending. That is what a stimulus proposal is about. It seems to me, if you want to measure the impact of a stimulus proposal, it is how many dollars do you get people that they have to spend based on the number of dollars that you have that you spend.

If the best argument you can make is, well, if we give it to them, they will spend all of it, why don't you just drop it out of airplanes? By focusing on investment, that is where the problem is, and if we are going to get a substantial response, if we are going to put people to work, it has got to be in investment. Unfortunately, if you want to get into a debate about, well, equity and things of that nature—equity is growth. Equity is jobs. I think that is where people get confused. I think it is why we have such a hard time debating these subjects, but it is something I have watched for a quarter of a century, and it is not likely to be wished away.

Mr. HENSARLING. Thank you, Senator.

Thank you, Madam Chair.

Chairwoman KELLY. Thank you.

Mr. Crowley?

Mr. CROWLEY. Thank you, Madam Chair.

Senator Gramm, both sides recognize your great service to this country and we are very pleased to have you here before us this afternoon.

Senator GRAMM. Thank you very much.

Mr. CROWLEY. I know that you have probably gone over a little bit of the time, Madam Chair, so I will try not to keep you much longer than necessary.

Senator, you said on the second page of your statement—I was not here for your statement; I read through it afterwards—and I will just quote from the double taxation on dividends portion of your statement, the last paragraph and the last sentence, "And finally, the elimination of dual taxation on dividends is both an effective stimulant and sound economic policy which will speed up the recovery and increase long-term growth." I am assuming the growth you are talking about is job development. Would that be correct?

Senator GRAMM. When I am talking about economic growth, I am talking about job creation and real income of workers.

Mr. CROWLEY. Let me just read a statement from the Wall Street Journal, in fact, which is not known to be a liberal newspaper. A quote from a January 17 article of this year, and I quote, the elimination of taxes on dividends will diminish the abilities of businesses to take tax incentives on capital investment in R&D, things that actually create jobs, and basically saying that, my interpretation of it, that this stimulus package will not, through the reduction of the double taxation of dividends, create new jobs. In fact, I was just handed an article from today's—I am sorry—the March 13 Wall Street Journal that says that four Senators, including two Senators from the Republican side, Senators Olympia Snowe and Senator George Voinovich of Ohio, will not support the President's tax cut proposal.

Is the Wall Street Journal wrong? Are these Senators wrong as well?

Senator GRAMM. Let me tell you what would be right. What they are saying is that if you lower tax rates that the R&D tax credit is not as valuable. Well, why don't you make tax rates 100 percent and then we could just grow the economy like "hello?" The problem is that then people would not have anything to invest. It takes a good idea to limit—I must be getting old using words like "hello"—but it takes a good idea to sort of an absurd limit. I have supported the R&D tax credit. I support the deductibility of mortgage interest rates. I support the tax exempt nature of municipal bonds. But the idea that making people pay more taxes helps the economy by making those deductions more valuable, I think is taking a good idea and just extending it to where it is illogical.

I would say this, and I would ask you to look at it. In 1981, we cut the marginal rate from the top rate from over 70 percent down to the 50 percent range, and then ultimately we cut it in 1986 to 28 percent. I have never seen any evidence to substantiate that that had a negative effect on municipal financing or home ownership. The point is, there is an income and a substitution effect. When people had more money, it is true that the value of the deduction was less, but they had more money to spend and housing was something they wanted, and they spent more money on housing.

So I think you can take a little point and stretch it to the limit, but I just do not see any economic foundation to any belief that elimination of the dual tax on dividends would do anything other than help the economy.

Mr. CROWLEY. Let me just reclaim the time, and that is, I come from a city, New York, where we have lost almost 250,000 jobs—about half are related prior to 9-11. So this is not all 9-11-created; 500,000 jobs statewide. We have seen two million jobs lost throughout this country in the last over two years. I see very little in terms of immediate stimulation in this package—maybe long-term, but not immediate. It is not going to put people back to work.

Let me just ask you this question, do you have—I know you are not in the political realm anymore—do you have any reservations or are you uncomfortable in any way at the timing of this tax proposal, given the fact that we are poised to be in war. There are 300,000 young men and women sacrificing their time away from family right now, many of whom will be asked to make the ultimate sacrifice in defense of this nation. Do you have any reservations or concern about the timing of the calling for this tax cut, that will affect in essence the wealthiest in this country?

Senator GRAMM. Let me try to give you a totally honest reaction to that. First of all, it is not as if we ought to be raising their taxes because they are going to sacrifice for America. I mean——

Mr. CROWLEY. It is not their taxes I am talking about.

Senator GRAMM. I understand that. Let me just make this point. In 1991 when we had the Gulf War, I do not see, other than bringing down oil prices, which was a rich bounty to the economy of the 1990s, I just did not see any real economic impact coming from the war. If we did not have this lingering downturn, I do not think you could make a case for part of this economic growth package right now. I think you could make a case on dual taxation on dividends, but I think the rest of it you could not take a case for. But the fact that we are getting ready to have a war probably this week does not change the fact that we have got some real economic risk out there.

If you read the testimony, you know I made the point that this recession is different than the ones we had in the 20th century. We do not totally understand it. There are a lot of uncertainties about it. I am confident that the economy is going to get better. If I did not think so, I would not have gone to work for an investment bank. I would have gone to work for a law firm where you can make money on people's misery.

But I think there is reason to be cautious about the economy, is all I am saying. I think that I would be for it, given the fears I hear from people in New York who are talking about investing money, the fears they have got about the economy, I would be a little forward-leaning knowing what I know now if I were in public office, in trying to sort of put on a little insurance in terms of this recovery. I think it is going to be fine. I think the recovery is going to occur no matter what we do. I think we can speed it up, but there is enough that is new and different about it that I would just urge in thinking about it. It is obvious in listening to you that you are thinking about it and that you are looking at a lot of different things.

I think there is a reason to be cautious about this downturn because it is so different than any other one we had in the 20th century; that we just do not know how it is going to behave. That makes me a little bit nervous.

Chairwoman KELLY. Thank you.

Mr. Murphy?

Mr. MURPHY. Thank you, Senator. I wonder if you could just continue that thought—it makes you a little bit nervous, how?

Senator GRAMM. Well, because, you know, we have had some speculative bubbles historically. We had the South Sea bubble. We had the tulip bubble. But they were in the 17th and 18th centuries. I do now know anything about them. If any economist has looked back at speculative bubbles and how they behave, I am not aware of it.

So all I know is during my lifetime of awareness, the kinds of recessions we have had were things that I knew something about. They were inventory cycles. We could never predict them, but we knew how they behaved. If we were at this point in an inventory cycle, we would have a pretty great deal of certainty about what is going to happen.

This is a different kind of downturn, subject to different kinds of behavior. While I would bet money that things are going to be all right, I still, if I were in your position, I would be cautious—the reason I would vote for the stimulus package, even if I had questions about dual taxation of dividends or even if I had questions about accelerating this tax cut, is because of the economic uncertainty. I think this economic growth package is a good plan overall in terms of economic effect. I think there is one other part of the President's package that is not part of this that is good, and that is that $15,000 IRA-type investment where you can invest up to

$15,000 for a couple. You could put after-tax money in, but the buildup for college education, retirement, house, housing, buying your own home is tax-free. I think that is a good policy as well. But I just would be cautious given the uncertainties of this downturn we are in.

Mr. MURPHY. Thank you. You made a statement in your opening statement I would like you to also elaborate on this, if you would. This has to do with the impact upon small businesses, which you portrayed as the basis of really so many jobs in our economy. You said the elimination of double taxation of dividends will help small businesses that are currently discouraged by tax policy from adopting a corporate structure, even if it would allow them greater access to capital.

Do you see that small businesses are willing to—this would give them that incentive to jump in and take some of those? Would it be more risk, less risk for them? I would like for you to comment.

Senator GRAMM. Currently, if I am running a company and we are beginning to grow, up to a point, I have an incentive to stay away from the full-fledged corporate structure because of the double taxation on dividends, because I can be taxed as an individual with a proprietorship or partnership or subchapter S corporation. Once I start growing, then I begin to get into a conflict between the improved access to capital I can get through full incorporation versus the tax advantages I get by staying a subchapter S or by staying a partnership or proprietorship.

All I am saying is that no rational society would let the tax code dictate the structure of the business firm. It would let the market do that. That is one of the reasons why the dual taxation on dividends is such bad policy.

Mr. MURPHY. Thank you.

I yield back the rest of my time.

Chairwoman KELLY. Thank you.

Mr. Garrett?

Mr. GARRETT. Thank you, and professor in light of the splendid introduction that you received, my first question I guess is are there any grades currently being held back that have not been delivered as of this date?

Senator GRAMM. Well, if Congressman Hensarling had had poor grades, I would think about going back and changing them. I do not know if after all these years that they would let me do it. In fact, I would say in all of my years as a college professor, I only changed one grade, and it ended up being for now a Democrat member of Congress. So they do not always work out.

[Laughter.]

Mr. GARRETT. You made a statement in your introductory comments with regard to the history. I found that interesting as far as that we are in the speculative phase right now in the equity markets, and that may be part of the cause of where we find ourselves now, and how that differs from what over history it was like. Right now, I am reading a book about the history of going into the late 1920s into the Florida speculative housing boom, and how you had the ups and the downs and the little panicky phases at that time as well. So maybe we have had certain—and I am not as good on history as you are—but maybe we had certain little periods like this in the past that we could look to.

Senator GRAMM. The Great Depression was a financial panic, and I do not think Alan Greenspan would disagree with this, that in part because of bad government policy, became a full-fledged depression. This is a different kind of downturn, this speculative bubble. I do not see any significant chance of it becoming worse in terms of becoming of depression proportions. It is just not recovering as quickly as we might recover that I think the whole debate is about.

I do not think there is or should be any realistic debate about, is America going to recover; is investment in American equities the best investment you can make. I think the answer is yes. The question is, how quickly is it going to recover, and what could we do to speed it up. I think that is the debate.

Mr. GARRETT. Okay. And in that, you continue with your opening remarks with regard to how in this period of time, you have seen the consumption remain strong. So for that reason, you do not want to necessarily go down the road of the consumption-driven alternatives. And yet, a lot of the—I will not use the word "rhetoric"—but a lot of the language that we hear as far as proponents, and from the proponents of the tax measure is that the average family of this size will receive around $1,000 or $1,100 back, and that is one of the strong reasons why we should be supporting it. Obviously, that $1,000 or $1,100—and I am a supporter of this, I just wonder how we pin this down—that $1,100 is not, I do not think, the same classification where you are talking about the 85 percent language later on and it is really going to the investment side. That $1,100—that is really going to the consumer, the consumption side, correct?

Senator GRAMM. Well, there are two different debates here. The one debate is the so-called equity debate. It is always skewed by the fact that half of Americans pay very, very little taxes in income taxes. So it is so easy to stand up and say 50 percent of Americans will get 5 percent of the benefits. Well, 50 percent of Americans pay about 5 percent of the taxes. So all you are saying in saying that is the tax code is progressive, and not saying—but it confuses people.

The real debate is what gets the economy growing so people are making more income so they can pay taxes with it? I think that that is where we get pulled off the track into this debate about the distribution of the tax cut. The truth is, this economic growth package will make the tax code more progressive than it is. But the reason you ought to vote for it is it gives us a good chance of making the economy bigger than it is going to be over the next three years, so everybody will benefit. I do not think we ought to worry about somebody profiting by investing. I do not understand loving capitalism and hating capitalists. I do not understand this preoccupation that somebody might somewhere benefit by doing something productive. If we do not let people benefit, they will not do it.

Mr. GARRETT. I will just close, then, on this. I think that point you made just 30 seconds ago as far as the progressive nature of this tax cut is a message that I hear here, and I have heard with the Secretary of Commerce in the past, but it is a message that seems to be lost in the entire discussion and maybe goes back to that last point that you made before with regard to those who are attacking this plan never look at the spending side of the equation, and the fact that that is really a larger cause than the tax cut side of the equation.

Thank you for your testimony.

Senator GRAMM. Just always remember this when you are debating this issue, that 19 percent of Americans when they are polled believe they are in the top 1 percent of income and 40 percent believe they are in the top 5 percent of income. So when people are talking about the top 5 percent, 40 percent of Americans believe they are in the top 5 percent and they are voters. So I would never be afraid of this issue.

Finally, as sort of a solicitous comment, if this were a society where people somehow were set forever in some kind of class based on economics, maybe all this silly argument would make sense. But I do not know each of your backgrounds, but I know Congressman Hensarling's background and his father was a chicken-raiser. My dad was a sergeant in the United States Army. Congressman Hensarling is a member of the United States Congress and grew up scooping chicken manure out of coops. My dad was a sergeant in the Army. I am an investment banker and a former United States Senator. This class warfare stuff in America is an absolute farce and joke. It is hard for me to see how people can say it with a straight face.

That is the end of my sermon.

Chairwoman KELLY. Thank you very much.

Mr. Sherman, have you any questions for this witness?

Mr. SHERMAN. I do indeed.

Senator, rest assured I love capitalists. My father was executive vice President of a New York Stock Exchange-listed company, but I am frankly embarrassed by this class warfare attack against working families. Only in a room like this could we refer to this exemption of dividends as a progressive tax cut, when I can remind the subcommittee that you take all the benefit for 95 percent of Americans—all those with incomes of under $140,000—and it just barely equals the benefit to the top 2 percent; no, correction—the top .02 percent.

We had the chair of the full committee sit here and say that Alan Greenspan endorses this proposal—I was here. He said he endorsed this proposal if it was revenue-neutral. Senator, other than dynamic storing and other drug-induced fantasies, I would like someone to tell us how this is a revenue-neutral proposal.

We have concluded or are about to conclude the second panel. We have yet to hear from a witness who opposes this program or would oppose any give-away to the wealthiest. That is why Peter Fisher sat there in the same seat the Senator is and said he had not heard of anyone who supports the present system for taxing dividend income. You know, he could have sat here until now—he may have said that twice—taxing it twice? Taxing it twice. Well, he has not obviously listened to any Democrats and he could have sat here and listened to both the first full two panels and he would not have heard anybody. But there are many advocates of the present system—myself included—but I guess according to Peter, he had not heard my opening statement, although he was sitting there, or I am among the people that do not exist.

This proposal went over on the markets like a thud. The President announced it; the markets did not go up. Why? Perhaps there is an understanding that this is going to hurt the economy, or perhaps just an understanding that it is going to hurt the economy, then it is going to hurt the Republican Party, then it is going to get repealed so you cannot count on it as a long-term fixture of American tax policy.

The Senator pointed out to us that 40 percent of Americans think they are in the top 5 percent, which means the success of this proposal politically is based on Americans being off by a factor of seven. That may not last. You may invest in stocks today assuming that a political party that believes that this is a progressive tax proposal will remain in power. It is just possible that Americans will not continue to be ignorant of the fact that seven out of eight Americans who think they are in the top 5 percent are not.

Now, if you can bet on continued ignorance of economic facts by the American people, then you can bet on this continuing to retain its level of popularity. But what I want to point out here is the interesting shell game. When you can lower taxes on the ultra-wealthy by saying that we need to favor investment over consumption, then you trot out that argument and justify a low rate on capital gain income, which spends just like regular income, except it spends more because it is not subject to the same tax.

But when you want to lower taxes on the wealthy and give 70 percent of the benefit to the top 5 percent, then you are neutral as to whether the money remains locked in the corporation available exclusively for business investment, or whether it gets distributed to those who may decide not to reinvest in other stocks, not to redeploy the money into other investments, but buy that new $350,000 Mercedes. As a matter of fact, I do not think it is a mere coincidence that Mercedes comes out with a $350,000 car and then there is pressure to exempt dividends from taxation. If only Mercedes limited their cars to $100,000, it would place less political pressure on this House to come up with ways to make sure that the top one-tenth of 1 percent can afford the latest imported toy.

Chairwoman KELLY. Mr. Sherman, if you have a question, would you ask it please, because your time is up.

Mr. SHERMAN. My time is up. The flaws of this proposal cannot be summarized in a mere five minutes.

Thank you. I yield back. If the Senator wants to respond, he can——

Chairwoman KELLY. Senator Gramm, if you would like to respond, please feel free to do that.

Senator GRAMM. We had a debate about luxury taxes and taxed yachts. I would have to say that I do not know how the Senator from Maine, the Democrat majority leader at the time voted on the yacht tax, but he discovered something. That is, people build those yachts and they make a good living at it. We came back and repealed the yacht tax. Now, I do not ever intend to own a yacht. I do not intend to own a Mercedes. But I just would say this, that the Joint Committee on Taxation and everybody with any degree of knowledge that has looked at the President's proposal concludes that it makes the system more progressive. I can tell you why.

Accelerating the marriage penalty, accelerating the child exemption—those are costly benefits that go directly——

Mr. SHERMAN. Senator, if I can just interrupt—all the benefits that go to working families out of this bill are temporary. They take something that would have happened two years from now and for two years the law is made more progressive. The dividend cut and the estate tax repeal are permanent, so the benefits that go to the wealthiest 1 percent continue to be true next decade, the decade after, the decade after that.

Senator GRAMM. The President's proposal is to make all the provisions permanent.

Mr. SHERMAN. But some are going to be permanent anyway because that is existing law.

Senator GRAMM. Anyway, Madam Chairman, thank you very much for giving me the opportunity.

Mr. SHERMAN. Thank you, Madam Chair.

Chairwoman KELLY. Thank you very much, Senator. We are very pleased to have had you here on your maiden flight testifying before this committee here on the House side. I want to note that some of the members may have additional questions for you that they may wish to submit in writing. So without objection, this hearing will be held open for the next 30 days for members to submit those written questions.

Senator, we once again thank you so much for your appearance here today. This panel is now excused.

I want to introduce the third panel as they are seated. First, we will welcome our former colleague in the House on the Banking Committee, the Honorable Rick Lazio, a proud New Yorker and now the President and CEO of the Financial Services Forum; John Castellani, President of the Business Roundtable; Peter Orszag, Joseph A. Peckman Senior Fellow in Economic Studies at the Brookings Institution; Stephen Moore, Senior Fellow in economics at the CATO Institute and President of the Club for Growth; William Spriggs, Executive Director of the National Urban League Institute for Opportunity and Equality; and finally, Bobby Rayburn, First Vice President of the National Association of Home Builders.

I want to thank you gentlemen for testifying before us today and I welcome you on behalf of the full committee. Mr. Lazio, it certainly is a pleasure to have you back with the committee again. Without objection, your written statements for all of you will be made part of the record. You will have five minutes for your oral testimony, and we will begin with you, Mr. Lazio.

STATEMENT OF HON. RICK LAZIO, PRESIDENT AND CEO, FINANCIAL SERVICES FORUM

Mr. LAZIO. Thank you, Madam Chair. It is wonderful to be back and to see you again, Madam Chair, and my other colleagues. I appreciate very much the opportunity to be here and to share this table with some distinguished speakers. I hope I can shed some light on our feelings on behalf of the Financial Services Forum on the proposal as it particularly relates to the exclusion of dividend income.

The Financial Services Forum which I have the pleasure of being the chief executive officer of, is composed of the chief executive officers of some of the largest and most diversified financial institutions in the United States. The purpose of the forum is to promote policies and enhance savings and investment in the United States and that ensure an open, competitive and sound financial services marketplace that contributes to the long-term growth of the American economy.

We believe that ending the double taxation of dividends will benefit investors, strengthen the capital markets, and improve our prospects for long-term growth. The measure will stimulate the economy in the short term. However, we strongly believe that longer-term positive consequences are most important.

The most obvious benefit to ending the double taxation of dividends, which has been referred to earlier, is the promotion of a steady dividend payment to investors. Within normal ranges of share prices and business performances, individual investors receive cash in hand with reasonable certainty, and immediate ongoing return on shareholding. This flow of funds enhances the lives of American families, retirees and other individuals in our society. Currently, many shareholders receive the benefit of stock ownership only when they sell their stock. Clearly, it is desirable to increase investor benefits in a manner that does not require stock sales to achieve. Ending the double taxation on dividends also gives the average investor a simple basis on which to evaluate equities—the value of the dividend.

Double taxation of dividends results in the inefficient allocation of our nation's resources. Companies are penalized for returning funds to shareholders. Under current law, businesses are incented to reinvest earnings, which often could be put to better use elsewhere. Eliminating these perverse incentives leads to a more efficient capital market and a far more productive economy. Further, this measure would make American firms more competitive in the international arena by lowering overall the cost of capital.

It has been clear for some time, Madam Chair, that double taxation has created a bias in favor of debt, as opposed to equity capital because of the deductibility of interest payments. We have seen over and over again that excessive levels of debt become problematic during an economic downturn. Firms with too much leverage do not have sufficient flexibility to cope with adverse market conditions, to the detriment of their shareholders. Eliminating the double taxation of dividends removes the bias toward corporate debt, encouraging more equity in capital structures, which allows firms to weather adversity and protect investors in difficult times.

Double taxation encourages corporations to engage in share repurchases because current law permits the distribution of earnings in this manner at lower capital gains rates. Investors, however, do not realize the cash benefit of the share repurchase until they sell their stock. Eliminating the double taxation of dividends makes it more likely that shareholders will receive higher dividends and realize corporate gains without having to sell their stock.

Because the tax code discourages payment of dividends, publicly traded companies often are focused on goals that can become problematic. Under present circumstances, shareholder value tends to be equated with an appreciation of stock price by many firms. Regrettably, we have also observed too many companies resorting to accounting manipulation to inflate earnings and stimulate stock price appreciation. Correcting this bias against dividends will cause both firms and their investors to emphasize cash flow and cash dividends as true and more appropriate measures of true value.

In summary, Madam Chair, removing the double taxation of dividends results in significant benefits to individual Americans and American families. The measure will restore balance to the manner in which publicly traded firms are managed by removing incentives to issue excess debt, repurchase shares, invest retained earnings in sub-optimal investments, and designing unproductive strategies just to avoid taxes and inflate earnings.

We believe that eliminating the double taxation of dividends will cause firms to focus on creating true value for shareholders and other stakeholders. Share prices of dividend-paying stocks tend to be less volatile, and thus are a stabilizing force in the capital markets and that certainly has been the case over the last few years, and that is empirically provable. Eliminating the dividend tax will contribute in a major way to restoring and increasing confidence in our markets and contribute to long-term productive growth in the economy.

Finally, this proposed change would correct the fundamental lack of fairness in the tax code by ending the bias against equity capital and dividends, and increasing the competitiveness of United States firms.

Thank you, Madam Chair.

[The prepared statement of Hon. Rick Lazio can be found on page XX in the appendix.]

Chairwoman KELLY. Thank you, Mr. Lazio.

Mr. Castellani?

STATEMENT OF JOHN J. CASTELLANI, PRESIDENT, THE BUSINESS ROUNDTABLE

Mr. CASTELLANI. Thank you, Madam Chair.

I am pleased to be here this afternoon on behalf of the chief executive officers who make up the Business Roundtable. The Business Roundtable is an association of CEOs of major corporations that have a combined workforce of 10 million employees in the United States and $3.7 trillion of annual revenues. Although we are in the business of creating jobs and contributing to economic growth, we have serious concerns about our ability to do so in these times with a fragile economic environment.

The chief executive officers of the Business Roundtable feel that the U.S. economy is not growing to its potential. Consumer demand and consumer confidence are shaky. The confluence of our nation's war on terrorism, the potential war with Iraq, and the decline in stock prices have resulted in diminished assets and savings and have led to consumer retrenchment. Our CEOs feel that business investment will only return when there is sufficient consumer demand to exhaust the existing capacity in the U.S. economy. Only by increasing demand will we return to a level that supports investment and more importantly supports job growth.

We feel we need to ignite consumer confidence and stimulate consumer spending, and that is why we are urging the enactment of President Bush's economic growth and jobs package as reflected in H.R. 2. If enacted, we believe that it will significantly stimulate the economy in the short term, as well as boost long-term economic growth. PricewaterhouseCoopers recently conducted a study for us using a widely supported macroeconomic model that is housed at the University of Maryland. The study showed that if H.R. 2 was enacted this year by July 1, it would create an average of 1.8 million jobs in each of the next two years and an average of 1.2 million jobs per year in the next five years. It would boost gross domestic product in the U.S. economy by 2.4 percent by the end of 2004.

The plan would boost incomes and jobs and help all sectors of the economy, including housing and capital markets. Working consumers will have more money to spend and more confidence to spend it on goods and services. By accelerating the 2001-enacted rate cuts, the marriage penalty reduction and the child tax credit increase and by eliminating the double taxation of dividends, the proposal will not only provide immediate boost to the U.S. economy, it will also add millions of jobs and again increase confidence and economic growth.

As importantly, the single element of eliminating the double taxation of dividends will have the most positive impact on long-term economic growth. That provision alone will create by the model's projections 500,000 jobs per year for the next five years. It will also have an additional number of important and multiplying effects. First, it will spur consumer spending by increasing the after-tax income of stock investors. Shareholders will benefit because they will no longer bear the unfair burden of paying taxes twice on the same income, and they will benefit again when companies boost their dividend payments. By our estimates, we would expect a 4 percentage point increase in dividend payout ratios over the next 10 years.

Second, eliminating the double taxation of dividends will improve corporate governance in a number of ways. Companies will have less incentive to engage in structured financing transactions that have little or nor business purpose. We can expect better transparency in the reporting of corporate earnings because investors will reward companies that pay tax-free dividends. And companies will be less likely to take on excessive debt and risk bankruptcy in pursuit of lower taxes.

Third, while it is difficult to predict stock market reaction, even the most conservative analysts predict increases in stock prices. All three combined will not only benefit the broad spectrum of the economy that receives dividends, particularly those people who depend on them in their retirement, but it will also benefit all of those funds which are invested in equities, including 401(k)s, IRAs, and public and private pension funds.

The positive effect on stock prices that would arise from the elimination of the double taxation of dividends would, for example, translate into a potential increase of $4,200 per 401(k) participant and $110 billion in the aggregate of all 401(k) plans. On the defined benefit side, millions of Americans would see substantial improvement in their retirement security and companies would have additional operating capacity to invest, resulting in more profits and increased stock prices.

The Roundtable urges the Congress to move quickly to enact an economic growth plan that will give both an immediate boost to the economy and put people back to work. The President's plan is the best means for creating jobs, encouraging business investment, strengthening the capital markets, enhancing corporate governance and igniting economic growth. It is the right prescription for an ailing economy.

Thank you.

[The prepared statement of John J. Castellani can be found on page XX in the appendix.]

Chairwoman KELLY. Thank you, Mr. Castellani.

Mr. Orszag?

STATEMENT OF PETER ORSZAG, JOSEPH A. PECHMAN SENIOR FELLOW IN ECONOMIC STUDIES, THE BROOKINGS INSTITUTION

Mr. ORSZAG. Thank you, Madam Chairwoman.

I would like to make five points in my five minutes, so if I stick to one point per minute, I should be fine.

The first point is that the administration's tax proposals will exacerbate the long-term budget outlook. We have heard a lot about the effect of the proposals on the deficit, but let's just look at CBO's numbers in 2013. This is after any temporary downturn would presumably be over, when the economy is at full employment, and as Senator Gramm said, in that kind of setting he would be reconsidering the forms of various tax provisions. At that point, the tax cut that the administration is proposing would amount to 1.8 percent of GDP, and the cost would increase thereafter because many of the provisions are so back-loaded that their full cost is not apparent even in 2013.

If you look out over the next 75 years, the tax cuts the administration is proposing would amount to 2.3 percent to 2.7 percent of GDP. That may sound abstract, but just to put that in context, the Social Security deficit over the next 75 percent is 0.7 percent of GDP, so these tax cuts are more than three times as large as the entire Social Security deficit over the next 75 years.

The Medicare part A deficit is 1.1 percent of GDP, so even if you add Social Security and Medicare part A, that is 1.8 percent, that is still smaller than the size of these tax cuts. So these are large.

The Committee for Economic Development, a leading business organization, has put it in common sense terms. The first step in climbing out of a hole is to stop digging. We already face very large long-term deficits because of the retirement of the baby boomers. We do not need to make them worse. Second, on the economic effects, the long-term economic effects of the proposal, it is very important to remember that these are not revenue-neutral proposals. If it were a revenue-neutral proposal it would be a very different ballgame. Because it is not revenue-neutral and because it does expand the budget deficit, there is a positive effect from the improved allocation of capital across sectors, but a negative effect because of the increased budget deficit which reduces national savings, which is the flow of financing for investment. You have to weigh the two effects against each other. You cannot just look at the positive effect.

An organization that did that, Macroeconomic Advisers, whose model by the way is the one that is used by the Council of Economic Advisers to produce its own numbers—in other words, it is the model used by the administration—has found that the negative effects from reduced national savings because of those larger budget deficits will outweigh any positive effects from the improved allocation of capital across sectors, so the long-term impact from the proposal is negative.

I understand that the Business Roundtable model shows somewhat different results than Macroeconomic Advisers. In my opinion, although the details are a bit sketchy in terms of exactly what that model is or how it was applied, I think it was mis-applied for this purpose, and I would be happy to answer questions about that.

The third point is on the distributional effects. We have heard a lot about the average tax cut. I think it is very important to remember that averages can be quite misleading. The average of my one-year-old son and Senator Gramm is a 30-year-old who is about four-feet tall. That is not particularly insightful. Instead, you have to look at the distribution of people. When you do that, you see that half of tax filers would get a tax cut of $100 or less; two-thirds of tax filers would get a tax cut of $500 or less; and 78 percent of tax filers would get a tax cut of $1,000 or less.

Similarly for the elderly, and here I think it is very important. We cannot just look at the number of elderly who benefit, because if an elderly couple had a penny in stocks and received a penny in dividends, they would be counted as receiving dividends. You have to look at the amounts that are involved. When you do that, what you see is that two-thirds of the elderly would get $500 or less from the administration's growth package, and for the dividend proposal alone, the two-thirds of the elderly who have incomes below $50,000 in income would receive just 4 percent of the total tax cut. It is only when you throw in the elderly who have very high incomes that you start to get those numbers up.

Fourth point, small businesses—58 percent of tax returns with small business income are in the 15 percent or lower tax bracket. Senator Gramm talked a lot about the top tax bracket. Only 2.3 percent of small business tax returns are in the top tax bracket. So most small businesses are not facing that 38.6 percent rate. Furthermore, more than half of those 2.3 percent have a very small share of their income coming from small business income. They are not really small businesses in any meaningful sense.

Finally, on corporate tax reform, I think it is very important to realize again this proposal is not revenue-neutral. What that means is that as Chairman Greenspan has emphasized, if you did it as a revenue-neutral proposal, there is just that unambiguous positive effect, rather than the positive effect and the negative effect from the expanded budget deficits. From a political economy perspective, you are basically giving away the candy with this proposal. If you think that corporate tax reform is going to involve both spinach and dessert—the spinach of closing down corporate tax loopholes and the dessert of giving away some tax preferences, you want to combine them in a single package to make the package as a whole politically viable.

What this proposal does is gives away the dessert without forcing corporations or the tax code as a whole to eat the equivalent of the spinach. It thereby undermines any chance of getting real corporate tax reform.

Thank you.

[The prepared statement of Peter Orszag can be found on page XX in the appendix.]

Chairwoman KELLY. Thank you.

Mr. Moore?

STATEMENT OF STEPHEN MOORE, PRESIDENT, CLUB FOR GROWTH

Mr. MOORE. Thank you.

I support the President's tax plan. I wish it were bigger, but I think it is a good tax plan. I would like it to include a capital gains cut, although there is a capital gains reduction, in that we should cut the capital gains rate to 15 percent. Every time we have cut the capital gains tax for the last 40 years, we have gotten more revenues, not less.

We also ought to do what Senator Gramm talked about and President Bush is talking about, which is the expansion of the IRAs. That would have a dramatic impact on increasing the investment and savings rate in this country. I thought I would just spend a couple of minutes just talking about some of the points that were made in earlier testimony and some of the questions, and try to clear up some of the points.

First was the effect on the budget deficit. I hope that the Congress will focus on the most important deficit that we have right now, which is not the budget deficit, it is the growth deficit. The budget deficit that we are facing right now is a ramification of the growth deficit that we face. We have gone from 3 to 4 percent real economic growth rate in the late 1990s to closer to 1 to 2 percent right now. That accounts mostly for the increase in the budget deficit that we have seen. So the Bush tax cut, if it increases growth, which I think it will, can have a very dramatic impact on reducing the growth deficit, and thereby the budget deficit.

Just to punctuate that point, if we could grow the economy just by 1 percentage point faster than is currently projected, that will erase about $1.5 trillion of deficits over the next 10 years. So increasing growth can have a very substantial impact on the deficit.

Second of all, it was brought up several times about the impact of this tax cut on States and localities. I must say I am absolutely baffled about how anyone can make the argument that cutting taxes by $750 billion over the next 10 years could possibly hurt State and city governments. We are talking about taking money out of Washington and putting into the pocketbooks of state and local taxpayers, where it never comes to Washington in the first place. That can only have a very salutary and healthy effect on states and localities. Of course, the best example of that is when we did the Reagan tax cut, which was about three times larger than this tax cut. It led to the most prosperous period in state and local finance in history. Senator Gramm touched on that as well.

A third point that was made was that now is not the time—that we are on the eve of war and that a time of war, should we really be cutting taxes. I would say again the best example of how a tax cut can actually help us win this war is what happened in the early 1980s with the Reagan tax cut, where basically President Reagan said we are going to do two things. We are going to have a massive increase in defense buildup to win the Cold War, and we are going to cut taxes. I think the evidence is now very clear that the tax cuts helped generate the economic growth that led to the victory in the Cold War. In fact, the Soviets now say that the reason that we won the Cold War was because of the superiority of our economy, and not just our military.

Fourth and final point is about the revenue loss. I think this is such an important point to make because everybody is throwing around all these numbers about what the tax cut is going to cost. I would just urge you all to think about the fact that every time we have cut taxes over the last 40 years, we have always—always, 100 percent of the time—we have always overestimated how much revenues we are going to lose from the tax cut, in every single case. That was true when Kennedy cut taxes in the 1960s. It was true in the 1980s when Reagan cut taxes.

The starkest example and the most recent example was what happened in 1997 when we cut the capital gains tax. If you look at the official revenue estimates that came out of this institution, the Joint Tax Committee, they estimated, Madam Chairwoman, that we were going to lose $50 billion over the next five years if we cut the capital gains tax. In fact what happened is we gained $100 billion in revenue. So oftentimes when we look at these static-based revenue estimates, they tend to be very wrong. We ought to move towards a more dynamic estimation model that takes into effect the economic growth consequences of tax cuts. So I would urge you to pass the Bush tax cut, grow it, and do it as fast as possible.

[The prepared statement of Stephen Moore can be found on page XX in the appendix.]

Chairwoman KELLY. Thank you, Mr. Moore.

Dr. Spriggs?

STATEMENT OF WILLIAM E. SPRIGGS, EXECUTIVE DIRECTOR, NATIONAL URBAN LEAGUE INSTITUTE FOR OPPORTUNITY AND EQUALITY

Mr. SPRIGGS. I am going to try and behave, Madam Chairwoman, because Steve just finished in under five minutes, so I am going to try and do the same thing.

Chairwoman KELLY. I appreciate that.

Mr. SPRIGGS. I want to thank you for allowing me to testify. I do appreciate that this panel does have a diversity of views, and thank you very much for the diversity reflected here.

I represent the National Urban League, which is the nation's oldest and largest community-based organization dedicated to moving African Americans into the economic and social mainstream. We are very happy that the President and the Congress recognize that the economy is in a slump. However, we are very concerned about the consequences of some of these proposed fiscal policy changes and their unintended consequences as well.

The President has proposed excluding dividend income from the taxes of individual taxpayers. Now, as currently constructed, the proposal would allow for the tax redistribution of corporate earnings on which the corporation has paid taxes. This, then, sets up actually our dichotomy, because there is going to be a different interest in terms of those who are institutional investors for whom the tax does not mean anything anyway, and the corporate directors and officers, who will be making the decision, for whom the tax does mean something. So we will have a difference between the motivation of officers and directors, between do they maximize shareholder after-tax income, or do they maximize the corporation's after-tax income? Those two lead to, I think, not ending the type of uneasiness that investors have as to what our corporate leaders' motivations, since there would still be this conflict in what is to be done.

Now, one of those key areas in which there are differences between what the corporation has in terms of tax liability results from acts of Congress to help encourage certain types of investment by corporations which benefit low-income communities in part, and the Secretary of Treasury talked about other loopholes for corporations as well, but I think that some of these are very well thought out items. They include such things as the low-income housing tax credit, the tax credit for the rehabilitation of historic structures, and the empowerment zone tax incentive, the renewal community tax incentives, the new market tax credits, tax credits for employee-provided child care, tax credits for holders of qualified zone academy bonds—all of these things help low-income neighborhoods.

I think that it is misleading, as we have heard before, to argue that the relative marginal tax difference for shareholders leads to corporations making decisions about whether they will use equity financing or whether they will use debt finance, then to argue that the change in the relative tax rates has nothing to do with whether businesses would decide to take advantage of these tax credits. Either the relative marginal tax rates matter and do something, or they do not matter.

Now, if we live in a world where we are going to be consistent and we are going to say that these marginal tax rates do matter, then there will be negative impacts on these programs. Does that mean that they are going to be eviscerated? No, but it means that their costs will be increased. I think it does mean that we have to think about what are the collateral costs of ending the dividend tax.

The low-income housing tax credit I am going to mention a little bit more because of its size. That is $15.1 billion over the next four years in terms of tax expenditures. So by comparison to the other ones, this is huge. Then also if you look at it relative to where does the money come from for low-income housing tax credits, almost all of the money comes from corporations taking advantage of this tax credit. Then you look at what does it mean for the low-income housing tax market—the development of units—and it has a huge impact. Most of the growth has been attributable to that tax credit.

Now, there has been much said about no one would ideologically be opposed to double taxation. Corporations are legal entities unto themselves. The assurance that an investor has is that the corporate officers ought to look after the health of that individual, that corporation. The income from a corporation therefore is not like the income from a partnership. The liability implications are very different between a partnership and a sole proprietorship. So this is not double taxation.

In any event, even if one bought the idea that there was double taxation, there is no reason to buy into the idea that what we should do is end the tax on the individual as opposed to treating the dividend as an expenditure in the same way that we treat wages. So I do not think that ideologically the argument is there.

Finally, as to cost, I think we raise the issue of cost because over the projected life of this budget, the 10-year period, this is going to cost $388 billion. That is more money than we are going to spend on the U.S. Department of Education for at least four years. That is more money than we are going to spend on the Department of Labor and Small Business combined. So it is the issue of priorities. Where could that money best be spent? If we try to solve the problem for these many tax credits, which are important to low-income neighborhoods, and increase the cost of this, isn't there a more effective way of achieving some of these same ends?

So I would hope that you would think seriously about the size, the magnitude of this proposal, as well as its collateral cost.

[The prepared statement of William E. Spriggs can be found on page XX in the appendix.]

Chairwoman KELLY. Thank you, Dr. Spriggs. Although you did not make it to your goal on timing, I appreciate your testimony.

Mr. Rayburn?

STATEMENT OF BOBBY RAYBURN, FIRST VICE PRESIDENT, NATIONAL ASSOCIATION OF HOMEBUILDERS

Mr. RAYBURN. Thank you, Madam Chairwoman, for the opportunity to testify today on the impacts of the President's economic growth package. My name is Bobby Rayburn and I am a homebuilder and developer from Jackson, Mississippi. I am also the First Vice President of the National Association of Home Builders, which I am here today to represent.

First, I want to say that NAHB supports President Bush and the Congress in their efforts to achieve an economic stimulus package that will provide near-term stimulus to consumer spending and capital investment, including more housing consumption and production. We were disappointed that the stimulus package did not contain a housing component, specifically the proposed homeownership tax credit. This proposal has bipartisan support in the Congress and has been part of the administration's budget for the previous three years.

The primary focus of my testimony today is on the impact of the administration's proposal to eliminate the double taxation on corporate earnings on the low-income tax credit program. The distribution of a dividend from tax corporate earnings to a shareholder, who then pays tax on the dividend, is double taxation of the corporate earnings. One of the ways corporations reduce the impact of the double taxation and increase corporate earnings is to buy low-income housing tax credits. Unfortunately, the dividend exclusion proposal reduces the value of tax credits like the low-income tax credit. The value of tax credits is reduced compared to today's value of tax credits, because corporate earnings that are exempted from tax by the credit are taxable to the shareholder and will not increase the cost basis of the shareholder's stock when the corporation retains the earnings.

Affordable housing uses a variety of financing sources, including the low-income housing tax credit, home funds, Federal Home Loan Bank affordable housing program, and revenue bonds. These projects operate on very narrow margins. States try to serve the lowest income tenants possible and locate affordable properties in areas where development frequently is difficult, such as rural and inner-city areas. Even a modest change in the value of the credit and the resulting reduction in the amount of equity the credit can generate will have adverse consequences to the low-income housing program.

Two studies have been published that analyze the impact of the administration's dividend proposal on the low-income housing tax credit program. The first study prepared by Ernst and Young predicted that there would be a reduction of 40,000 low-income housing tax credit units per year, which is a 35 percent reduction from the current level of 115,000 units. The Mortgage Bankers Association published a second study that predicted the dividend proposal would actually benefit the production of low-income housing tax credits and have virtually no negative effects at all. We are still reviewing this particular study.

It is our view that the Ernst and Young study overstates the impact of the credit. The emphasis on units produced fails to reflect the full range of the impact on the dividend proposal on the operation of the low-income housing tax credit program. NAHB estimates that a more realistic decline in the value of the credit is from 10 to 15 percent, rather than 21 percent. We also believe that there will be significant revisions in state priorities for the low-income housing tax credit programs. Tenants at the upper end of the eligible income will be sought, and fewer properties will be built, particularly in hard to develop areas.

There are several approaches that could be used to protect the credit. The first approach would be to exempt the low-income housing tax credit from the dividend proposal. This can be done within the structure of the administration's proposal by treating earnings corresponding to the low-income housing tax credit as taxed earnings. Other solutions would be to exempt all or part of the dividends received by the shareholders from the tax and by providing the corporation with a deduction for dividends paid.

The other approach to protecting the low-income housing tax credit would be to make up for any adverse impact on the program by expanding availability and the market for the credit. The first step in this approach would be to eliminate restrictions on the individual's passive loss reductions and to provide them with exemption from alternative minimum tax. Since the individual market for the credits is not as efficient as the corporate market, the amount of the credit that can be sold to raise equity, as well as the amount of the credits that can be dedicated to individual properties would need to be increased.

Madam Chairwoman, that concludes my remarks. NAHB looks forward to continuing to work with you, the members of your committee, the Ways and Means Committee, and the Treasury Department to keep the low-income housing tax credit program operating at today's levels well into the future.

Thank you.

[The prepared statement of Bobby Rayburn can be found on page XX in the appendix.]

Chairwoman KELLY. Thank you, Mr. Rayburn.

Mr. Castellani, I have a question for you. You cited the Joint Committee on Taxation report for ending the double taxation of dividends. The Business Roundtable was among the first groups to encourage new measures for honest corporate governance last year. I wonder if you could quickly elaborate on the link between the double taxation of dividends and the use of the Enron-style accounting gimmicks that I spoke about in my opening statement.

Mr. CASTELLANI. I would be delighted to. As you know, we have been, particularly with this committee's leadership, working on trying to restore the confidence of the American investor in our system of corporate governance. I think the Sarbanes-Oxley Act has gone a long way in doing so. Part of the issue, which has been alluded to and discussed by several of the folks who have been testifying here, has been what the impact of the double taxation of dividends has been on corporate behavior.

Since the tax code as it currently exists benefits debt financing over using equity to raise funds, stocks have not been valued as in the past, based upon their future dividends. When dividends are not paid, investors have to value stocks based on a corporation's earnings statement, which in the case of Enron could have been manipulated or can be manipulated to make a company appear to be more profitable on paper than it is in reality.

In addition to removing this incentive to cook the books, which I guess, was the case with Enron, eliminating the double taxation of dividends will put more money in the hands of individuals because shareholders at all levels will demand that, and it will give an incentive to those companies that do pay dividends. So again, cash will be paid out; cash will become a premium; cash flow will become a premium; corporations that pay dividends will be rewarded, and the kind of paper manipulation that we saw in the Enron case will be further inhibited because shareholders will be looking for true cash flow.

Chairwoman KELLY. Thank you.

Mr. Lazio, I wonder if you would discuss how States like New York, Texas, Florida will benefit from this tax plan?

Mr. LAZIO. I would be happy to, Madam Chair. As you know, because I know you spend a lot of time with the people of the New York City prudential marketplace getting to know how those markets work and understanding what the problems and concerns are in the banking and securities market and the insurance industry, this is going to have a very significant impact on the employment base in the New York metropolitan area and the tax base. In New York alone, it is estimated that just the dividend exclusion would return about $2 billion in the first year. I think Texas is about $1.6 or $1.7 billion. I can get that exact number—and Florida is about

$1.4 billion. So very significant returns to those states just on this one element of dividend exclusion.

It is not difficult to see why, for two reasons. First of all, it obviously has the immediate impact of providing higher after-tax income for those individuals that depend on dividend income. That is skewed to, frankly, older Americans who benefit disproportionately on this initiative. The second, longer-term, and in my opinion more important reason is that it does overall strengthen corporate management, that it provides superior financing for expansion, for acquisitions. That, in turn, leads to jobs, higher income and more tax revenue.

The real question, it seems to me, is between immediate consumption today and lowering taxes so that we can get higher growth numbers later. It is very difficult to see how we are going to create the kinds of jobs that Americans are calling for in the shorter, intermediate run unless we get on a higher growth path. We are not going to do that at 1.5 or 2 percent.

Chairwoman KELLY. Thank you.

Mr. Orszag and Mr. Moore, I have seen the two of you before, talking with each other about the various economic issues. I am going to fire this question to the two of you and let you answer it. I want to know what the record of the impacts on economic growth—now, you both presented two different views here—the impacts on economic growth and on federal revenues from the cuts in taxes on savings and investment, specifically the 1997 capital gains tax cut. By the way, Mr. Moore, I ran on my maiden flight for Congress was to zero the capital gains tax, so I am right there with you on that.

I would like to know—the 1997 capital gains tax cut, the 1981 Reagan tax cut, and the Kennedy tax cut in the early 1960s. Mr. Orszag, let's go with you first.

Mr. ORSZAG. Okay. You want to know what the impact was on the economy of those proposals?

Chairwoman KELLY. Yes.

Mr. ORSZAG. First, with regard to the 1997 capital gains reduction, I think it is very difficult to interpret the data, given that that was occurring in the midst of a stock market boom. Some may argue that the capital gains tax reductions is what caused the stock boom—which is what Mr. Moore will argue. But the stock market boom was occurring before that capital gains reduction, and if the capital gains tax reduction caused the boom, then it led to the bubble that everyone is complaining about now. So there is sort of an inconsistency there. But I think it is difficult to interpret because we were in the midst of such a strong stock market performance at the time, so there is a natural upswing in capital gains from year to year as the stock market continued to increase, which could outweigh the effect from a reduced rate.

With regard to the early 1980s tax cuts, there is an ongoing debate about what the effect was. A couple of things are relevant. First, it is important to realize that we reversed about a third of the tax cut in 1982. So in 1981 we cut taxes; in 1982 we came back with TEFRA and reversed about a third of the tax cut that remained in place because of concerns about the long-term deficit. That is in marked contrast to what appears to be occurring now, when circumstances have changed, but we are not trying to reverse course to take that into account.

Secondly, there is a lot of movement between personal income and small business income that makes it difficult to interpret the data. Some people have looked at what happens to personal income returns following a reduction in personal income tax rates. What you see is a significant amount of shifting from income from small businesses onto personal tax returns, which does not necessarily correspond to any change in the underlying economy.

The bottom line is I think it is a very difficult question. I think people who give an unambiguous answer that is either unambiguously positive or unambiguously negative are probably oversimplifying the situation. There is an ongoing academic debate about it.

Chairwoman KELLY. Thank you.

Mr. Moore?

Mr. MOORE. We have a much better tax system today than we did 20 years ago. I do not think there is any question about that. When I first arrived in this town, we had a 70 percent top marginal tax rate; you could get tax deductions for investing in windmills and bull sperm and all sorts of things. I think the two Acts that we did in the 1980s were very positive—the 1981 Act which cut the top rate from 70 to 50 percent, and all the rates, by the way, and indexed for inflation.

And then, I am a big believer in what we did in 1986. I know there is some disagreement about that, but we brought the top rate down from 50 to 28 percent. The reason I mention that is that I do not think there is any question that nobody wants to go back to 70 percent rates. In fact, when you cut the rate from 70 to 50 percent, you are going to have an extremely strong supply side effect. You are not going to get the same kind of supply side growth effect when you got from 39 to 35 percent that we did when we went from—well, when Kennedy went from 91 to 70 percent, and then Reagan went from 70 to 50 percent. So we should not oversell the supply side effects from cutting these rates by a few percentage points.

I guess my advice to you, Madam Chairwoman, is we ought to move toward the promised land in tax policy, and that is a flat tax type of regime where you have a single rate, where you are taxing consumption, you are taxing income only once, but once, with as little leakage as possible. The thing that I like about the President's approach to tax policy is if you look at what he has done over the last two or three years on tax policy, he has basically said we are going to get rid of the death tax, which is a double tax on savings; we are going to get rid of the dividend tax, which is a double tax on savings; we are going to expand IRAs; we are going to cut the rates. And all those things, I am in favor of.

I probably would be in favor of some of the things that Peter is in favor of in terms of broadening the base at the same time, but I think the dividend tax cut is probably the jewel of this package. If we took out the dividend tax cut, I probably would not be very enthusiastic about the rest.

Mr. ORSZAG. We did agree on something.

[Laughter.]

Chairwoman KELLY. Thank you.

Dr. Spriggs, do you agree with the Home Builders' assessment of the flaws in the Ernst and Young study? Have you reviewed the MBA study, and if so, I would like to know what your judgment is on that.

Mr. SPRIGGS. I have not reviewed the MBA study. I have reviewed the Ernst and Young study. I am not sure that they have, in fact, overstated, because again part of this has to do with how the gap financing takes place for low-income housing. Low-income housing tax credit picks up a portion of it, and then what happens is the local government steps in with a bond. Those bonds are going to cost more money. I think unambiguously the dividend break means that those bonds are going to have to cost more money. Given the current situation of where states are right now, it is unlikely that they will make it up in some other way. So I am not sure if you look at the totality of the issue that Ernst and Young have overstated what the likely impact would be.

Part of this has to do with the growth pattern we see in the willingness of corporations to pay for the credit keeps going up. Part of that was reflected in making the credit permanent. So corporations could lock this into their tax strategy. This changes their tax strategy. We saw when it had to be annually reauthorized that corporations were not as willing to pay as much.

So I think there are a number of issues within the Ernst and Young that actually make them understated, which I think will probably wash out with whatever the Home Builders think is overstating it.

Mr. LAZIO. Madam Chair, could I give some feedback on that as well?

Chairwoman KELLY. By all means.

Mr. LAZIO. As you know, I was very active in housing issues and the tax credit in particular during my years in the House. Just a few observations—first of all, the thought that somehow the yields or municipal bonds would have to necessarily increase because an equity would be more attractive to an investor because of its tax free flow-through, I think probably overstates the case. Right now, you have, for example, taxable and non-taxable bonds. The spread is very small between taxable and non-taxable bonds. The reason why people invest in municipal instruments is for preservation of capital; for security for a long-term investment, in that sense. And there is a trade-off involved in that. So I just do not see that the same investor that invests in a municipal security or bond is going to be attracted to a more volatile equity simply because of the tax treatment of dividends.

The second thing is, less than half of the earned income of the S&P 500 is paid out in dividends. Unless there is an enormous increase in the amount of dividends that we paid out, and I do believe in speaking to some of our members, for example, that companies will call for higher dividends if this passes, which will be very good for shareholders, and that is across the quadrants. There is still going to be plenty of room for companies to invest in tax credits.

Finally, less than 1 percent of all corporate tax right now is offset by way of housing tax credits. So they are an exceedingly valuable housing tool. I think the case that is made that somehow that they are going to be overwhelmed or eviscerated because of this provision is overstated.

Chairwoman KELLY. Thank you very much.

Mr. SPRIGGS. If I can be allowed just one point, though, I think again this is inconsistent to argue that on the one hand marginal tax rates matter, and then to argue that they do not matter. Yes, there is a risk premium, but we are changing the size of that risk premium by making these things deductible. I think we have to look at it from the real world perspective. When Microsoft decided for the first time in its history that it would give an eight cents dividend, for Bill Gates that is $96 million. Now, under this proposal that is $96 million tax free. There is a huge difference for those who are making these investments, in terms of how much money we are talking about.

So I think it is inconsistent, and I think we should be consistent about whether relative tax rates matter or not in terms of investment decisions.

Chairwoman KELLY. Thank you, Dr. Spriggs.

I want to thank all of you for testifying today. Without objection, I want to enter into the record the Business Roundtable's study that was done by Pricewaterhouse, the Ernst and Young study, and the MBA studies that are referred to today, and the SIA report "Defending the Dividend," which was issued January 31, 2003.

I note that some members may have additional questions for this panel they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses and to place their responses in the record.

The third panel is excused, with the great appreciation of the committee. I want to briefly thank all of the members and the staff for their assistance in making the hearing possible.

This hearing is adjourned.

[Whereupon, at 6:04 p.m., the subcommittee was adjourned.]

A P P E N D I X

March 18, 2003

OPENING STATEMENT OF REP. SUE KELLY

CHAIRWOMAN

SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

"Paying Dividends: How the President's Tax Plan Will

Benefit Individual Investors and Strengthen the Capital Markets"

March 18, 2003

The September 11th terrorist attacks, the end of the telecom and Internet bubbles, the corporate accounting scandals, and now the uncertainties accompanying war have left Americans feeling uncertain about their economic future. Business investment has been flat or down for two years now. Only consumer spending has kept the economy afloat, and now there are signs that consumer confidence is down to 1992 levels.

President Bush's plan to eliminate the dividend tax is a sound, common-sense approach to growing this economy. Cutting taxes and encouraging consumer spending and investment is the way to go. We want to create jobs and spur growth. That will only happen by letting American investors keep more of their own money and giving them incentives to invest it in this economy.

For millions of individual Americans, encouraging investment means encouraging the purchase of stock, which has the best long-term return of any investment. Half of all American households, more than 84 million individual investors, already own stock directly or through mutual funds. Today, millions Americans of all income levels receive dividends from stock; in fact, 45 percent of all dividend recipients make under $50,000 per year. Three-fourths make less than $100,000 per year. The problem is that America has the second highest dividend tax rates among the 26 most developed nations in the world, second only to Japan. So it only stands to reason that if we need more corporate investment, we need to reduce the tax rate on the dividends which we receive from corporate stock. Those dividends are already taxed when the corporation earns income; it is fundamentally unfair for us to pay more taxes on that income.

Another reason we need to end double taxation is to help our seniors to live more independent lives. More than half of all dividend income goes to America's seniors, many of whom rely on these checks as a steady source of retirement income. More than 9 million seniors would receive an average $991 in tax relief in 2003 if they did not have to pay income tax on those dividends.

Maybe there was a day when ending double taxation would have helped a small handful of rich, privileged Americans. But with 84 *million* individual investors owning stock, those days are over, and it's time to bring economic thinking into the 21st Century.

Our witnesses today will discuss the increases in corporate investment, the hundreds of thousands of new jobs, and the improvement in the quality of life for seniors and all individual investors that will result from passing President Bush's proposal to end the double taxation of dividends.

But there is yet another reason for ending double taxation of corporate dividends. On December 12, 2001, I co-chaired the first Congressional hearing examining corporate fraud and mismanagement at Enron. Investigations by law enforcement and by this and other Congressional committees found that senior Enron management intentionally twisted its corporate finances to hide billions in debt from investors. A massive and detailed report released last month by the bipartisan Joint Committee on Taxation shines a special light on Enron management's sordid actions. Part of the report lays out how Enron raised over $800 million through hybrid financial instruments, called "tiered preferred securities," which were specifically designed to be treated as debt for income tax purposes and as equity on its books, so Enron could deduct corporate interest payments on its tax returns without revealing its debt service on consolidated financial returns. I have provided copies of this section of the report to Members and witnesses, and I invite your attention to the last two pages, in which the Joint Committee stated four recommendations for dealing with tiered preferred securities. The very last recommendation states, and I quote, "Reduce or eliminate the disparate taxation of interest and dividends (for both issuers and holders of financial instruments) that creates the market for hybrid financial instruments. By providing more equivalence in the tax consequences of debt and equity, this approach would eliminate tax considerations from the process by which corporate taxpayers decide to obtain financing." End quote.

Now, certainly the most important factor in Enron's demise was plain old greed. But the lesson from this bipartisan report, hailed by Members of both parties in both houses, is clear: If we don't want any more Enrons gaming the system to line their pockets, one step we can take is to end the double taxation of dividends. Ending double taxation is not a panacea for the stock market's ills, but it would add to this Committee's record as the home of sound corporate governance on Capitol Hill.

Numerous Presidents as far back as Franklin Roosevelt have proposed ending the double taxation of dividends, but the proposal always seems to get caught up in outdated, tired, class warfare arguments. For the sake of our economy, our seniors, our financial markets, and our investors, Congress should support President Bush's plan to end the double taxation of dividends.

Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services

Subcommittee on Oversight and Investigations
"Paying Dividends: How the President's Tax Plan Will Benefit Individual Investors and Strengthen the Capital Markets"
March 18, 2003

The 5th Amendment to the Constitution holds that no person shall be subject for the same offense to be twice put in jeopardy. This same fundamental principle of fairness applied also to our tax laws for the first 150 years in this country, reasoning that the same income shouldn't be taxed twice. Then in 1936, in the middle of the Great Depression, Congress imposed a double tax penalty on dividends paid to individuals. The distortions and unfairness of this tax penalty became immediately apparent, and Congress has been trying to fix the problem ever since.

President Bush's jobs and economic growth plan would finally end double tax jeopardy for Americans receiving dividends. More than half of these dividends go to America's seniors, many of whom rely on these checks as a steady source of income in their retirement. Because the income gets taxed once at the corporate level, and again at the individual level, nine million of these seniors get shortchanged by the government an average of almost $1,000 a year.

In fact, almost half of all dividend recipients make under $50,000 per year, and they're getting up to one-third less than people who can get around the double tax through special offshore or non-taxed entities.

But the double taxation on dividends not only penalizes seniors and other American households, it also has a pernicious and distorting effect on corporations' fiscal policy. Since corporations can get around the double tax by relying on debt financing and retaining earnings, they leverage themselves to the hilt and go on questionable empire-building acquisition sprees. This results in greater debt, more bankruptcies, more economic volatility, less flexibility in down markets, less efficient allocation of income, and numerous Enron-style tax shelters. Ending the double taxation of dividends is not just an issue of fairness, it's a necessary reform to improve corporate governance and protect the future health of our economy

The Council of Economic Advisors estimated that ending the double taxation of dividends would create almost half a million new jobs. A PricewaterhouseCoopers study estimated that ending the double taxation of dividends would increase American welfare by $339 billion over the next five years. Business investment, which has been one of the single greatest factors weighing down our economy, would turn around, giving an immediate boost to the U.S. economy and enhancing long-term growth.

Federal Reserve Board Chairman Alan Greenspan recently testified before us that "The elimination of the double taxation of dividends will be ... a benefit to virtually everyone in the economy over the long run, and that's one of the reasons I strongly support it." President Bush's proposal to end the double tax on dividends is something we should all support – for our seniors, our workers, and our economy.

Congressman Vito Fossella

Statement for the record: Subcommittee on Oversight and Investigations: Impact of the President's tax plan on Individual Investors. March 18th 3:00pm.

I would like to highlight three major factors we should keep in mind when discussing the repeal of the tax on dividends. The current system goes out of its way to target seniors, hurts an increasingly large majority of the population and encourages bad corporate governance.

As a starting point, the stock market has grown increasingly important to the US economy due to the rapid increase of investors in America. Today, 52% of American families (or 84 million people) are invested in the stock market. The increase from just a few years ago highlights one of the most remarkable changes currently underway in American society. It is also expanding the middle class and enriching many lower-income families. With more than $7 trillion of value lost in the stock market since March 2000, abolishing the double taxation of dividends will restart the stock market and hence, economic growth. The time to act is now, before any more harm is done to family savings for retirement and education and, indeed, to the economy as a whole.

Second, many seniors rely on dividend income for their retirement. Seniors take in only 15% of national income, but receive 50% of the dividend income, according to Treasury statistics. That shows just how disproportionately the dividend tax affects our parents and grandparents. Many seniors who do not have other sources of income rely on dividend income. The double taxation inherent in the dividend tax means especially rough treatment at the hands of the tax code.

Finally, abolishing the double taxation of dividends will promote honest accounting and better corporate governance. The Enron mess last year shows us a key way in which elimination of the dividend tax will serve the public good. The double taxation of dividends tax lowered rate of returns relative to other investments, the number of firms offering dividends has dramatically declined: from 66% in 1978 to only 21% in 1999. Companies and investors have instead pursued high-growth stocks to take advantage of the lower capital gains tax rate. The difficulty is that the value of a company is often based on speculative theories of future earnings. But dividends can only be paid on actual earnings and thus, serves as a true indicator of a company's health. The paper empire that Enron had built would have been much less difficult to accurately assess. I believe that by abolishing the double taxation of dividends better accounting practices will be pursued and investors will have a renewed confidence in the companies they invest in.

Companies are also currently able to deduct debt but not dividends. This distortion results in a tax code that favors debt over equity - the result being that companies like Enron and United racked up enormous debt before declaring bankruptcy. This has the crucial secondary effect of harming creditors, which has contributed overall to the economic doldrums America and the world are trying to overcome.

It seems clear that elimination of the dividend tax will be an overwhelmingly positive measure for the economy, empowering shareholders and protecting our seniors. I want to thank everyone here today for coming in to share their views with us on this important subject and hope that we can get some effective discussion out of today's hearing.

OPENING REMARKS OF CONGRESSMAN RUBÉN HINOJOSA
HOUSE FINANCIAL SERVICES COMMITTEE
SUBCOMMITTEE ON OVERSIGHT & INVESTIGATIONS
MARCH 18, 2003

Chairwoman Kelly and Ranking Member Gutierrez,

I commend you for holding this important hearing on the President's tax plan and how it will affect our capital and consumer markets. Shortly after learning of the President's tax proposal, I began researching its ability to stimulate our economy and the impact it would have on individual communities. In conducting this research, I have become extremely concerned by the President's proposal to eliminate the taxation on individual dividends. It appears to have very dire consequences.

This hearing is also timely because it is being held right before the House takes up the Budget Resolution and when the U.S. is on the brink of war with Iraq. It also falls one week before the President intends to ask the U.S. Congress for $70 to $100 billion in emergency spending to pay for the coming war and occupation of Iraq. The price for this war and its aftermath could increase dramatically over time. This additional spending will not be reflected on the U.S. books because its potential cost was left out of the President's proposed budget. However, in reality, it does increase the President's $726 billion so-called "stimulus" plan, thus bringing the actual total cost of the President's budget to the American public to approximately $800 billion or more.

Of that amount of the economic stimulus, $396 billion would come from the elimination of the taxation on individual dividends as well as taxes from capital gains from retained earnings. The elimination of such taxation would have dire consequences on the U.S. economy in general and on my community in particular. President Bush's proposed tax cuts come at a time when we have record deficits. Instead of proposing ineffective tax cuts that disproportionately benefit high-income families, we should be finding ways to balance our budget, return to a surplus and fortify our economy with sound practices to increase consumer confidence. All this proposal does is create a false illusion of economic security; it offers no real solution to our economic crisis.

I cannot emphasize enough how important it is to dissect and closely examine all the ramifications of the President's dividend proposal. We must analyze it carefully since it results in the transfer of investment capital from the municipal bond market to the capital markets. At a time when our states, communities and localities are in dire straits, President Bush's proposal would transfer money away from them and give it to the highest-income families – the top 1% of the U.S. population. Money that could be used to build new schools, hire new teachers, improve our infrastructure and strengthen homeland security will go instead to private corporations.

Moreover, President Bush's budget would have a devastating impact on affordable housing. A study prepared by Ernst & Young estimates that the President's proposal would result in 40,000 fewer apartments serving about 100,000 residents being produced annually. It showed that the corporate Housing Credit investors would limit the amount of capital they invest in housing credits or lower the price they are willing to pay for them, thus reducing the amount of the Housing Credit equity available to produce affordable rental housing. Consequently, the dividends exclusion proposal would reduce the value of tax credits like the Low Income Housing Tax Credit (LIHTC).

In response to questions I submitted to him in writing after last month's Humphrey Hawkins hearing, Federal Reserve Board Chairman Alan Greenspan warned that if the dividend tax proposal becomes law, Congress would need to monitor whether the funding for low-income housing tax credit programs remained at desired levels. He went on to stress that Congress might need to adjust the structure of the programs to offset declines in the sources of funding if President Bush's proposal is enacted.

Overall, the President's dividend tax proposal seems to be a very ill-advised proposition at a time when our communities are suffering from state and federal deficits and underfunded federal programs. Only wealthy private corporations would benefit from it, while poor and middle class families in my district and across the country would continue their struggle to survive as their school programs and other programs are cut to benefit the wealthiest 1% of the U.S. population.

OPENING STATEMENT: Hearing on Paying Dividends: How The President's Tax Plan Will Benefit Individual Investors and Strengthen Capital Markets
Congressman Shadegg
March 18, 2003

Chairman Kelly, I appreciate your willingness to hold a hearing examining the President's tax proposal.

I strongly support President Bush's jobs and growth plan because it could result in an $80 to $100 billion stimulus in 2003 and create as many as $2.1 million new jobs if the proposal is adopted by Congress. The President's tax plan is guided by growing the economy and by making sensible changes to the complex and overly burdensome tax code.

Predictably, debate over the merits of President Bush's proposal has turned on the lowest common denominator of national politics: the stratification of the classes. Or, in typical Washington fashion – class warfare. Opponents contend that the Bush jobs and growth proposal favors tax breaks for the wealthiest Americans and does little to help the working class.

Critics are off the mark. There should be no question that with President Bush's economic proposal *all* Americans will be better off. Money that is withheld by the government does not create new jobs for the poor – that tactic drives money from the U.S. to our foreign-nation competitors that are able to create more economically favorable conditions for investment. Jobs are created from dividends and investments by people who have money to put at risk for the chance at an equitable (or better) return. While displaced workers recently received a renewal of the extension of unemployment benefits, they will not get what they really want – jobs – unless U.S. businesses are incentivized to promote growth and create jobs.

Under the Bush plan, the tax cuts implemented in 2001 and set to be phased-in in 2004 and 2006 will become immediately effective. The tax burden of the lowest income Americans will be reduced to ten percent. Tax rates for every other income bracket will be decreased by at least two points. Making the tax rate reductions immediately effective will encourage people to earn more income and therefore simultaneously boost consumption and saving. This is particularly important for short-term growth because workers, savers, and investors who now face a perverse incentive to defer economic activity to take advantage of future rate reductions will be encouraged to invest sooner. New companies, new ventures, new products, and new jobs will be a direct result of the President's jobs and growth proposal.

To be sure, opponents of the President's tax package are correct in one respect: the absolute amount of tax *reductions* does disproportionately benefit the wealthiest Americans. They have to. The top five percent of taxpayers, those with adjusted gross incomes at $128,366, pay over half of all tax revenue. Because the rich pay the most in taxes, it would be impossible to lower taxes to encourage investment without disproportionately benefiting this group. It's their money!

The most critical, and arguably the most sensibly guided aspect of the jobs and growth plan is the repeal of the double taxation of dividends. Currently, shareholders are taxed twice on their earnings from dividends distributed by corporations: when they are reported as corporate profits (a 35% tax) and when they are distributed as dividends. In total, depending on the taxpayer's income bracket, tax rates can exceed sixty percent. For example, an investor in the twenty-seven percent tax bracket receives less than forty-eight cents for each dollar in dividends. As a result of the unfavorable tax treatment toward dividends, only about twenty-percent of companies pay dividends today. The elimination of the double taxation of dividends solves a long-term wrinkle in the tax code that creates disincentives for companies to distribute wealth back to shareholders. It is simply good tax policy to encourage companies to bring wealth back to investors – the true owners of companies.

Tax relief and sensible short and long-term pro-growth policies should be the cornerstone of a stimulus proposal and are worthwhile achievements, even if it means carrying the burden of deficits before the economy can recover. It's time for partisan bickering over wealth and class status to take a backseat to the notion of passing a stimulus that is beneficial to all Americans. It's our duty to support President Bush's jobs and growth proposal and pass a strong stimulus package that creates jobs by encouraging investment and consumption and in the long-term implements sensible fiscal policy by correcting flaws in our tax code.

THE BUSINESS ROUNDTABLE

Testimony of
John J. Castellani of
The Business Roundtable
Before the
Subcommittee on Oversight and Investigation
House Financial Services Committee
On
The President's Economic Growth Proposal
Tuesday, March 18, 2003

My name is John J. Castellani. I am President of The Business Roundtable, an association of chief executive officers of leading corporations with a combined workforce of more than 10 million employees in the United States and $3.7 trillion in annual revenues. It is my pleasure to present the testimony of The Business Roundtable today in support of the President's economic growth and job creation package.

Overview

The Business Roundtable believes it is critically important for Congress to adopt a jobs and economic growth plan that will put more cash in the pockets of consumers, stimulate demand, create jobs, and get the world's strongest, most resilient economy moving again.

The economy is not performing up to its potential. Last November, The Business Roundtable conducted a survey of its 150 members, which cross all sectors of the economy, and we asked them what assumptions about employment, capital spending and economic growth they were embedding in their business plans for 2003. In summary, the results raise serious concerns for American workers, companies and the overall economy.

- 60 percent of CEOs expect their company's employment to drop in 2003; 28 percent expect it to remain the same, and 11 percent expect employment growth.

- 57 percent of CEOs expect their U.S. capital expenditures in 2003 to be the same as 2002 levels, while 24 percent expect a decline. Only 19 percent expect higher capital spending.

- 64 percent of the CEOs are expecting GDP growth rates of less than 2 percent in their 2003 planning, while 36 percent expect GDP growth of more than 2 percent. By comparison, the average annual GDP growth over the past decade has been 3.2 percent.

- 19 percent of CEOs expect their 2003 sales to be flat compared with 2002, while 9 percent expect sales to be lower. Seventy-one percent of the CEOs expect higher sales in 2003.

The BRT survey of CEOs reinforces a series of economic data released over the past several months that indicates a mixed economic performance and an unstable recovery. Consumer confidence fell this month to an eleven-year low. The gross domestic product (GDP) rose by a mere 1.4 percent in the fourth quarter of 2002 – the smallest gain since 2001 – when it could be growing at 4-5 percent without an increase in inflation.

That is why, last November, the BRT urged the President and Congress to take immediate action on a large economic growth package aimed at consumers. Business cannot create demand, so we need to ignite consumer confidence and consumer spending. The war on terrorism and fear of war with Iraq, and depressed equity valuations all have combined to undermine consumer confidence and push demand down. What the U.S. economy needs is significant and immediate tax relief for consumers.

The President's Economic Growth Plan

The President's economic growth and job creation package provides exactly the kind of boost our economy needs. It will do this by accelerating the 10 percent bracket expansion and rate reductions, with AMT hold-harmless relief; accelerating the marriage penalty reduction and child tax credit increase; and eliminating the unfair double taxation of dividends.

The President's plan, if enacted, will significantly stimulate the economy in the short-term and boost long-term economic growth. According to the results of a study conducted for The Business Roundtable by PricewaterhouseCoopers (PwC) using the widely-supported Inforum LIFT macroeconomic model housed at the University of Maryland (a copy is attached to this testimony), it will create an average of 1.8 million new jobs in each of the next two years and an average of 1.2 million new jobs per year for the next five years.

To put that in perspective, there are approximately 1.5 million fewer people employed today than the pre-recession high of 2 years ago, and we estimate that enactment of the President's growth package would put just as many people back to work in the first year.

The President's plan would, according to our study, boost the gross domestic product in the U.S. economy by 2.4 percent by the end of 2004. It will boost incomes and jobs and help all sectors of the economy, including housing and capital markets. Working consumers and investors will have more money to spend and more confidence to spend it on goods and services.

Eliminating the Double Taxation of Corporate Dividends

The dividend component of the President's plan, according to the BRT/PwC study, will have the single most positive impact on economic growth in both the short-term and the long-term. The dividend proposal alone contributes half of the plan's resulting job and GDP growth over five years. As a result, companies will be more likely to invest in new equipment, build new plants and develop new products, which will sustain economic growth and create jobs.

Abolishing the unfair double taxation of dividends will spur consumer spending by increasing the after-tax income of stock investors in three ways. First, it will put more money in the hands of individuals because shareholders from all income levels will pay less in taxes. Second, it will cause companies to increase their dividend payments to shareholders (by an estimated four percentage points). Third, it will put upward pressure on stock prices.

Eliminating the double taxation of dividends will improve corporate governance in a number of ways. First, as noted in the Joint Committee on Taxation's so-called "Enron Report" to the Senate Finance Committee last month, the different tax treatment of corporate debt and equity is a longstanding problem and motivation for the kind of hybrid financial instruments that Enron Corporation aggressively used to obtain favorable tax treatment on transactions that had little or no business purpose. To prevent such abuses, the Joint Committee urged Congress to "reduce or eliminate the disparate taxation of interest and dividends" (Volume 1, page 35).

Second, under present-law, retained earnings are preferred because they are taxed at the lower capital gains rate while dividends are subject to the higher individual income tax rates. Under the President's plan, dividends would be tax-free to shareholders. While this same tax treatment would apply to retained earnings, shareholders are likely to prefer immediate cash in their pockets in the form of dividends.

Third, the pay-out rate of dividends that are tax deductible to the shareholder would be an important measure of a company's financial health. Under the President's plan, shareholders will reward companies that pay tax-deductible dividends, and this will encourage better transparency in the reporting of corporate earnings. Likewise, companies that do not pay tax deducible dividends would be viewed less favorably by investors worried about inflated earnings and liquidity concerns.

Fourth, the tax code currently makes it cheaper for companies to finance new investments with debt rather than with equity because the payment of interest to bondholders is treated as a deductible expense while dividends paid to shareholders are taxed twice, once at the corporate level and again as income to the shareholder. This has led to a number of economic distortions, such as causing many companies to take on excessive levels of debt and risk bankruptcy.

Critics of the dividend component of the President's plan have suggested that it would only help companies that pay dividends and individuals who invest outside tax advantaged retirement accounts. But the resulting increase in equity valuations would benefit companies and investors as a whole. In addition to boosting consumer confidence through greater wealth, increased equity valuation would benefit college and university endowments, IRAs, corporate and public pensions and all savings.

Defined Benefit Plans. Defined benefit plans differ from defined contribution plans in that the employer bears the investment risk related to plan assets. The combination of the ongoing bear market and a low interest rate environment that artificially inflates plan funding requirements has created extreme plan funding difficulties for many defined benefit plan sponsors. With the number of defined benefit plans declining from 172,642 plans in 1986 to an estimated 32,500 plans today, our defined benefit system is at a crossroads.

Year-end 2002 data shows that defined benefit plans have \$1.6 trillion of assets, with about 48 percent (or \$770 billion) of assets held in corporate equities and mutual fund shares. (Federal Reserve, *Flow of Funds, supra.*) Based on these figures, a modest 7 to 9 percent stock market increase due to enactment of the dividend tax proposal would result in an increase of between \$54 billion and \$69 billion in defined benefit plan funding levels. As a result, millions of Americans will see a substantial improvement in their retirement security, and companies will have additional operating capital to invest, resulting in more profits and increased stock prices.

The economic benefits of a rising stock market are further multiplied when shareholders increase their spending on goods and services, which provides new income to other households. The increase in income leads to more demand, and producers will need to step up their hiring and capital spending in order to meet the increased demand. Because of this "multiplier effect," an initial \$1 increase in cash income – because of the reduced level of taxation and increase in the dividend payout rate – will result in more than \$1 of new income throughout the economy.

Budget Deficits and Fiscal Responsibility

The Business Roundtable acknowledges the importance of federal budget deficits, but also understands the importance of a healthy economy. Short-term budget deficits are understandable when there is below-optimal economic growth and a need to stimulate economic growth by allowing individuals to keep more of what they earn.

We believe the President's plan is fiscally responsible. Under the plan, deficits would start at 2.8 percent of GDP and decline to 1.4 percent by 2008, and average 2 percent during 2003-2008.

The economy can handle deficits of that relative size. Deficits averaged three percent of GDP during the 1970s and 1980s.

The primary cause of the current deficit situation is declining revenues due to the 2001 recession and the anemic growth coming out of the recession. The key to returning to a balanced budget is to return to higher growth rates by stimulating the employment of underutilized resources in the economy (i.e., people and plant and equipment).

According to the BRT study, one-third of the projected 10-year static deficit increase resulting from enactment of the President's plan would be eliminated as a result of the increased economic growth derived from the plan.

At that level, the return on the government's investment in additional GDP would be 340 percent. On the dividend component alone, the return on the government's investment would be 630 percent. So we view the President's economic growth package as an investment in our economy.

Conclusion

We urge Congress to move quickly to enact an economic growth plan that will give an immediate boost to the economy and put people back to work. The President's plan is the best means for sustaining new job creation, business investment, and economic growth, both in the short-term and in the long-term. It is the right prescription for an ailing economy.

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January 21, 2003

Mr. John J. Castellani
President, The Business Roundtable
1615 L Street, NW
Suite 1100
Washington, DC 20036

Dear John:

We have completed research requested by The Business Roundtable regarding national impacts of the Administration's proposal for economic growth. The results are summarized in this communication, which includes five tables.

Our research relates to the six items in the Administration's proposal that involve components of the individual income tax—specifically, marginal tax rates, the 10-percent rate bracket, the AMT exemption, the marriage penalty, the child credit, and exclusion of dividends. These components account for 97 percent of the proposed static effect on the federal budget deficit, according to the Treasury Department's estimates.

We began by estimating the static revenue loss of the program (official, year-by-year estimates from Treasury and the Joint Committee on Taxation are not available at this writing). The static estimates were then fed into a fully elaborated and well-established macroeconomic model—the Inforum LIFT model—that has been maintained by a not-for-profit economic research corporation housed at the University of Maryland for 35 years. After calibrating the Inforum LIFT model to overlay the CBO baseline of August 2002, we entered the Administration's proposed items (incorporating the three assumptions noted below) and let the model do the work without our intervention.

The results are forecasts of how the Administration's proposal would affect the economy and the federal budget. You will find the static and dynamic budget estimates at Table 2, macroeconomic impacts of the entire proposal at Table 1, and macroeconomic impacts of parts of the proposal at Tables 1a-1c.

As is evident from the tables, the Inforum LIFT model indicates that the Administration's program would be stimulative in the short run and growth-enhancing in the long run. The short-run impacts are a combination of all proposed items and the long-run impacts are due mainly to the proposed exclusion of dividends. The proposal would increase the number of

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civilian jobs by an average of 1.2 million per year during the first five years and an average 0.9 million per year for the 10-year forecasting period. The proposal would add between 0.5 and 1.8 percentage points to the growth rate of real GDP through 2005 and lesser increments thereafter. Because of the stimulus it would impart, the proposal would increase the federal deficit, including the additional interest expense, by just two-thirds of the static revenue loss.

It was necessary to make assumptions about a few things:

> First, we assume that the proposed items will expire after 2010, except for the proposed exclusion of dividends.
>
> Second, for the purpose of estimating benefits occurring in 2003 we assume that the proposal is enacted and ready for implementation on July 1, 2003. Taking into account the Administration's indications that new withholding tables would be constructed as if tax cuts were effective on or about the enactment date and that checks would be issued promptly for a higher child credit, we assume that the percentage of benefit for calendar 2003 that is realized in calendar 2003 is 100 percent for the child credit; 50 percent for reduced marginal income tax rates and a wider 10-percent rate bracket; 25 percent for marriage penalty relief and excluded dividends; and zero for the AMT fix. These assumptions imply that individuals would have a $49 billion cash benefit during 2003, receiving the balance of the benefit for 2003 in 2004.
>
> Third, we adopt the Treasury Department's prediction that the proposed exclusion of dividends would increase the dividend payout rate by four percentage points. Specifically, we assume a two-percentage-point increase beginning in 2004 and an additional two-percentage-point increase beginning in 2005.

This summary covers a lot of ground. Let's discuss any questions or comments.

Yours truly,

KLWertz

Kenneth L. Wertz

Enclosures

Table 1
Analysis of President's Economic Stimulus Proposal: All Provisions Combined
Changes to U.S. Economy
[Changes in $billions except as noted]

Calendar Year	Actual	Forecast										Totals/Averages	
	2001	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	1st Five Years	1st Ten Years
Nominal GDP	10,082	76	281	200	91	90	125	167	176	176	179	738	1,561
Personal income	8,685	52	205	174	92	89	121	159	170	171	173	611	1,405
Wages and salaries	4,951	30	113	87	40	37	54	76	83	83	83	308	687
Dividend income	409	19	68	46	25	30	39	49	48	44	43	188	410
After-tax corporate profits	471	22	75	26	-4	1	11	21	17	11	8	121	187
Real GDP ($2002)	10,108	55	195	114	17	11	37	62	61	56	54	391	662
Personal consumption	7,051	46	163	109	67	63	68	76	73	78	80	448	823
Gross private fixed investment	1,579	24	85	52	-25	-39	-13	14	19	9	4	97	130
Net exports	-208	-12	-46	-45	-27	-15	-18	-28	-33	-32	-32	-144	-287
Unemployment rate (percentage points)	6.0*	-0.6	-2.0	-1.2	-0.2	-0.1	-0.3	-0.5	-0.5	-0.4	-0.4	-0.8	-0.6
Total civilian employment (millions)	134.0*	0.8	2.9	1.8	0.3	0.1	0.5	0.8	0.8	0.7	0.7	1.2	0.9
10-year Treasury Bond (basis points)	500	2	8	10	7	4	0	1	2	1	1	6	4
Inflation rate (percentage points)	2.3	0.2	0.5	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.1
Personal savings rate (percentage points)	2.3	0.4	1.2	0.7	0.1	0.0	0.2	0.3	0.3	0.2	0.2	0.5	0.4

* for December 2002 (Department of Labor, Bureau of Labor Statistics)

Source: PricewaterhouseCoopers LLP and Inforum.

Table 1a

Analysis of President's Economic Stimulus Proposal: Rate and 10% Bracket Adjustment and AMT Hold-Harmless

Changes to U.S. Economy

[Changes in $billions except as noted]

Calendar Year	Actual	Forecast										Totals/Averages	
	2001	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	1st Five Years	1st Ten Years
Nominal GDP	10,082	27	78	63	14	5	15	28	30	8	0	187	267
Personal income	8,685	13	42	44	19	9	15	23	25	10	2	126	200
Wages and salaries	4,951	11	31	27	7	1	6	12	14	5	0	77	114
Dividend income	409	1	4	5	4	4	4	4	4	1	0	18	31
After-tax corporate profits	471	8	20	10	-5	-4	0	4	5	-2	-3	29	34
Real GDP ($2002)	10,108	20	55	38	-2	-7	2	13	16	1	-3	104	133
Personal consumption	7,051	17	47	38	14	11	11	16	16	4	2	127	176
Gross private fixed investment	1,579	8	23	16	-10	-18	-8	2	6	0	-5	18	13
Net exports	-208	-4	-13	-14	-6	-1	-1	-4	-6	-3	-1	-38	-54
Unemployment rate (percentage points)	6.0*	-0.2	-0.6	-0.4	0.0	0.1	0.0	-0.1	-0.1	0.0	0.0	-0.2	-0.1
Total civilian employment (millions)	134.0*	0.3	0.8	0.6	0.0	-0.1	0.0	0.2	0.2	0.0	0.0	0.3	0.2
10-year Treasury Bond (basis points)	500	1	3	3	2	0	-1	0	0	0	-1	2	1
Inflation rate (percentage points)	2.3	0.1	0.1	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Personal savings rate (percentage points)	2.3	0.1	0.3	0.2	0.0	-0.1	0.0	0.1	0.1	0.0	0.0	0.1	0.1

* for December 2002 (Department of Labor, Bureau of Labor Statistics)

Source: PricewaterhouseCoopers LLP and Inforum.

Table 1b

Analysis of President's Economic Stimulus Proposal: Marriage Penalty Relief and Child Tax Credit Increase

Changes to U.S. Economy

[Changes in $billions except as noted]

Calendar Year	Actual	Forecast										Totals/Averages	
	2001	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	1st Five Years	1st Ten Years
Nominal GDP	10,082	27	83	44	22	19	21	27	19	6	2	195	270
Personal income	8,685	13	44	35	19	17	20	23	19	8	4	129	203
Wages and salaries	4,951	11	33	20	9	7	9	12	10	4	1	80	116
Dividend income	409	1	4	4	4	4	4	5	4	1	0	18	32
After-tax corporate profits	471	8	22	4	-1	0	1	3	1	-2	-2	33	34
Real GDP ($2002)	10,108	20	59	25	4	3	6	11	7	0	-1	111	134
Personal consumption	7,051	17	50	26	20	17	15	16	11	4	2	131	179
Gross private fixed investment	1,579	8	24	11	-10	-11	-5	0	0	-3	-4	22	11
Net exports	-208	-4	-14	-11	-7	-3	-3	-5	-4	-2	-1	-39	-54
Unemployment rate (percentage points)	6.0*	-0.2	-0.6	-0.3	-0.1	0.0	-0.1	-0.1	-0.1	0.0	0.0	-0.2	-0.1
Total civilian employment (millions)	134.0*	0.3	0.9	0.4	0.1	0.0	0.1	0.1	0.1	0.0	0.0	0.3	0.2
10-year Treasury Bond (basis points)	500	1	3	3	2	1	0	0	0	-1	-1	2	1
Inflation rate (percentage points)	2.3	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Personal savings rate (percentage points)	2.3	0.1	0.3	0.1	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.1	0.1

* for December 2002 (Department of Labor, Bureau of Labor Statistics)

Source: PricewaterhouseCoopers LLP and Inforum.

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Table 1c
Analysis of President's Economic Stimulus Proposal: Dividend Exemption
Changes to U.S. Economy
[Changes in $billions except as noted]

Calendar Year	Actual	Forecast										Totals/Averages	
	2001	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	1st Five Years	1st Ten Years
Nominal GDP	10,082	9	85	86	77	82	94	121	139	161	171	339	1,026
Personal income	8,685	6	70	89	82	86	97	120	137	155	164	333	1,006
Wages and salaries	4,951	4	34	37	33	35	41	54	63	73	78	142	451
Dividend income	409	2	30	37	35	36	38	45	47	48	46	141	365
After-tax corporate profits	471	3	24	15	10	10	10	16	16	15	11	61	129
Real GDP ($2002)	10,108	5	58	51	34	30	32	44	48	57	58	178	418
Personal consumption	7,051	3	48	43	43	45	47	56	60	73	77	182	496
Gross private fixed investment	1,579	4	26	26	8	1	1	8	12	11	10	64	106
Net exports	-208	-1	-13	-17	-17	-15	-16	-21	-25	-28	-30	-64	-184
Unemployment rate (percentage points)	6.0*	-0.1	-0.6	-0.5	-0.4	-0.3	-0.3	-0.4	-0.4	-0.5	-0.5	-0.4	-0.4
Total civilian employment (millions)	134.0*	0.1	0.9	0.8	0.5	0.4	0.4	0.6	0.6	0.7	0.7	0.5	0.6
10-year Treasury Bond (basis points)	500	0	2	3	3	3	2	2	2	2	2	2	2
Inflation rate (percentage points)	2.3	0.0	0.2	0.1	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.1	0.1
Personal savings rate (percentage points)	2.3	0.1	0.4	0.3	0.2	0.2	0.2	0.2	0.3	0.2	0.2	0.2	0.2

* for December 2002 (Department of Labor, Bureau of Labor Statistics)

Source: PricewaterhouseCoopers LLP and Inforum.

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Table 2
Analysis of President's Economic Stimulus Proposal:
Changes to Federal Budget
[Changes in $billions]

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	1st Five Years	1st Ten Years
Calendar Year*												
Static Revenue Effect												
10% Bracket, Rate Cut, AMT fix	-21	-59	-42	-8	-8	-9	-8	-8	0	0	-138	-162
Marriage Penalty and Child Tax Credit	-22	-62	-24	-18	-15	-13	-8	0	0	0	-140	-161
Dividend Exemption	-7	-47	-30	-31	-33	-36	-39	-42	-48	-52	-148	-364
Total	-49	-169	-95	-56	-56	-57	-55	-49	-48	-52	-425	-687
Net Budget Deficit Impact												
10% Bracket, Rate Cut, AMT fix	-14	-37	-28	-13	-15	-12	-6	-5	-4	-6	-106	-139
Marriage Penalty and Child Tax Credit	-14	-39	-18	-20	-19	-14	-7	-1	-5	-5	-109	-141
Dividend Exemption	-4	-20	-6	-14	-19	-20	-17	-17	-20	-24	-64	-162
All combined	-25	-87	-53	-58	-60	-48	-33	-29	-30	-35	-283	-458
Fiscal Year**												
Static Revenue Effect												
10% Bracket, Rate Cut, AMT fix	-14	-46	-48	-19	-8	-8	-8	-8	-3	0	-135	-162
Marriage Penalty and Child Tax Credit	-14	-48	-37	-20	-16	-14	-10	-3	0	0	-135	-161
Dividend Exemption	-4	-33	-36	-30	-32	-35	-38	-41	-46	-51	-136	-346
Total	-32	-127	-121	-70	-56	-57	-56	-51	-49	-51	-406	-669
Net Budget Impact												
10% Bracket, Rate Cut, AMT fix	-9	-29	-31	-18	-14	-13	-8	-5	-4	-6	-101	-137
Marriage Penalty and Child Tax Credit	-9	-30	-25	-19	-19	-16	-9	-3	-4	-5	-102	-139
Dividend Exemption	-3	-14	-11	-11	-18	-20	-18	-17	-19	-23	-57	-154
All combined	-16	-65	-65	-56	-59	-52	-39	-30	-30	-34	-262	-446

* Assumes that 7/1/03 is the date of enactment. Assumes, therefore, that the percentage of benefit for calendar year 2003 that is realized in 2003 is 50% for the 10% bracket expansion, 50% for lower income tax rates, 25% for marriage penalty relief, 100% for the child tax credit increase, 25% for the dividend exclusion, and 0% for the AMT fix.

** Fiscal year estimates assume a 65-35 split between the current and following fiscal years.

Source: PricewaterhouseCoopers LLP and Inforum.

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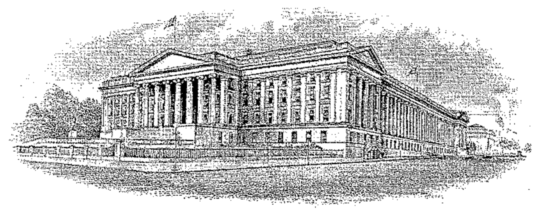

DEPARTMENT OF THE TREASURY
OFFICE OF PUBLIC AFFAIRS

Embargoed Until 3 p.m. EST
March 18, 2003

Contact: **Betsy Holahan**
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Testimony of Peter R. Fisher
Under Secretary for Domestic Finance
House Financial Services Oversight and Investigations Subcommittee
Tuesday, March 18, 2003

Chairwoman Kelly, Ranking Member Gutierrez, and distinguished members of the Oversight Subcommittee, thank you for your invitation to testify on the President's Jobs and Growth package. I will emphasize two critical features of the President's plan to create and secure jobs, accelerate and sustain our recovery, and increase workers' standards of living and the economic performance of our nation for many years to come.

The President's package is the right prescription for the macroeconomic circumstances we face today. We face more than the ups and downs of the regular economic cycle. We are recovering from the events of the 1990s, culminating in the stock market bubble and its aftermath, as well as the attacks of September 11th. A pure consumption-oriented, short-term stimulus is not the right response. Consumers and businesses need to perceive an enduring improvement in their cash flows to energize their behavior. We should support consumption and promote investment on a balanced, enduring basis. The President's package would do this.

Second, the President has proposed reducing the excess taxation of equity capital versus debt capital by taxing all corporate income just once and not twice. By enacting this proposal, this Congress has the opportunity to make the single biggest improvement in the efficiency of capital investment that Congress has taken in decades.

The right prescription for today's macroeconomic circumstances

It may be helpful to identify our macroeconomic challenge before we discuss a solution. The United States, in my judgment, is not facing just another swing of the business cycle, but the aftermath of the extraordinary events of the 1990s. Federal Reserve monetary policy, global economic integration, and telecommunications advances combined to fuel real prosperity and higher productivity, but investors' overestimation of their impact contributed to a stock market bubble. We continue to live with the dis-inflationary consequences and the destruction of trillions in household wealth as the bubble burst.

Under these circumstances, using fiscal policy only to deliver a "short-term stimulus" would be a mistake. The American people are smart enough to distinguish between a one-off injection of cash and an enduring improvement in their disposable income. When consumers re-finance their mortgages at lower rates, they gain the true wealth effect of an enduring improvement in household cash flow.

The same would be true of bringing forward to this year the tax rate reductions that Congress has already approved, of reducing the marriage penalty, of expanding the 10-percent bracket, of increasing the child credit from $600 to $1000 per child. Together with the reduction in taxation on equity capital (the dividend tax), these acceleration proposals would put cash in people's pockets right away and in the future. The plan would spur small businesses to invest as their marginal rates fall. Higher incomes stretching into the future will stimulate consumer demand and business investment – policy for the long-term, beginning today.

The scale of the package is central to accelerating growth and job creation. Over the next decade, U.S. economic output is projected to total $142 trillion, generating $27 to $28 trillion in federal revenues. The President's package would reduce taxes by $695 billion over that period (scored with static macroeconomic effects). Fiscal action cannot be timid or tiny if it is to influence such a massive economy. It must have some heft.

Let's not make the mistake of opting for unbalanced, just short-term consumption stimulus. We should choose policies that will promote consumer and business confidence, sustained consumption and investment, real economic growth and job creation, both now and over the coming decade.

Keener incentives for more efficient capital allocation

In the past year, Congress under Chairman Oxley's and Senator Sarbanes' leadership took a major step toward improving our capital markets' performance. While implementation is still underway, corporate executives, directors, auditors, and lawyers are already feeling the tighter accountability. Better run, better-disclosing corporations make for better capital markets.

But there is more to be done in setting the right incentives for corporate executives. By double-taxing profits but not interest, our tax code encourages executives to retain earnings instead of paying them to shareholders; to favor debt over equity finance; and to dedicate some of America's leading minds to tax alchemy instead of value creation. By imposing a high marginal rate on profit, our tax code thins the vital blood of economic growth, risk capital. No other major industrial nation taxes profits at such a punitive effective rate.

The President's proposal would reduce these biases against equity capital. Individuals would no longer pay taxes on dividends based on income for which the corporation has already paid tax. To avoid adding an opposite distortion, that is, forcing companies to pay dividends, the proposal would raise a shareholder's basis in his or her stock by a commensurate amount if a company chose to retain earnings for re-investment.

Shareholders would be tax-neutral between re-investing profits in the best projects a company could offer versus the best projects the market could offer. Today's tax code cordons off that choice inside the company.

The President's proposal would raise the burden of proof on corporate executives for retaining profits instead of sending them to shareholders. Some executives may prefer today's tax code, which places a less onerous burden on them for justifying their decisions to retain earnings. Yet corporations exist to serve shareholders, not corporate employees, and our tax code should reflect this.

The impact on capital efficiency may be huge. 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 if we accelerate and re-target this investment process.

The economy and financial markets would reap collateral benefits. With companies issuing less debt and more equity, balance sheets would become sturdier over time, and companies less prone to job-destroying bankruptcy. Eliminating this distortion would diminish the tax code's overall bias against savings and investment and lower the cost of capital – meaning higher capital investment, a higher-long-term growth rate, higher productivity, and higher wages for everyone. And the proposal would reduce the incentives for corporate tax engineering because the exclusion only applies to fully taxed profits. Net tax complexity and compliance costs would fall, freeing some of our keenest minds for more productive work.

Corporate executives would also face cleaner incentives for their own conduct. If dividends are suddenly a tax-efficient way of paying shareholders, executives will have fewer arguments to justify cash mountains and share buy-backs – which, a critic may note, offer the insider benefit of boosting the value of executives' stock options. And, because the President believes that profits should be taxed once – but only once – a company's payment of tax actually accrues as an asset to shareholders. In such a world, where a corporation's paying tax on dividends reduces shareholders' own tax liability, the rationale for "corporate inversions" would dissipate.

Impact of anticipated borrowing on fiscal sustainability

We are confident that the Treasury will have no difficulty financing the federal government's needs under all projected fiscal scenarios. In February 2003, the Treasury announced its most recent refunding needs and related financing changes. There were no changes in the issuance calendar for this quarter. Looking ahead, the Treasury announced plans to re-introduce a 3-year note in May, to be part of future quarterly financing packages, primarily to diversify issuance away from Treasury bills and the 2-year note. The Treasury instituted a regular re-opening policy for 5-year notes, beginning in May, and outlined additional steps in case more borrowing capacity proves needed.

The deficits projected are manageable and declining. At their peak – the immediate future – they are below recent U.S. historical experience. They compare favorably with fiscal conditions in other G-7 countries. Our debt remains modest by historical and international comparisons, and as a share of the U.S. credit markets it is at a 50+-year low.

Growth has been slower and unemployment higher than we would like. Prudent fiscal policy suggests we should work against the economic cycle to encourage job creation now and in the future – exactly as the President has proposed.

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Testimony Before the Oversight and Investigations Subcommittee of the House Financial Services Committee
Tuesday, March 18, 2003
by
Phil Gramm

Vice Chairman, UBS Warburg

Madam Chairwoman and Members of the Subcommittee, 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 a series of inventory cycles. On a more or less regular basis, economic signals became confused and unsold inventories mounted. Orders were cut back, the economy retrenched, workers were laid off, and over time the excess inventories were consumed. Orders then flowed 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. Economists never seemed to be able to predict when downturns would occur, but they understood how the cycle behaved once it started.

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 seasonal variations in the demand for money generated by the seasonal nature of agriculture.

The downturn we suffer from today is quite different from those we experienced during the 20th century. 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, the inventory cycles of the middle and late 20th century were a by-product of an industrial economy, and the current downturn is the first post-industrial recession.

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.

Double Taxation on Dividends

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 be improved by eliminating the current distortions, which encourage corporations to reinvest earnings even when rates of return on investment outside the company exceed internal rates of return. 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 by tax policy from adopting a corporate structure even if it would allow them greater access to capital. It will also 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. Finally, 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.

Accelerating Rate Reduction

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. According to the Joint Committee on Taxation, 85% of all taxes collected at the highest tax rate are collected from proprietorships, partnerships and sub-chapter S corporations filing as individuals. 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.

Conclusion

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.

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 may be achievable. 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.

Testimony of the Honorable Rick A. Lazio
President and CEO – The Financial Services Forum
March 18, 2003

Madame Chair, Ranking Member Gutierrez, and former colleagues: Though many of you know me, I am Rick Lazio and I am the President and CEO of the Financial Services Forum. The Financial Services Forum was organized in February of 2000. It is composed of the chief executive officers of twenty of the largest and most diversified financial institutions in the United States. The purpose of the Forum is to promote policies that enhance savings and investment in the United States, and that ensure an open, competitive and sound financial services marketplace that contributes to the long-term growth of the American economy.

Our members believe that ending the double taxation of dividends will benefit investors, strengthen the capital markets and improve our long-term growth prospects. This measure will stimulate the economy in the short-term; however, the longer-term positive consequences are most important.

Direct Benefits to the Investor

The most obvious benefit to ending the double taxation of dividends is the promotion of steady dividend payments to investors. Within normal ranges of share prices and business performance, individual investors receive cash in hand with reasonable certainty – an immediate on-going return on share holdings. This flow of funds enhances the lives of American families, retirees, and other individuals in our society. Currently many shareholders receive the benefit of stock ownership only when they sell their stock. Clearly it is desirable to increase investor benefits in a manner that does not require stock sales to achieve. Ending the double taxation on dividends also gives the average investor a simple basis upon which to evaluate equities – the value of the dividend.

Benefit to the Economy

Double taxation of dividends results in the inefficient allocation of our nation's resources. Companies are penalized for returning funds to shareholders. Under current law, businesses are incented to reinvest earnings, which often could be put to better use elsewhere. Eliminating these perverse incentives leads to a more efficient capital market and a far more productive economy.

This measure would also make American firms more competitive in the international arena by lowering their cost of capital.

Removing the Incentive to Issue Debt

It has been clear for some time that double taxation has created a bias in favor of debt as opposed to equity capital because of the deductibility of interest payments. We have seen, over and over again, that excessive levels of debt become problematic during an economic downturn. Firms with too much leverage do not have sufficient flexibility to cope with adverse market conditions, to the detriment of their shareholders. Eliminating the double taxation of dividends removes the bias toward corporate debt, encouraging more equity in capital structures, which allows firms to weather adversity and protect investors in difficult times.

Removing the Bias Towards Share Repurchases

Double taxation encourages corporations to engage in share repurchases, because current tax law permits the distribution of earnings in this manner at lower capital gains tax rates. Investors, however, do not realize the cash benefit of a share repurchase until they sell their stock. Eliminating the double taxation of dividends makes it more likely that shareholders will receive higher dividends and realize corporate gains without selling their stock.

Promoting Better Governance

Because the tax code discourages payment of dividends, publicly traded companies often are focused on goals that can become problematic. Under present circumstances, shareholder value tends to be equated with an appreciation of stock price by many firms. Regrettably we have observed too many companies resorting to accounting manipulation to inflate earnings and stimulate stock price appreciation. Correcting the bias against dividends will cause both firms and their investors to emphasize cash flow and cash dividends as true and more appropriate measures of firm value.

Conclusion

In summary, removing the double taxation of dividends results in significant benefits to individual Americans and American families. This measure will restore balance to the manner in which publicly traded firms are managed by removing incentives to issue excess debt, repurchase shares, invest retained earnings in sub-optimal investments, and designing unproductive strategies to avoid taxes and inflate earnings. We believe that eliminating the double taxation of dividends will cause firms to focus on creating true value for shareholders and other stakeholders. Share prices of dividend paying stocks tend to be less volatile, and thus are a stabilizing force in the capital markets.

Eliminating the dividend tax will contribute in a major way to restoring and increasing confidence in our markets and contribute to long-term productive growth in the economy. Finally, this proposed change would correct a fundamental lack of fairness in the tax code by ending the bias against equity capital and dividends and increasing the competitiveness of US firms.

Testimony on President Bush's Economic Growth Tax Cut

Before the Subcommittee on Oversight and Investigation

U.S. House of Representatives Committee on Financial Services

Stephen Moore
Senior Fellow in Economics at the Cato Institute

March 18, 2003

President Bush's tax cut has the potential to substantially increase economic growth, boost the stock market, and increase business investment. The jewel of the President's tax plan is the elimination of the dividend tax on individuals. Another key economic growth provision of the tax plan is the acceleration of income tax rate reductions. My estimates are that the tax plan, if fully implemented, would increase stock values immediately by 5% to 15% and would reduce the cost of capital for businesses by 10% - 30%, depending on the industry.

Contrary to concerns that the Bush tax cut is "too big and too bold," I believe that the President's plan would be even more stimulative for economic growth if it were expanded to include several provisions. First, Congress should cut and consolidate income tax rates more than in the President's plan. The income tax rate should be consolidated down to 3 tax rates: 10%, 20%, and 30%. Second, tax free IRA savings accounts should be vastly expanded, in much the same manner as the White House has suggested. Super saver IRA accounts should be established with a cap of $20,000 per year per individual. The money in these funds should not be taxed until it is withdrawn for consumption purposes. Third, the capital gains tax should be lowered to 10% on all new investment.

The President's tax plan has many strengths, but one overriding virtue is this: it moves the federal tax system inexorably toward a single flat rate consumption tax system. Eliminating the double tax on dividends, abolishing the death tax, lowering income tax rates, and expanding tax free savings accounts are all big steps toward the promised land of a flat rate tax system that ends doubled taxation of saving and investment—the building blocks of a rapidly growing economy. Whatever modifications or additions to the Bush tax cut that Congress enacts should be consistent with the principles of a tax system that taxes all income at the same rate, once, and only once.

Myths About the President's Tax Plan

1. The Bush tax cut "benefits only the rich."

The media continues to report, as The New York Times has, that "90% of Americans…will get little or nothing from the dividend tax cut." Wrong. The Tax Foundation's recent examination of IRS tax return data finds just the opposite. Fully 34 million American tax filers reported some dividend income in 2000 and these returns represent 71 million people. That is a whole lot more than 10% of the population who will directly benefit.

The income tax cuts are even more widely distributed. Anyone who pays income taxes and dreads the coming of April 15th will get an income tax cut under the Bush plan.

The typical working family with 2 incomes and an income of $60,000—and I suspect very few of these households regard themselves as "rich"—would get a $1,200 a year tax cut from the Bush plan. If the income is $40,000 the family gets a $600 tax cut —and not just for one year, as under the Democratic alternative plan, but forever.

Proportionately, the rich get a smaller share of the Bush tax cut pie, not a bigger slice than the middle class. For example, the Treasury Department reports that for Americans who make more than $100,000 a year, the share of all federal income taxes paid would rise from 74% to 75%. For those who make less than a six-figure income a year, their overall share of the tax load goes down.

2. The Bush tax cut will blow a hole in the deficit.

The Bush tax cut provides $670 billion in tax relief for Americans over the next 10 years. This will hardly bankrupt the federal treasury. Over the next ten years the IRS will collect some $25 trillion in taxes from Americans. So the tax cut comes to less than 3 cents on the dollar, hardly a massive givcaway.

Nor is it accurate to say that the national debt will rise by the amount of the tax cut, unless one believes that tax cuts result in absolutely zero change in economic behavior. The truth is that for every action in the economy, as in physics, there is a reaction. If we cut income tax rates and eliminate the double tax on dividends, surely workers, and businesses, and investors will behave differently. If the tax on work and hiring goes down, surely we will get more of both. If the tax on investment goes down and the after-tax rate of return goes up, surely we will get more of that too. If the tax on dividends is eliminated and the capital gains tax falls as well, surely we will get more business investment and higher stock values.

Opponents of the tax cut continue to tout the results of economic models that have a perfect batting record of being wrong in predicting the future. For example, in 1997,when the capital gains tax rate was cut from 28% to 20%, the crystal ball gazers inside and outside government predicted a multi-billion dollar "cost" to the Treasury. In fact, the capital gains receipts doubled in 4 years. These are precisely the same defective models that are now telling us the Bush tax cut will lead the nation into bankruptcy.

Bill Beach, the economist and forecaster at the Heritage Foundation, reports that the dividend tax cut alone is such potent medication for the economy that the Treasury Department should recapture about 50 to 70% of the supposed tax revenue loss from the tax cut. Beach finds that the real world cost to the government of the Bush tax cut is probably at most half the reported "cost." I'd put my money on Beach's estimates, which have a far more accurate track record of accuracy.

But let us assume the worst-case scenario: no economic response from the Bush tax cut whatsoever. We could still have the Bush tax cuts and a balanced budget. If Congress were to modestly control its appetite for new spending, the tax plan could be implemented fully and the budget returned to balance by 2006. In a study for the Cato

Institute I found that if overall federal spending were restrained to 2% annual growth over the next four years (which shouldn't be too difficult in this era of almost no inflation), the federal government would start running surpluses by 2006 even if we assume that the Bush tax cut incited no economic feedback and we include the costs of the war. If the tax cuts do generate growth, the budget would be balanced by 2005 or sooner.

Another reason to suspect that the Bush tax cut will not run up the deficit is that if the taxes aren't cut, it is much more likely that Congress will spend the money than save it. In other words, taxes cause spending, and the lack of taxes impose at least some spending discipline. Ohio University economist Richard Vedder has documented this relationship between tax revenues and spending and has found that each additional dollar of taxes available for Congress to spend leads to nearly a dollar of added spending. Nobel prize winner Milton Friedman notes that one of the strongest arguments for the Bush tax cut is that it will discourage a stampede of congressional spending over the next several years.

3. The Bush tax cut won't stimulate economic growth or jobs.

All we can really rely upon to judge the economic value of tax rate reductions is the economic reaction to tax cuts in the past. Fortunately, Bush has history firmly on his side. The 1962 Kennedy income tax rate reductions spurred a bull market expansion and balanced budgets through the mid-1960s. The 1981 Reagan tax cuts ushered in 7 consecutive years of prosperity and 15 million new jobs. The 1997 capital gains cut corresponded with a bull market rally in the stock market and a surge of investment spending and venture capital funding for new businesses.

The critics argue that the 2001 Bush tax cut has failed to provide any juice for the economy. But there's a good reason for that. Seventy percent of the tax cuts haven't taken effect yet. All the more compelling reason to speed up the tax cuts so they can provide immediate economic aid. Especially critical is to chop the highest and most economically punitive tax rates. Roughly two-of-every-three Americans who pay the top income tax rate are business owners or sole proprietors. If you want jobs, you need financially healthy and confident employers with dollars to invest.

The dividend tax cut will have the same salutary effect on larger businesses. For example, John Rutledge, a respected Wall Street economist, has estimated that ending the double tax on dividends increases stock values by roughly 10% or an $800 billion increase in wealth, reduces businesses cost of raising investment capital by 25%, and helps stimulate a recovery in the battered high technology and telecom industries most. Many stock analysts, including economist John Rutledge of Kudlow and Co., believe that passing the dividend tax exemption and the acceleration of income tax rate reductions could add another 5 - 10% or so to equity values. That's the equivalent of a $500 billion to $1 trillion instant boost in wealth.

Clearly, even Americans who do own stocks that do not pay dividends or who own stocks in tax free 401k plans or IRAs will benefit from the dividend tax cut because of the increase in the valuation of stocks.

The Case for Growing the Bush Tax Cut

To maximize the positive job and wealth-creating impact of the Bush tax plan, it should not be shrunk, as some in the House suggest, it should be expanded to perhaps twice the size that the White House has recommended. I am pleased that Rep.s Paul Ryan of Wisconsin and Pat Toomey of Pennsylvania have teamed up to craft such a plan.

President Bush's plan will incentivize supply side growth by eliminating the dividend tax elimination and speeding up income tax rate cuts. But it omits tax policy changes that would improve the tax code, help the economy immediately, and cost the Treasury little or nothing in terms of lost revenues. This strategy would lift the tax drag that is still impeding growth and hasten the economy's recovery to the 4% to 5% real GDP growth that the United States is uniquely capable of achieving. It is worth reminding the members of the Committee that even in the first year of the plan, the tax cut amounts to less than 1% of the entire GDP. The Reagan tax cuts of 1981 and the John F. Kennedy tax cuts of 1964 were about 3 to 4 times larger in size than what President Bush has proposed.

Growth is the key to balancing the budget. A balanced budget will require at least a 3% to 4% economic growth rate to generate the revenues to pay for expected federal spending over the next decade. Every 1 percentage point increase in sustained economic growth generates an extra $1 trillion of tax receipts over ten years. The best way to produce tax receipts is to put people back to work; to get the stock market growing again; and to return American businesses to robust profitability. Tax cuts aren't then only way to make higher growth achievable, but history repeatedly shows they can sure help.

As such, here are the additions to the Bush tax plan that are worth consideration:

1) Consolidate the income tax rates down to three: 10, 20, and 30. Getting the top tax rate down to 35% is good, but 30% would be even better. For those who argue that this would lower the top tax rate too much, we would remind critics that in the late 1990s Reagan got the top tax rate down to 28%. Lowering the top income tax rate back down to 30% would help attract trillions of dollars of foreign investment capital back to the U.S. and would help reverse the decline in the dollar. Also, because 2 of every 3 taxpayers in the highest tax bracket today is a sole proprietor of a small business, lower tax rates will mean more business expansion and more jobs.

2) Cut the capital gains tax to 10% on all new investment. The last capital gains tax cit in 1997 increased stock values, increased business investment and venture capital funding, and helped spur a huge stock market rally. That has been the economic reaction to virtually every capital gains tax cut over the past 40 years.

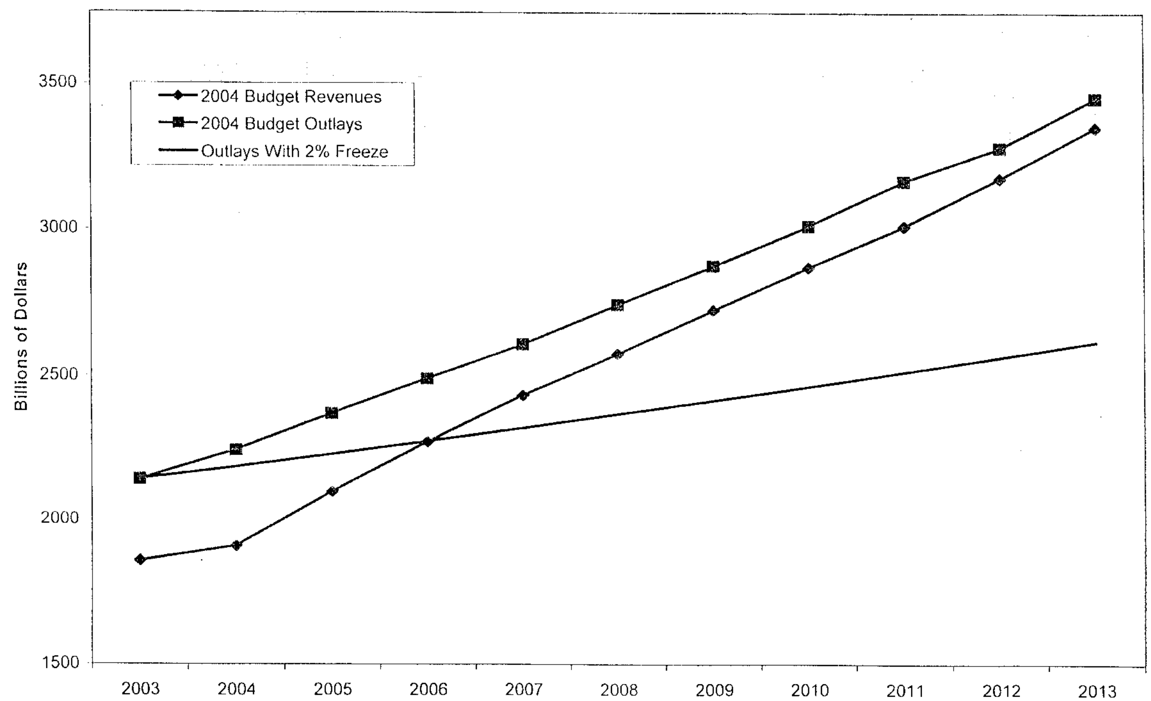
The capital gains tax cut is the goose that lays the golden eggs. Keep cutting until we eventually get down to zero.

3) Expand tax free IRAs and 401k super-saver accounts. This will help create larger individual pools of household savings and wealth accumulation. The latest Fed report shows that 52% of households now own stock and that this mass democratization of the U.S stock market has caused impressive increases in average household wealth in the U.S. – from $50,000 on average in the mid 1980s to almost $75,000 today (adjusted for inflation). IRAs and 401ks help build financial self-sufficiency and less reliance on the government programs. Moreover, we should stop double-taxing Americans' savings. IRAs and 401k's should be dramatically liberalized by raising limits by $5,000 per year. The goal should be to eventually create unlimited supersaver IRAs, where any money that is saved out of income is not taxed, until the funds are taken out of the savings account to be spent. The income limits for IRAs should be repealed too.

One last, but crucial point. Republicans need to adopt dynamic, real-world scoring of tax policy changes. Stop using a tax referee that is biased against the President's program and that consistently produces discredited predictions of the future. For 30 years economic models in Washington have over-estimate the revenue gains from tax hikes, and overstated the tax losses from tax rate cuts.

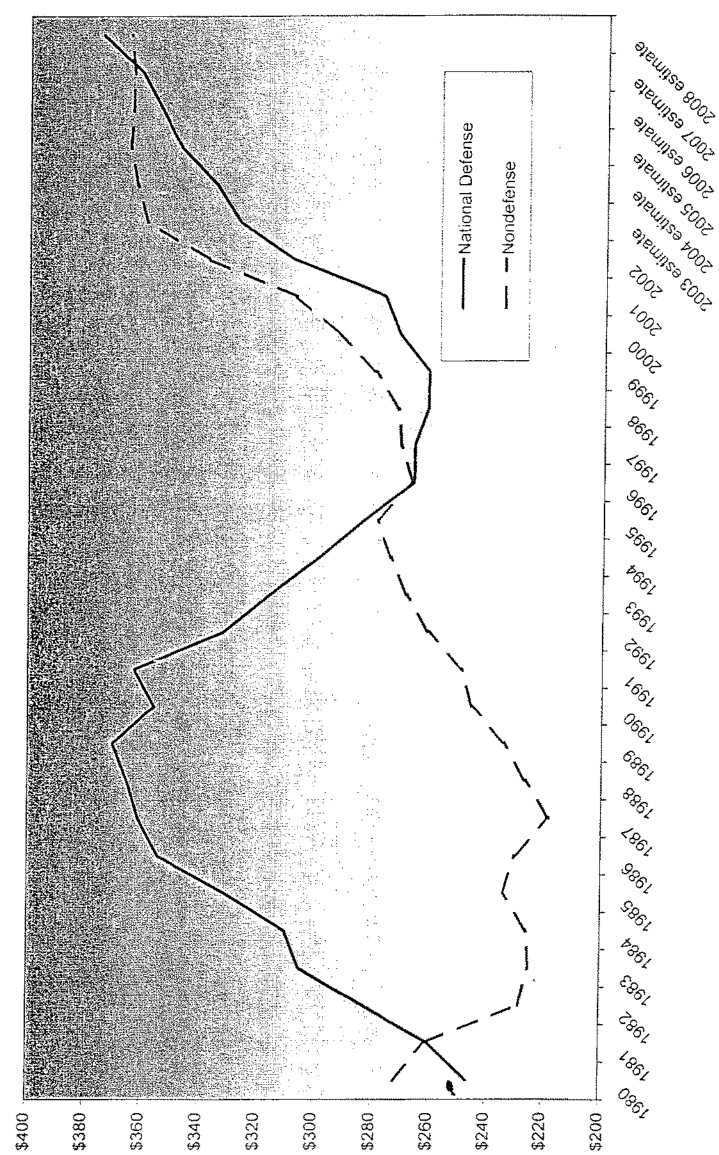
President Bush deserves great credit for proposing a tax plan that has the potential to increase economic growth and create jobs. The economy needs a jolt of tax cut adrenaline given the recent discouraging financial numbers that have been released. The fact that we are on the eve of war, is an argument for revving up our economic engine of industrial might, not hindering its productive capacity with a dysfunctional tax system.

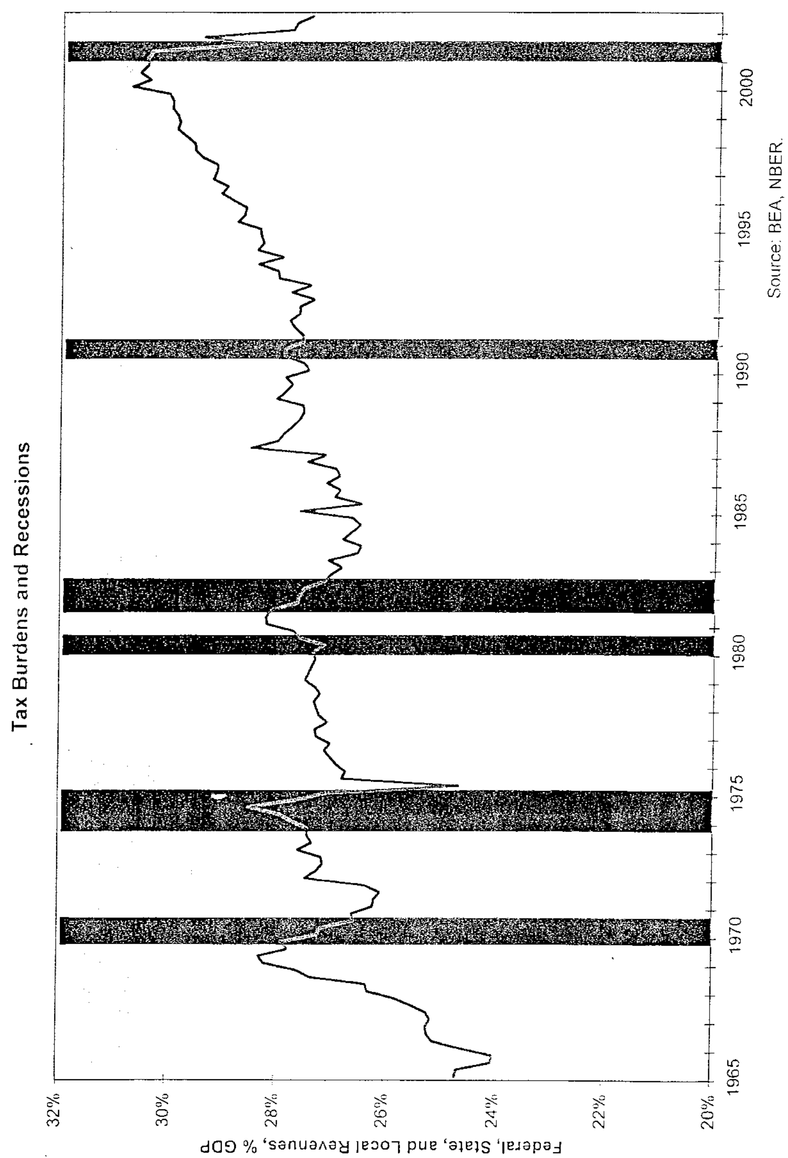
Controlling Spending Is the Key to Restoring Surpluses



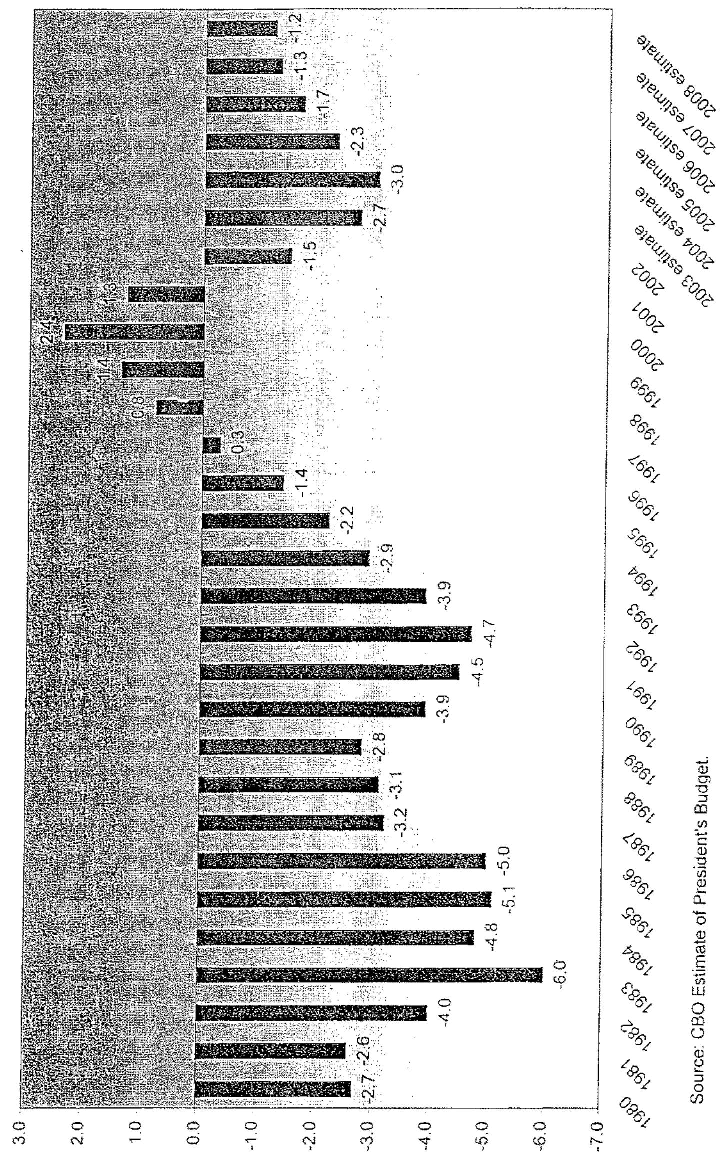
Source: CBO, "An Analysis of the President's Budgetary Proposals for Fiscal Year 2004."

Defense and Nondefense Discretionary Spending
Billions of Constant 1996 Dollars

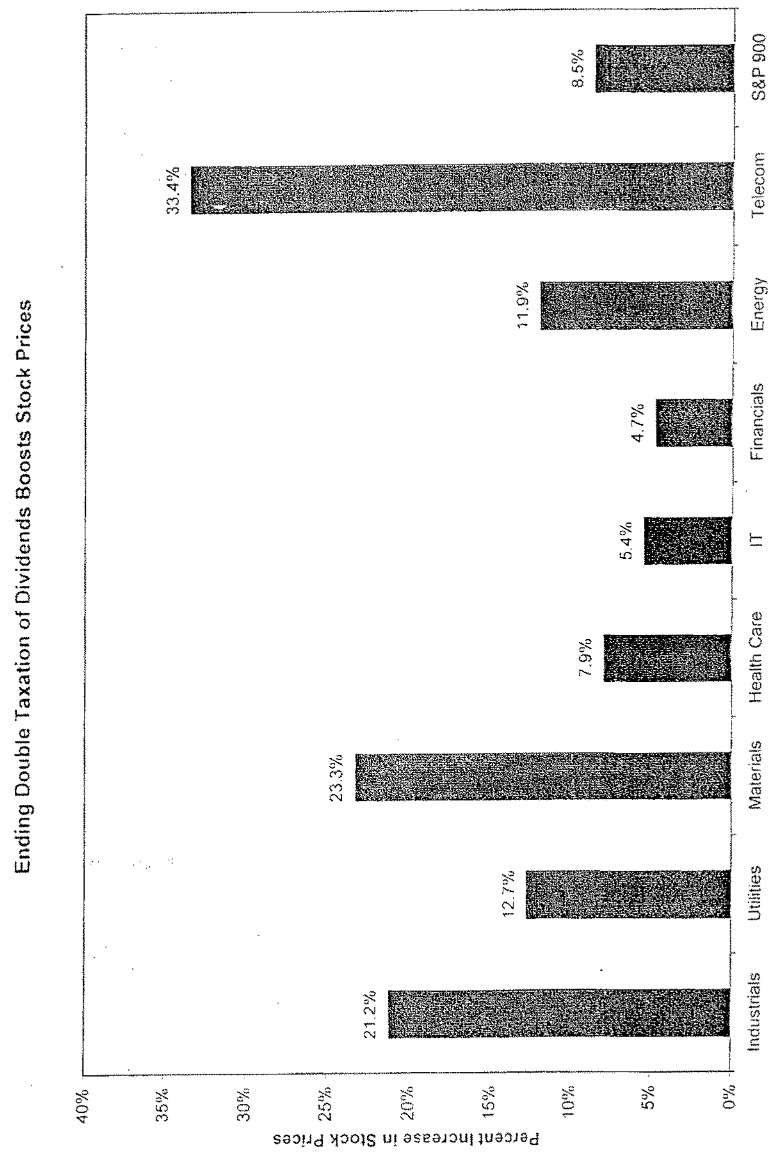



Tax Burdens and Recessions
Federal, State, and Local Revenues, % GDP
32%
30%
28%
26%
24%
22%
20%
1965
1970
1975
1980
1985
1990
1995
2000
Source: BEA, NBER.

Surplus/Deficit as Percent of GDP



Source: CBO Estimate of President's Budget.


Ending Double Taxation of Dividends Boosts Stock Prices
Percent Increase in Stock Prices
40%
35%
30%
25%
20%
15%
10%
5%
0%
21.2%
12.7%
23.3%
7.9%
5.4%
4.7%
11.9%
33.4%
8.5%
Industrials
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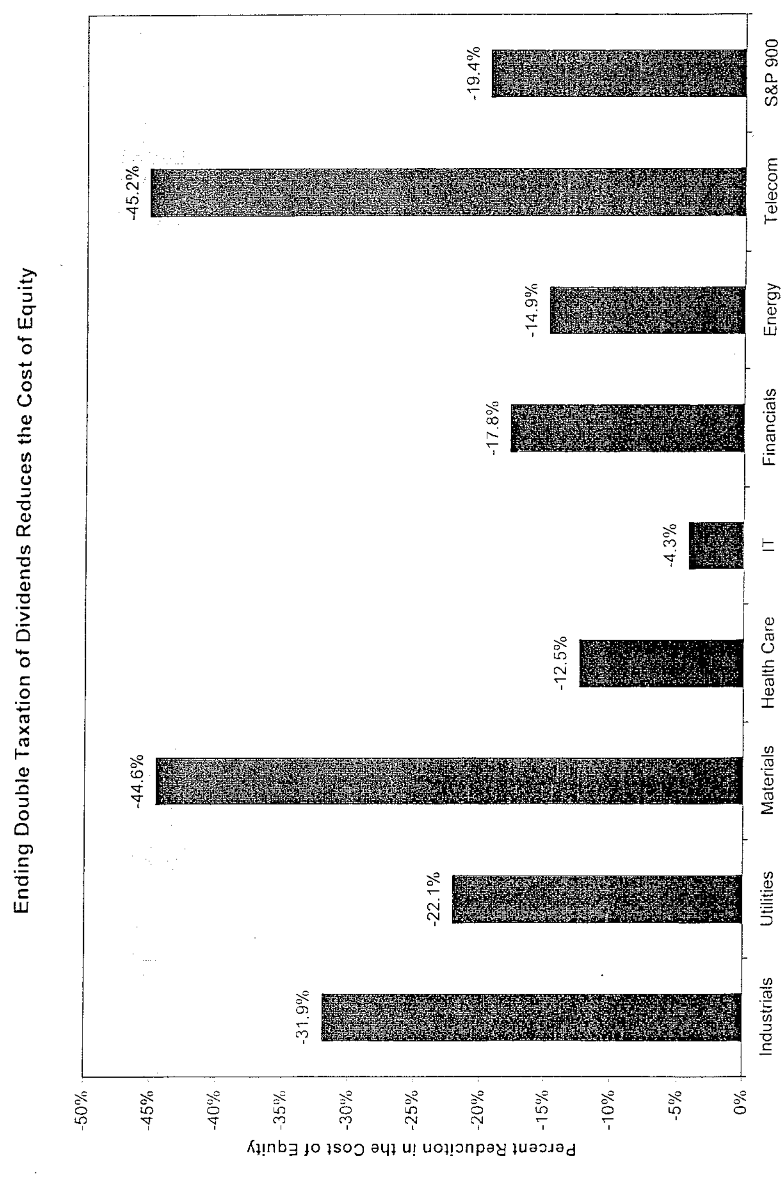
Financials
Energy
Telecom
S&P 900



Ending Double Taxation of Dividends Reduces the Cost of Equity
Percent Reduction in the Cost of Equity
-50%
-45%
-40%
-35%
-30%
-25%
-20%
-15%
-10%
-5%
0%
-31.9%
-22.1%
-44.6%
-12.5%
-4.3%
-17.8%
-14.9%
-45.2%
-19.4%
Industrials
Utilities
Materials
Health Care
IT
Financials
Energy
Telecom
S&P 900

Testimony on the Administration's Tax Proposals

Peter R. Orszag[1]
Joseph A. Pechman Senior Fellow in Economic Studies
Co-Director, Tax Policy Center
The Brookings Institution

Testimony before the Committee on Financial Services
Subcommittee on Oversight and Investigations
United States House of Representatives
March 18, 2003

Chairman Kelly, Ranking Member Gutierrez, and Members of the Committee, it is an honor to appear before you to discuss proposals for economic growth and job creation.

My testimony argues that the Administration's tax proposals are not well-designed for boosting economic growth in either the short run or the long run:

- In the short run, the key to economic growth is expanded demand for the goods and services firms could produce given current capacity.

- In the long run, a key to economic growth is higher national saving, which finances ongoing expansions in capacity over time.

Yet the Administration's proposals would have only modest effects on demand in 2003 and would expand budget deficits in the long run. All else being equal, the expanded budget deficits would reduce national saving in the long run, exactly the opposite of what would be needed to boost long-term economic performance. Furthermore, the proposals would exacerbate after-tax inequality of income in the United States.

It is also important to put the current proposals in context. The first wave of baby boomers will become eligible for retirement benefits under Social Security in 2008; they will become eligible for Medicare in 2011. As the baby boomers begin to retire, the Federal budget will come under increasing pressure.[2] Given that budgetary outlook, policies that significantly exacerbate long-term deficits seem especially reckless. As a recent report from the Committee for Economic Development, a leading organization of business leaders and educators, put it: "The first step in climbing out of a hole is to stop digging. We cannot afford economic policy decisions today that further raise deficits tomorrow."[3]

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[1] Peter R. Orszag is the Joseph A. Pechman Senior Fellow in Economic Studies at the Brookings Institution and a Co-Director of the Tax Policy Center. Much of this testimony draws upon joint work with William Gale. I thank Henry Aaron, Robert Cumby, Robert Greenstein, and Jonathan Orszag for helpful discussions and comments, and Jennifer Derstine, David Gunter, and Matt Hall for excellent research assistance. The views in this testimony are those of the author alone, and should not be attributed to the staff, officers, or trustees of the Brookings Institution or the Tax Policy Center.

[2] For specific estimates of the long-term budget imbalance, see See Alan J. Auerbach, William G. Gale, Peter R. Orszag, and Samara Potter, "Budget Blues: The Fiscal Outlook and Options for Reform," in Henry Aaron, James Lindsay, and Pietro Nivola, *Agenda for the Nation* (Washington: Brookings Institution, forthcoming).

[3] Committee for Economic Development, "Exploding Deficits, Declining Growth," March 2003.

Especially in the face of significant uncertainties involving the war on terrorism, it is difficult for me to see the wisdom in a set of policies that would expand the long-term budget deficit; have at best a minimal positive effect on economic activity, and more likely a negative effect; and widen income inequalities.

Administration's tax proposals

The Administration has proposed two sets of tax cuts: those included in its growth package and other tax cuts included in the budget. The growth package would, along with other smaller changes, accelerate the 2001 tax cuts and exclude dividends and some capital gains from taxation at the individual level. A letter released in January that was signed by 10 Nobel Prize winners in economics, along with more than 400 other economists (including myself), emphasized:[4]

> "...The tax cut plan proposed by President Bush is not the answer to these problems. Regardless of how one views the specifics of the Bush plan, there is wide agreement that its purpose is a permanent change in the tax structure and not the creation of jobs and growth in the near-term. The permanent dividend tax cut, in particular, is not credible as a short-term stimulus. As tax reform, the dividend tax cut is misdirected in that it targets individuals rather than corporations, is overly complex, and could be, but is not, part of a revenue-neutral tax reform effort.
>
> Passing these tax cuts will worsen the long-term budget outlook, adding to the nation's projected chronic deficits. This fiscal deterioration will reduce the capacity of the government to finance Social Security and Medicare benefits as well as investments in schools, health, infrastructure, and basic research. Moreover, the proposed tax cuts will generate further inequalities in after-tax income..."

That letter was written primarily in response to the Administration's growth package, which was announced on January 7th.[5] The additional tax cuts in the budget include, most prominently, substantially expanded tax-preferred savings accounts and the removal of the sunsets on the 2001 tax legislation. These proposals also do not seem well-designed for either the short run or the long run, since they would fail to do much to boost demand in 2003 and would expand budget deficits in the long run.[6]

Economic effects of deficit-financed tax cuts

An important aspect of all the Administration's tax proposals -- including making the 2001 tax cuts permanent, the new dividend proposal, and the new savings account proposal -- is that they are effectively deficit-financed. (It should be noted that the House budget resolution may effectively finance the tax proposals in a different manner than the Administration's budget.)

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[4] See http://www.epinet.org/stmt/2003/statement_signed.pdf.

[5] For further analysis of the dividend proposal, see William G. Gale and Peter R. Orszag, "The Administration's Proposal to Cut Dividend and Capital Gains Taxes," The Brookings Institution, January 13, 2003; and William G. Gale and Peter R. Orszag, "The President's Tax Proposals: Second Thoughts," *Tax Notes*, January 27, 2003.

[6] For an analysis of the savings proposals, see Leonard E. Burman, William G. Gale, and Peter R. Orszag, "The Administration's New Tax-Free Saving Proposals: A Preliminary Analysis," *Tax Notes,* March 3, 2003.

Deficit-financed tax cuts are unlikely to have significant positive effects on economic growth in the long-term, and may well reduce it. A full analysis of tax cuts that result in larger budget deficits needs to take into account (1) the direct effects of the policy in question, ignoring any change in the deficit; and (2) the decline in national saving caused by the expanded budget deficit.

The most recent prominent example of the tradeoffs involved is the 2001 tax cut. The net effect of the 2001 tax cut on growth is the sum of its (possibly positive) effect from changes in incentives and its (negative) effect through increases in the budget deficit. Given the structure of the 2001 tax cut, researchers have generally found that the negative effects of the tax cuts via expanded budget deficits (and reduced national) saving offset and potentially outweigh any positive effects on future output from the impact of reduced marginal tax rates.[7] Similarly, an analysis of the new tax cuts proposed by the Administration needs to account for any positive incentive effects from reduced taxes *and* negative effects from expansions of the deficit and reduced national saving. Over the long-term, the result is likely at best to be a modest gain, and may well be negative.[8]

Effect on budget

The revenue losses from the Administration's proposals are substantial: The tax cuts would amount to approximately 1.8 percent of GDP in FY 2013, for example.[9] That 1.8 percent of GDP figure may understate the permanent cost of the Administration's tax proposals, since it is artificially restrained by failing to address the looming alternative minimum tax problem and since it does not fully reflect the long-term cost of the proposed savings accounts.

To put the size of the tax cuts even after 2013 in perspective, it may be helpful to compare the fiscal dimensions of two major items: the projected long-term actuarial deficit in Social Security and the long-term cost of the Administration's tax cuts. As Table 1 shows, *the*

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[7] See Alan J. Auerbach, "The Bush Tax Cut and National Saving," Prepared for the 2002 Spring Symposium of the National Tax Association, May 2002; Congressional Budget Office, *The Budget and Economic Outlook: An Update*, August 2001; Douglas W. Elmendorf, and David L. Reifschneider, "Short-Run Effects of Fiscal Policy with Forward-Looking Financial Markets," Prepared for the National Tax Association's 2002 Spring Symposium; and William G. Gale, and Samara R. Potter. 2002, "An Economic Evaluation of the Economic Growth and Tax Relief and Reconciliation Act of 2001," *National Tax Journal* Vol. LV, No. 1 (March): 133-186. One reason for the tepid estimated response to the 2001 tax cut is that 64 percent of filers, accounting for 38 percent of taxable income, would receive no reduction in marginal tax rates, according to Treasury estimates (Donald Kiefer, et al., "The Economic Growth and Tax Relief Reconciliation Act of 2001: Overview and Assessment of Effects on Taxpayers," *National Tax Journal* Vol. LV, No. 1 (March 2002): 89-117.).

[8] For an example of a quantitative analysis of the Administration's growth package finding a negative long-term effect, see Macroeconomic Advisers, LLC, "A Preliminary Analysis of the President's Jobs and Growth Proposals," January 10, 2003. The report does find a significant increase in demand in the short run, but also finds that the proposals would reduce potential GDP in the long-term: "Initially the plan would stimulate aggregate demand significantly by raising disposable income, boosting equity values, and reducing the cost of capital. However, the tax cut also reduces national saving directly while offering little new, permanent incentive for either private saving or labor supply. Therefore, unless it is paid for with a reduction in federal outlays, the plan will raise equilibrium real interest rates, crowd out private-sector investment, and eventually undermine potential GDP."

[9] According to the Congressional Budget Office and Joint Committee on Taxation, the revenue loss in FY 2013 is $324 billion. The CBO forecast of GDP in FY 2013 is $17,851 billion. The tax cut is thus 1.8 percent of GDP in FY 2013. See Congressional Budget Office, "An Analysis of the President's Budgetary Proposals for Fiscal Year 2004," March 2003.

long-term cost of the Administration's tax cuts is more than three times the entire long-term Social Security shortfall. The Administration's tax cuts would cost between 2.3 percent and 2.7 percent of Gross Domestic Product (GDP) over the next 75 years; the Social Security deficit amounts to 0.7 percent of GDP.[10]

Table 1: Administration tax cuts and Social Security deficit over next 75 years

	Present value over the next 75 years, % of GDP	Present value over the next 75 years*, $ trillion
2001 tax cut if made permanent	1.5% to 1.9%	$7.7 trillion to $9.8 trillion
Dividend / capital gains proposal	0.3%	$1.5 trillion
Tax-free savings accounts	0.3%	$1.5 trillion
Other proposed tax cuts	0.2%	$1.0 trillion
Total, Administration tax cuts	***2.3% to 2.7%***	***$11.8 trillion to $13.9 trillion***
Social Security actuarial deficit*	0.72%	$3.7 trillion
Medicare Hospital Insurance actuarial deficit*	0.96%	$5.0 trillion
Combined Social Security and Medicare HI deficit*	***1.67%***	***$8.7 trillion***

* Assumes level of GDP and interest rates projected by the Social Security actuaries. Based on 2002 Trustees Report, which was the most recent available when this testimony was written. The 2003 Trustees Report was scheduled to be released on March 17, 2003.

The bottom line is that, especially in the face of substantial projected budget deficits, enacting large, permanent tax cuts must mean some combination of: (1) shifting tax burdens to future generations, which will already be facing higher taxes based on current projections; (2) reneging on government promises in some form; or (3) running substantial budget deficits that would likely become unsustainable.

Distributional effects

Many Administration officials have been advertising the "growth" package as providing an average tax cut of $1,083, suggesting to many Americans that they would receive a tax cut of this size.[11] Other officials have been highlighting the fact that the tax cut provided to the top 1 percent of tax filers in 2003 is smaller than the share of income taxes they pay. Finally, the White House claims that the proposed tax cut will provide benefits to "everyone who pays taxes -- especially middle-income Americans."[12] These claims raise three important issues.

[10] For further details, see Peter Orszag, Richard Kogan, and Robert Greenstein, "The Administration's Tax Cuts and the Long-Term Budget Outlook," Center on Budget and Policy Priorities, March 2003.
[11] See, for example, "Taking Action to Strengthen America's Economy," Chicago, Illinois, January 7, 2003, available at www.whitehouse.gov.
[12] http://www.whitehouse.gov/infocus/economy/

First, the use of averages can be misleading. As Robert Reich is fond of pointing out, the average of himself and Shaquille O'Neal is a man about 6 feet tall. Averages are also misleading with regard to the Administration's proposal. Under that proposal, 78.4 percent of income tax filers and 71.1 percent of income tax payers would receive less than $1,000 (see Table 2). By contrast, the average tax cut in 2003 for those filers earning more than $1 million would amount to $90,222.

Table 2: Size of tax cut under Administration's "growth" proposal

Size of tax cut received, 2003	Percent of income taxpayers	Percent of income tax filers
$100 or less	37.5%	49.3%
$500 or less	60.0%	68.6%
$1,000 or less	71.1%	78.4%

Source: Urban-Brookings Tax Policy Center and author's calculations

Second, comparing the share of the tax cut received to the share of income tax paid in 2003 is problematic for three reasons:

- It is misleading to examine only the share of income taxes paid, since the top 1 percent pays a significantly smaller share of all Federal taxes than its share of income taxes. In 2003, the top 1 percent of tax filers would pay 36.7 percent of income taxes, but only 24.8 percent of all Federal taxes in the absence of the Administration's growth proposal (Table 3). Since the top 1 percent would receive 28.8 percent of the Administration's proposed tax cut in 2003, it would receive a larger share of the tax cut than its share of Federal taxes paid. As a result, the share of total Federal taxes paid by the top 1 percent would decline if the Administration's proposal were enacted.

- The Administration's proposal becomes more regressive over time, since the provisions primarily affecting the middle class are overwhelmingly temporary (reflecting merely the acceleration of several provisions from the 2001 tax cut) whereas the major provision primarily affecting higher earners (the dividend tax proposal) would be permanent. For example, in 2010, the top 1 percent of tax filers would enjoy 44 percent of the tax cut – almost twice their share of Federal taxes paid and substantially more than their share of income taxes paid. Focusing solely on 2003 is misleading.

- Finally, measuring the progressivity (or lack thereof) of a tax cut by comparing the share of the tax cut to the share of taxes paid is a flawed approach when the proposal is changing the level of overall revenue and the tax system is progressive. To see why, consider the elimination of a progressive tax system. By definition, since taxes would be eliminated, everyone would receive a share of the tax cut equal to his or her share of taxes paid. The net result, however, would be to make the after-tax distribution of income more unequal – since the tax system would no longer be partially offsetting the inequality in pre-tax income. The most insightful measure of the progressivity of a tax cut is therefore the percentage change in after-tax income. If higher earners enjoy a larger percentage increase in after-tax income than lower earners, then the change is regressive. As Table 3 shows, the top 1 percent would experience a 3.7 percent increase in after-tax income in 2003; the bottom 80 percent would experience a 1.0 percent increase. The proposal is thus very regressive even in 2003 – and more so in 2010.

Table 3: Distributional implications of Administration "growth" package

	Share of income taxes paid, 2003	Share of total Federal taxes paid, 2003	Share of Admin. tax cut, 2003	Share of Admin. tax cut, 2010	Change in after-tax income, 2003
Bottom 80 percent	16.8%	30.5%	21.3%	15.5%	+1.0%
Top 1 percent	36.7%	24.8%	28.8%	44.2%	+3.7%

Source: Urban-Brookings Tax Policy Center and author's calculations

On a related note, the Administration's claims about the effects of the tax cut on the elderly and small businesses would also be extremely easy to misinterpret. The reality is:

- More than two-thirds of elderly tax filers (67.3 percent) would receive a tax cut of $500 or less.

- More than half (51.6 percent) of tax returns with small business income would receive a tax cut of $500 or less.[13]

Furthermore, the proposal would divert capital from the small business sector and put upward pressure on interest rates. The loss in revenue entailed by the proposal may also ultimately force reductions in government programs that disproportionately assist the elderly, as well as middle-income and lower-income families.

Some Administration officials have argued that examining the distribution of benefits based on the flow of taxable dividends presents an incomplete picture, since the elimination of dividends may boost the stock market and therefore provide benefits to all households owning stocks. Such arguments then typically provide a statistic regarding the share of households at different income levels who own stocks. The problem with that type of statistic, for the purposes of examining the distributional consequences of the proposal, is that a household with $1 in stocks is treated equivalently to a household with $10 million in stocks. Table 4 provides a more useful perspective: It shows the distribution of the value of stock holdings among different types of households, according to the 2001 Survey of Consumer Finances (SCF). As the table shows, the top 10 percent of households ranked by income own more than 60 percent of the aggregate stock owned (either in taxable or tax-preferred accounts) by households. Another perspective on the same point is that the SCF data suggest that households with incomes below $75,000 represent about 60 percent of stock owners, but only about 20 percent of the value of stocks owned.

Table 4: Distribution of equity holdings

[13] For further discussion of the effects on small businesses, see Andrew Lee, "President's Radio Address and Other Administration Statements Exaggerate Tax Plan's Impact on Small Businesses," Center on Budget and Policy Priorities, January 18, 2003.

	Percentage of total equity holdings, by type of holding			
	All equity holdings	Held directly or through mutual fund	Held in retirement account	Held in other account/trust
Percentiles of income				
Less than 20	1.3	1.0	1.1	3.2
20-39.9	2.8	2.7	2.3	4.6
40-59.9	6.9	5.4	9.0	8.0
60-79.9	14.2	11.3	19.4	13.0
80-89.9	12.7	9.6	18.0	12.3
90-100	62.0	69.9	50.1	58.8
Age of head (years)				
Less than 35	5.0	5.6	4.0	4.6
35-44	12.8	10.7	17.8	8.4
45-54	26.5	24.5	34.1	14.4
55-64	25.3	24.2	25.0	30.9
65-74	17.3	18.0	13.9	23.2
75 or more	13.2	17.0	5.2	18.5

Source: Analysis of the 2001 Survey of Consumer Finances.

<u>The taxation of corporate income once and only once</u>

My final topic focuses specifically on the dividend tax proposal that is intended to tax corporate income once and only once.[14] Three points are important to emphasize about this proposal:[15]

- First, most corporate income in the United States is not taxed twice. A substantial share of corporate income is not taxed at the corporate level, due to shelters, corporate tax subsidies and other factors.[16] Recent evidence suggests growing use of corporate tax shelters.[17] Furthermore, half or more of dividends are effectively untaxed at the individual level because they flow to pension funds, 401(k) plans, and non-profits.[18] Although data

[14] The provision would represent a significant tax cut for both dividends and capital gains on corporate stocks. In simplest terms, under the Administration's proposal, dividends paid out of corporate earnings that were already taxed at the corporate level would not be subject to the individual income tax. In addition, earnings that were already taxed at the corporate level and that were retained by the corporation would generate a basis adjustment for shareholders. Such a basis adjustment means that, when the stock is ultimately sold, the increase in stock price due to retained earnings taxed at the corporate level would not generate a capital gains tax liability at the individual level.
[15] This section draws heavily on William G. Gale and Peter R. Orszag, "The Administration's Proposal to Cut Dividend and Capital Gains Taxes," *Tax Notes*, January 20, 2003.
[16] Robert McIntyre, "Calculations of the Share of Corporate Profits Subject to Tax in 2002." January 2003.
[17] Mihir Desai, "The Corporate Profit Base, Tax Sheltering Activity, and the Changing Nature of Employee Compensation," NBER Working Paper 8866, April 2002.
[18] William G. Gale, "About Half of Dividend Payments Do Not Face Double Taxation," *Tax Notes*, November 11, 2002. Although taxes are due on pensions and 401(k) plans when the funds are paid out or withdrawn, the effective tax rate on the return to saving in such accounts is typically zero or negative because the present value of the tax saving due to the deduction that accompanies the original contribution is typically at least as large as the present value of the tax liability that accompanies

limitations make definitive judgments difficult, the component of corporate income that is not taxed (or is preferentially taxed) appears to be at least as large as the component that is subject to double taxation. That is, the non-taxation or preferred taxation of corporate income is arguably at least as big of a concern as double taxation.

- Second, under the Administration proposal, firms would maximize shareholders' after-tax returns by sheltering corporate income from taxation and then retaining the earnings -- the same strategy that maximizes shareholders' after-tax returns under current law.[19] The proposal therefore does not eliminate the incentives that exist under the current tax system to shelter corporate income from taxation and then to retain the earnings; the degree to which it reduces such incentives will depend on a variety of firm-specific factors.

- Third, the Administration's proposal does the "easy" part of tax reform: it cuts taxes. It fails, however, to do the difficult part of any serious tax reform effort: broadening the tax base and eliminating the share of corporate income that is never taxed (or taxed at preferential rates). That difference is what distinguishes "tax reform" from "tax cuts." The approach proposed by the Administration would undermine the political viability of true corporate tax reform. Any such reform would have to combine the "carrot" of addressing the double taxation of dividends with the "stick" of closing corporate loopholes and preferential tax provisions, but the Administration's proposal simply gives the carrot away. Burman (2003) and Gale and Orszag (2003) discuss modifications to the Administration's proposal that would represent a more balanced approach to changing the system of taxing corporate income.[20]

Conclusion

The economic challenges facing the nation differ significantly depending on the time horizon. In the short run, a key challenge is to boost spending (to expand demand for the capacity we have available to produce goods and services). In the long run, a key challenge is to boost saving (to finance expansions in capacity over time). Unfortunately, the Administration's proposals seem poorly designed to meet either challenge. They would expand the long-term deficit and exacerbate income inequality. A better package would combine targeted short-term stimulus (limited to 2003 alone) with long-term fiscal discipline (to boost national saving).

the withdrawal. Also note that a substantial share of capital gains on corporate stocks is never taxed because of the basis step-up at death.

[19] See William G. Gale and Peter R. Orszag, "The Administration's Proposal to Cut Dividend and Capital Gains Taxes," *Tax Notes*, January 20, 2003.

[20] Leonard E. Burman, "Taxing Capital Income Once," Urban-Brookings Tax Policy Center, January 2003, and William G. Gale and Peter R. Orszag, "The Administration's Proposal to Cut Dividend and Capital Gains Taxes," *Tax Notes*, January 20, 2003.

NAHB
NATIONAL ASSOCIATION
OF HOME BUILDERS

ACROSS THE COUNTRY HOME BUILDERS CARE

Testimony Of

James R. Rayburn

First Vice President

On behalf of the

National Association of Home Builders

Before the

United States House of Representatives

Oversight and Investigations Subcommittee

of

Financial Services Committee

On

The President's Economic Growth Package

March 18, 2003

Thank you Madam Chairwoman for the opportunity to testify before the Subcommittee on Oversight and Investigations of the Committee on Financial Services on behalf of the National Association of Home Builders (NAHB). NAHB represents more than 205,000 members involved in home building, remodeling, multifamily construction, property management, subcontracting and light commercial construction. NAHB is affiliated with more than 800 state and local home builder associations around the country. Our builder members will construct approximately 80 percent of the more than 1.6 million new housing units projected for construction in 2003.

The home building industry has been one of the strongest contributors to the national economy in recent years. We have had record years of production that have led to the highest homeownership rate in U.S. history -- 67 percent. It is in America's interest to assure that the home building industry maintains its leadership role in the economy, not only because housing and related industries account for 14 percent of the gross national product (GDP), but most importantly because of the benefits of home ownership to our country.

The subject of these hearings, the "Economic Growth Package" in the administration's FY 2004 budget, is a complicated proposal that affects a variety of issues of interest to the home building industry that warrant careful consideration and review by the committee. In addition to stimulating increased consumption and capital investment, these issues include interest rates, rates of return on tax exempt bonds, possible effects on targeted tax credits such as the Low Income Housing Tax Credit, the proposed Homeownership Tax Credit, New Markets Tax Credit, and Historic Preservation Tax Credit.

First, I want to say that NAHB supports President Bush and the Congress in their efforts to achieve an economic stimulus package that will provide near term stimulus to consumer spending and capital investment, including more housing consumption and production. NAHB supports changes in the Bush Administration's tax proposal or any Congressional tax proposal that will avoid unintended consequences that would be harmful to the housing industry such as increasing interest rates or the rate of return on tax exempt bonds, or negatively impacting housing affordability by lessening the value of targeted tax credits such as the LIHTC, the President's proposed HOTC, the New Markets Tax Credit and the Historic Preservation Tax Credit.

NAHB specifically supports the primary short term stimulus elements of the "Economic Growth Package" that would accelerate the implementation of changes in the tax law scheduled to take place in the future and increase capital formation incentives for small businesses. The accelerated changes in the tax code are tax rate reductions, an expansion of the 10 percent rate bracket, providing marriage penalty relief, and increasing the child tax credit. The small business capital formation proposal would increase the amount small businesses can annually expense from $25,000 to $75,000. We do, however, have concerns with some aspects of the Economic Growth Package. We are concerned about the possible consequential effects of eliminating the double taxation of corporate earnings, as well as, the failure of the package to include a housing component.

The primary focus of my testimony today is focused on the impact of the administration's proposal to eliminate the double taxation of corporate earnings on the LIHTC program. This is a complicated issue that requires some background information before it can be understood.

Background

Under present law, "C" corporations, generally large corporations with many shareholders, pay federal income tax on their earnings. After the tax is paid the corporations either pay dividends to shareholders from the earnings or retain the earnings in the corporation. When a shareholder receives a dividend payment from a corporation, the shareholder reports the dividend as taxable income on his or her personal tax return. If the corporation retains earnings, the shareholder does not receive a direct benefit for the retained earnings. However, the retained earnings may produce an indirect benefit of increasing the value of the corporation's stock because the corporation has more capital.

The distribution of a dividend from taxed corporate earnings to a shareholder who then pays tax on the dividend is a double taxation of the corporate earnings. This double taxation of corporate earnings affects how businesses conduct their financial affairs and can create economic distortions. Many businesses avoid organizing as "C" corporations. They operate as pass through entities, i.e., businesses that pass through their items of income and expenses to the owners who report the items on their individual tax returns. When businesses operate as pass through entities there is only one level of tax and the double taxation of corporate earnings is totally avoided. Pass through entities are generally Sub Chapter S corporations and different types of partnerships.

Corporations that cannot do business as a pass through entity can minimize the impact of the double tax on earnings in a number of ways. Corporations may avoid raising capital though stock offerings and instead raise capital with debt. Interest payments on the debt are fully deductible, and as a result, less costly than paying dividends. Corporations also can buy back stock. To shareholders that sell their stock, the gain is a capital gain that is usually taxed at the capital gains rate of 20 percent, rather than higher personal income tax rates. The shareholders that do not sell their stock also receive a benefit from corporate repurchases of outstanding shares. As the number of corporate shares in the market declines, the price of the remaining outstanding shares tends to increase. Corporations also may retain more earnings than they would otherwise to avoid having shareholders pay additional tax on the earnings. By retaining the earnings, the value of the stock may increase due to the additional capital that the corporation keeps, especially if the corporation profitably uses the retained earnings.

Another way corporations can reduce the impact of the double taxation of corporate earnings is to reduce their tax liability. Corporations today can increase their earnings by buying Low Income Housing Tax Credits (LIHTCs) that can offset a dollar of tax liability with a dollar of tax credit. Corporations pay less for the credit than the amount of tax credit the corporation uses to offset its tax liability, producing a return on the transaction for the corporation. The increased earnings can be paid directly to shareholders as a dividend or retained in the corporation, indirectly benefiting the shareholders by increasing the corporation's capital. Today corporations make up approximately 98 percent of the market for LIHTCs. The large share of the market that corporations have is in part due to restrictions in the alternative minimum tax and on passive loss deductions applicable only to individuals. The LIHTC is considered a tax preference that is subject to AMT, which affects more and more taxpayers because the thresholds are not indexed. The passive loss rules limit the use of the LIHTC in offsetting the tax owed by individuals from non real estate investments.

The President's Proposal

The President's proposal to eliminate the double taxation of corporate earnings is accomplished in two ways. First, shareholders are entitled to exclude any dividend received from the taxable income they report on their personal tax returns that is attributable to taxed corporate earnings. The exclusion eliminates one of the two layers of tax that is currently imposed on corporate earnings. Second, shareholders are entitled to increase the cost basis of their stock by the amount of any retained corporate earnings that were subject to tax. The increase in the cost basis of the shareholder's stock reduces the amount of capital gains tax the taxpayer must pay if the stock is sold for more than its cost. This provision helps equalize the tax treatment of dividends and retained earnings in the proposal.

The president's proposal is expected to increase the amount of dividends paid because it will reduce the tax cost for the shareholders receiving the dividend. Since shareholders vote for the management of a corporation, corporate officers are expected to be compelled to increase dividend payments. The proposal also is expected to reduce the amount of capital raised with debt and increase the capital raised from stock issues because interest payments and dividend payments will be treated essentially the same. More businesses are expected to operate as C corporations than pass through entities because the adverse consequences of the double taxation of corporate earnings will be eliminated.

The relative beneficial changes to corporate earnings caused by the dividend proposal to other forms of investments will likely lead to a reduced rate of return on stocks because the amount received is not taxed. As a result, alternative forms of investment will likely experience a required increase in their rates of return in order to remain competitive. These other forms of investment include taxable and tax exempt bonds, interest earning accounts, and real estate, including home ownership.

The macro economic effect of the proposal will likely result in more employment and a higher level of economic output, at least in the short run. Corporate stock values should increase. In the long run, interest rates may increase because of additional federal borrowing due to an increased federal deficit. An increase of approximately 75 basis points in long term interest rates is predicted by Macroeconomic Advisors (MA), LLC, one of the premier economic analysis firms in he country.

Tax Effects Of The Dividend Proposal On The LIHTC

Unfortunately, the dividends exclusion proposal reduces the value of tax credits like the Low Income Housing Tax Credit (LIHTC). The value of tax credits is reduced compared to today's value of the tax credits because corporate earnings that are exempted from tax by the credit are taxable to the shareholder and will not increase the cost basis of the shareholder's stock when the corporation retains the earnings. Today, the use of the tax credit by the corporation has no effect on the tax treatment of dividends paid to the shareholder or the cost basis of the shareholder's stock, i.e., there is no tax cost to the shareholder for the use of the credit by the corporation. The reduced value of the credit due to the change in the tax treatment of corporate earnings is expected to lower the price corporations will pay for the LIHTC.

The computation that reduces the value of the LIHTC relative to the current treatment is performed as follows. In order to determine the amount of the corporation's dividend that is either exempt from tax at the shareholder level or used to increase the cost basis of shareholders' stock, the corporation must perform a calculation to determine it's excludable dividend amount (EDA). The shareholder's excludable portion of any dividend received is the amount of the dividend payment that bears the same ratio to the dividend payment as the amount of the corporation's EDA to all dividends paid by the corporation. If EDA exceeds the dividends paid during the year, the cost basis of the shareholders' stock is increased by the amount of EDA the corporation did not pay out as dividends.

The computation of EDA that affects the value of tax credits is:

$$\text{EDA} = \frac{\text{Federal Income Tax} - \text{tax credits except for the Foreign Tax and AMT credits}}{\text{Highest Corporate Income tax Rate (35 Percent)}}$$

In the formula above, the amount of a corporation's EDA is reduced when tax credits like the LIHTC are subtracted from the corporation's Federal income tax. When the amount of federal income tax is reduced, a smaller EDA amount is computed after the federal income tax is divided by the 35 percent corporate tax rate. As EDA becomes smaller, the portion of the shareholder's dividend that is excluded from the shareholder's income is also smaller. The ratio or the shareholder's excluded dividend to the overall dividend paid to the shareholder is the same as the ratio of EDA to all corporate dividends. In addition, when the amount of EDA is made smaller by subtracting credits from the corporation's federal income tax, the amount by which EDA exceeds dividends paid also becomes smaller. As a result, there is less EDA excess over dividends paid to increase the cost basis of the shareholder's stock.

The impact of the administration's dividend proposal on the price that will be paid for tax credits such as the LIHTC depends on the mix of dividends paid and taxed earnings retained in the future. The value of the LIHTC is more adversely affected if more dividends are paid relative to earnings retained (i.e., the more tax benefit forgone, the lower the value of the credit). Since the proposal is designed to eliminate a bias against paying dividends, it is likely that dividend payments will increase relative to the current level of dividend payments.

The value of a dividend exclusion to the shareholder is based on the shareholder's current income tax rate that can be as much as 38.6 percent under present law or 35 percent if the stimulus package is enacted into law. The value of the dividend benefits the shareholder in the year the dividend is paid. If the LIHTC is used to increase earnings to be distributed as dividends in the future, the credit will have to generate enough extra earnings so that the shareholder can pay the personal income tax on dividend while still getting as much of the dividend as the shareholder would have received tax free without the use of the credit.

Shareholders receive less of a benefit when the basis of the shareholder's stock is increased as a result of the corporation retaining taxed earnings. The shareholder does not realize the value of the increase in the stock's cost basis until the stock is sold. At the time of sale, the shareholder will probably be subjected to the 20 percent capital gains rate on the difference between the stock's cost basis and its sales price. The capital gains tax that is not paid on stock sales because of the increased cost basis of the stock is less that the ordinary income tax that is not paid when tax free dividends are distributed. In addition, the smaller tax benefit of the stock cost basis adjustment must be discounted to its present value because it will not occur until some point in the future.

<u>Operation Of The LIHTC Program</u>

The LITHC program produces 115,000 units of affordable housing each year. Credits are allocated by state agencies and claimed by investors over a 10 year period. The affordable housing property must stay in compliance with the requirements of the LIHTC program for 15 years for investors to avoid a recapture of the tax benefits of the credit they claim over the 10 year period.

Affordable housing built with the LIHTC has different layers of support and operates on narrow margins. States try to serve the lowest income tenants possible and locate affordable properties in areas where development frequently is difficult, such as rural and inner city areas. A developer who sells the LIHTC to investors uses the proceeds from the sale as equity in LIHTC properties. The amount of equity generated with the credit reduces the debt financing the property must carry. As a result, rents lower than market rates can be charged to eligible tenants, i.e. tenants at or below 60 percent of area median income, because less debt is carried on LIHTC properties than on market rate properties.

There are other factors that affect the purchase of LIHTCs and influence the analysis of the impact of the dividends proposal on the credit. Some purchasers of the LIHTC are in the business of investing in real estate and can be expected to continue to invest in the credit as part of their business. Although these businesses will remain a part of the market for purchasing credits, they will buy the credit at market prices if prices decline. If companies that are not in the real estate business reduce their purchases of LIHTCs, the price of the credit may go down despite the continued interest of businesses in real estate. Some businesses purchase credits because they are subject to legal requirements that credit purchases satisfy, such as the Community Reinvestment Act (CRA). The credit is purchased today to meet these requirements. While the credit will continue to satisfy the obligation of these firms under CRA, other forms of investments can be made to satisfy CRA requirements. As result, the alternative investments may become more attractive when the value of purchasing the credit is reduced by the dividend proposal, reducing the CRA-driven demand.

Effect Of The Dividends Proposal On The LIHTC Program

Even a modest change in the value of the credit and the resulting reduction in the amount of equity the credit can generate will have adverse consequences on the LIHTC program. When the credit is worth less, corporations will pay less for the same amount of credits than they pay today and less capital will be available to invest in affordable housing properties.

Dividend Proposal

Two studies have been published to date that analyze in impact of the administration's dividend proposal on the LIHTC program. The first study released was prepared by Ernst & Young (E&Y) for the National Council of State Housing Agencies (NCHSA) that predicted there would be a reduction of 40,000 LIHTC units per year, which is a 35 percent reduction from the current level of 115,000 units that will affect 80,000 people. The Mortgage Bankers Association (MBA) published the second study. The negative effects of the dividend proposal on the LIHTC program was driven by a 21 percent decrease in the prices for the credit due to the tax change in corporate earnings. The MBA study predicted the dividend proposal would actually benefit the production of LIHTC units and have virtually no negative effects at all.

There are many assumptions that must be made to perform an analysis like the E&Y and MBA studies. We believe the static assumptions in the E&Y study result in too much emphasis being place on the effects the proposal would have on the production of units. The changes induced by the full tax proposal will provide an incentive for some firms to become Chapter C corporations that are now Chapter S, which will provide new demand for the LIHTC. Some corporations that have average tax rates below 35 percent will benefit from the EDA calculation that uses an average tax rate of 35 percent. Such corporations will effectively be able to pass more of the benefit of the credit to the shareholder without tax. The combined effect of more demand for the LIHTC from new sources is uncertain but in the direction of tempering the price impact. It is not clear to us how the MBA study was actually performed. We are continuing to review it now.

It is our best estimate at this point that the 21 percent estimate of the price reduction in the E&Y study is overstated and that the emphasis on units produced in the analytical formula fails to reflect the full range of the impact of the dividend proposal. NAHB estimates that a more realistic decline in the value of the credit is 10 to 15 percent. We also believe that there will be significant revisions in state priorities for the LIHTC program if the dividend proposal is enacted into law. Higher income tenants will be sought and fewer properties will be built, particularly in hard to develop area.

LIHTC properties are financed in three layers – equity, soft gap funding and first mortgage debt. While the exact impact of dividend proposal on the amount of equity available for LIHTC properties is still open to question, it seems certain that a significant erosion will occur, requiring offsetting increases in the other funding slices. Most observers agree that current federal and state sources of soft financing/grants are already fully tapped. That leaves first mortgage debt financing as the only available offset and unfortunately, as discussed below, this avenue has severe limitations on expansion.

These limitations, simply stated, revolve around the difficulty in increasing rental income from LIHTC properties. Loans for LIHTC properties are underwritten on the basis of the capacity of the ongoing net operating income of the property (the margin of rental and other income over operating expenses and reserve payments) to cover mortgage payments. Lenders establish minimum debt coverage or debt service ratios (DCRs) that determine how much mortgage debt a property can support. Fannie Mae, for example, enforces a debt service ratio of 1.15 percent, requiring properties to generate operating income significantly in excess of expenses. Other financing programs require DCRs in the 1.10 to 1.20 percent range.

Such limitations on debt coverage greatly limit the capacity of LIHTC properties to take on additional debt needed to significantly offset the expected reduction in equity funding. Rents on eligible LIHTC units by law cannot increase above 30 percent of 60 percent of area median income. This is the constraint producing the program's unusually low loan-to-value ratios. Therefore, the impact of the dividend proposal provision on the number of units produced and the characteristics of households and areas served will be well beyond incidental and ultimately determined by the capacity and willingness of state allocating agencies to fund properties at higher rent levels.

Adjustments are possible. State allocating agencies strive to serve households at the lowest income levels possible. The states could redirect the program to those earning closer to the maximum statutory limit of 60 percent of area median income. States also likely will attempt to allocate more credits to properties than they do today in an effort to reduce debt requirements. Reducing service and increasing rent loads for low-income families is not likely to be a welcomed option and will be limited by the facts that any increase in incomes served would come from levels that are, in most cases, not that far below the statutory maximums and market rents in many areas would not permit significant or any rent increases. This would be particularly true in rural and economically distressed urban areas.

These factors lead NAHB to conclude that the dividend proposal component of the President's proposal would have a significant adverse impact on the supply of rental housing available for low-income families. This effect would take the form of a sizable reduction in the number of units produced each year, as well as a shift in the composition of the units produced away from those serving families at lower income levels and located in rural, urban and other difficult to develop areas.

Solutions:

There are two approaches that can be used to avoid a negative impact of the administration's dividend proposal on the LIHTC. The first approach would be to exempt the LIHTC from the adverse effects of the elimination of the double taxation of corporate earnings. This can be done within the structure of the administration's proposal by treating earnings corresponding to the LIHTC as taxed earnings. Other methods of not affecting the LIHTC by a dividend proposal would involve structural changes the proposal such as exempting all or part of dividends received by shareholders as exempt from tax or by shifting the tax benefit of eliminating the double taxation. The tax benefit could be shifted to a corporation with a corporate deduction for dividends paid.

The other approach to protecting the LIHTC from the adverse consequences of the administration's dividend proposal would be to make up for any adverse impact on the credit from the dividend proposal by expanding the availability and the market for the credit. This proposal requires adjustments to the program and other parts of the tax code that limit the market for the credit.

1. Exempting The LIHTC From The Effects Of The Dividend proposal

a. Treat Earnings Excluded from Income by the LIHTC as Taxed.

This option would treat corporate earnings that are not subject to tax because of the LIHTC in the same fashion as earnings subject to foreign taxation and exempted from federal taxation by the Foreign Tax Credit (FTC) or earnings that were previously subject to the AMT and credited for past payments of that tax. The proposal exempts the LIHTC from the impact of the dividend proposal because the earnings that are exempted from tax by the LIHTC are treated as taxed earnings that can be paid out as tax free dividends or used to adjust the cost basis of a shareholder's stock. The solution fits into the format of the dividend proposal in the Economic Growth Plan without changing the basic structure of the proposal.

As discussed above, EDA is computed with the following formula:

$$\text{EDA} = \frac{\text{Federal Income Tax -- tax credits except for the Foreign Tax and AMT credits}}{\text{Highest Corporate Income tax Rate (35 Percent)}}$$

If the LIHTC were added to the FTC and AMT credit in the formula, the adverse consequences of the dividend proposal on the LIHTC would be avoided.

b. Equivalent Solutions To Treating LIHTC Excluded Earnings As Taxed.

There are other approaches that could accomplish similar results as the FTC treatment of the LIHTC. For example, providing corporations with a dividends-paid deduction for dividends paid to shareholders from taxable earnings and a capital basis adjustment for shareholders' stock when taxed earnings are retained by the corporation, or, provide shareholders with an exclusion (with or without a limit) for dividends received would effectively protect the LIHTC from the adverse consequences of a dividend exclusion. In fact, the Treasury Department made such a proposal in 1992 in "A Recommendation for Integration of The individual and Corporate Tax Systems." The Treasury Department's 1992 proposal would exempt all dividends received by a shareholder from ordinary income taxes. A capital gain tax would apply to dividends that represent a return on capital rather than ordinary income earned by the corporation.

2. Expanding LIHTC Limits And Market

Today's LIHTC market among individuals is limited by limits on passive loss deductions and the imposition of the alternative minimum tax. Eliminating these restrictions could substantially expand the LIHTC market. However, removing these restrictions would not fully compensate for reducing the corporate market for LIHTCs due to the administration's dividend proposal. Individuals cannot be expected to pay as much for the credits as the current group of corporations that make up the market. The corporations are in a better position to assess the risk of purchasing credits and require a lower rate of return than investors who cannot perform the same level of risk assessment. As a result, if the program is to be maintained at current levels by expanding the market for the credits among individuals, the amount of credits that can be sold to raise equity, as well as the amount of credits that can be dedicated individual properties, would need to be increased to make up for inefficiencies in the individual market. A more detailed discussion of these changes follows.

a. Increase the amount of LIHTC individual investors can take annually against ordinary (non-passive) income.

The current very low deduction limitation—$25,000—on the amount of LIHTC individual investors can take each year to offset individual ordinary income tax liability should be raised or eliminated. The current limit has all but eradicated the market for the LIHTC among individuals, which reduces demand for LIHTCs and, consequently, the amount available each year for the apartment investment the LIHTC can generate from any particular amount of LIHTCs.

b. Allow the use of the LIHTC to reduce Alternative Minimum Tax (AMT) liabilities.

Individuals use the LIHTC to reduce their regular tax liability. However, the LIHTC cannot be used to offset the Alternative Minimum Tax ("AMT"), which applies to increasing numbers of individuals. To the extent that potential LIHTC investors are subject to the AMT, they either pay less for the LIHTCs they buy, reducing the dollars available from the LIHTC for housing, or may refuse to buy LIHTCs at all. Providing an exemption from the individual AMT would increase the marketability of the credits and help alleviate any reduced value due to the elimination of the double taxation of corporate earnings.

c. Remove LIHTC Limits per Project & Increase the volume cap on LIHTCs

Currently, the volume cap on LIHTCs is $1.75 per capita per state indexed for inflation and with a "small state minimum" of $2 million. LIHTCs per project are limited to four percent and nine percent of total development costs, depending on the type of transaction.

This proposal fills the financing gap due to the administration's dividend proposal by eliminating the four and nine percent credit limits per project, allowing states to put as much credit as is needed (subject to the required feasibility analysis by the allocating agency) into an individual project. The increase in credits per project is necessary because less capital will be raised by the LIHTC from the individual market than the current corporate market. An increase in the state per capita allocation and minimum state allocation must also be made to keep the program at current operating levels to make up for the additional credits each project will require. Without more credits per state, some projects would be fully funded while others would not be funded and a net loss in affordable units would result. If more credits per state under the per capita and minimum state allocation are allowed, then the current level of production could maintained, even with a lower credit price due to the inefficiencies of the individual market.

Madam Chairwoman, that concludes my remarks. I urge you to consider the unintended adverse consequences of the Economic Growth Package on the LIHTC and devise solutions that will keep the program operating at the same levels as it does today. NAHB looks forward to working with you and your committee, as well as the Ways and Means Committee and Treasury Department to fully protect the LIHTC.

Thank you for having me here today.

NATIONAL URBAN LEAGUE

Paying Dividends: How the President's Tax Plan Will Benefit Individual Investors and Strengthen the Capital Markets

Before the
Committee on Financial Services
United States House of Representatives

TESTIMONY
Concerns about the Collateral Costs of Tax Exemption for Individual Dividend Income

March 18, 2003

By

William E. Spriggs
Executive Director, National Urban League Institute for Opportunity and Equality

The Urban League is the nation's oldest and largest community-based movement devoted to empowering African Americans to enter the economic and social mainstream.

The Urban League movement was founded in 1910. The National Urban League, headquartered in New York City, spearheads our nonprofit, nonpartisan, community-based movement. The heart of the Urban League movement is our professionally staffed Urban League affiliates in over 100 cities in 34 states and the District of Columbia.

The mission of the Urban League movement is to enable African Americans to secure economic self-reliance, parity and power and civil rights. On behalf of the League, I thank Chairman Oxley and ranking member Congressman Frank for this opportunity to share the thoughts of the League on this important topic.

The National Urban League is pleased that the President and Congress recognize the need to get the economy going. We are concerned however, that the consequences of some of the proposed fiscal policy changes may not have the intended consequences, and may have some unintended consequences that would be troubling.

1. The Proposal to Exempt Dividend Income for Individuals

The President has proposed excluding dividend income from the taxes of individual taxpayers. As currently constructed, the proposal would allow for the tax-free distribution of corporate earnings on which the corporation has paid taxes. This does not, however, include income against which the corporation could apply a tax credit. Under current law, however, there are a number of programs Congress has authorized to benefit the public good from lowering corporate tax liability.

It is suggested by the Treasury Department, in its Blue Book, that taxing corporate profits and individual dividend income both creates a bias for corporations to favor debt over equity—because interest payments are deductible to the corporation but dividend payments are not—and that taxing individual taxpayers' dividend income encourages corporations to finance investments using retained earnings instead of debt financing—which would impose more scrutiny on the decisions. This contradictory position in the likely effects of removing taxes on dividend income for individuals however does not mean that the effect of the proposed change will be ambiguous for other outcomes. Namely, the Treasury Department argues that a bad thing about taxing dividend income for individuals is that it leads corporations "to engage in transactions for the sole purpose of minimizing their [corporate] tax liability." Actions taken to lower corporate income taxes are at the heart of a number of federal programs supported by the current tax code.

The Congressional Budget Office estimates the cost of excluding dividend income for individuals from taxation to be nearly $8 billion in FY2003 and total $388 billion over FY2004-2013. That is a large personal and private benefit extended to those who receive dividend income.

The Joint Tax Committee cites several studies by prominent economists confirming there is a lack of consensus from econometric evidence on the responsiveness of aggregate investment to tax policy. Of course, in part, this is due to the very large amount of corporate equity owned by those who do not face U.S. income tax, such as foreign persons and tax-exempt institutions like pension funds. And, the immediate benefit of this proposal would be to give a tax benefit for investments already made by corporations, not for new investment decisions. This means that there may be very little public gain in the form of new investment.

On the other hand, there are several key programs with significant public benefits that are put in jeopardy if corporations take actions to raise shareholder after-tax income as opposed to raising the corporation's after-tax income. Among those programs are the Low-income Housing Tax Credit, the Tax credit for Rehabilitation of Historic Structures, Empowerment Zone Tax incentives, Renewal Community Tax incentives, Tax Credit for Employer-provided Child Care and the Tax Credit for Holders of Qualified Zone Academy Bonds. Of these programs, the largest by far is the Low-Income Housing Tax Credit, and the ramifications of switches in policy on dividend income would be greatest to the public for undermining that tax credit.

And, to the extent that the tax incidence on investment matters, there are significant implications for the cost of capital for states and municipalities, who benefit from tax-exempt bonds. Those potential costs will be passed on to the public in higher state and local taxes.

2. The Low-Income Housing Tax Credit

Under current law, Congress provides through the tax code, a number of incentives to encourage corporate investment in specific areas. Under the current proposal on the treatment of dividend income, these corporate tax provisions would not pass through to the individual shareholder. This creates a gap in effects between decisions to increase corporate after-tax income and shareholder after-tax income. Several of the current provisions encourage corporate investment in the needs of our nation's low-income neighborhoods and cities.

The Joint Tax Committee evaluates all tax expenditures, including these incentives to corporations. It estimated for FY2002 to FY2006 that these tax expenditures to help America's low-income neighborhoods attributable to corporations would amount to: $15.1 billion for the Low-Income Housing Tax Credit, $2 billion for the Tax Credit for the Rehabilitation of Historic Structures, $1.4 billion on Empowerment Zone Tax Incentives, $700 million on Renewal Community Tax Incentives, $500 million on New Markets Tax Credits, $400 million for Tax Credits for Employer-provided Child Care and $300 million on Tax Credits for Holders of Qualified Zone Academy Bonds. Two other programs with important implications for low-income rural and urban communities—the Welfare-to-Work Tax Credit, and the Work Opportunity Tax Credit, totaling a projected $600 million—are set to expire. In a related category would be the $9.1 billion for tax credits or Puerto Rico and possessions income.

Corporations make these investments in helping America's communities for several reasons. One of them is to lower the corporation's effective tax rate and so increase their after-tax earnings. A study of the implications of the current proposal by Ernst & Young found that corporate decisions on dividends are sensitive to the tax implications for shareholders, and so the proposal would diminish the participation of corporations in these programs. The President's own proposal for a tax credit to encourage single-family home ownership would fall into this category.

The Low-Income Housing Credit is unique in its importance to low-income neighborhoods because of its size—relative to the other credits and incentives, relative to the importance of corporate investment to the credit and relative to the stock of low-income housing that it underwrites. Ernst & Young's study found that corporations provide nearly all the annual Housing Credit investment, and that since the credit's inception in 1986, it has "become the leading tool for the development of affordable renting housing."

The credit is effective because it decentralizes decision making on low-income housing, making it function on a market-based model. States are allocated a set amount of housing credits based on the state's population. Those seeking to use the credits are certified by the state. Syndicators then bundle the investments to make them large enough, and diverse enough, to create attractive investments for corporations. Corporations purchase those instruments as they would a bond. The higher corporations are willing to pay, the lower the cost of raising funds for low-income housing. The lower the price corporations pay, the higher the cost of raising funds.

Ernst & Young report that, on average, developers of low-income housing obtain about 42 percent of the property's cost from using the credit. They report that first mortgage financing helps to fund a portion of the rest, with subordinate financing, primarily from state and local governments closing the gap. With a much lower first mortgage than conventionally financed housing, low-income housing produced with the credit is able to charge reduced rents compared to the market.

The price corporations are willing to pay to purchase the credits has risen over time. Ernst & Young show it going from around $0.55 per dollar credit in 1987 to $0.82 per dollar credit in 2001. Part of this reflects a marked increase beginning in 1994, coincident both with declining interest rates brought on by Federal Reserve Policy, an increase in corporate earnings and investment, changing the credit from facing annual reauthorization to being made permanent, and changes in the Community Reinvestment Act.

Because Ernst & Young found that the major corporations claiming the credit are also subject to provisions of the CRA, the decision to invest is related both to tax implications and regulatory issues. Clearly, some of it is also related to corporations making investments in-line with corporate mission and expertise.

But, it also reflects a perception that the program has performed well, lowering initial perceptions of risk and thus allowing the rate of return to lose some its risk adjustment. And, Ernst & Young argue that Congressional support for the credit, especially its change from being subject to annual reauthorization to being made permanent, has assured corporations of the value of the instrument in their tax strategies. Thus, this proposed change in the treatment of individual dividend income and its implication for corporate tax strategies is very important.

The higher price that corporations are willing to pay for the credit allows more housing units to be built for the credits each state is allocated. That in turn, allows states to expand their programs and reach lower-income families and special need households. Since the switch from annual reauthorization to permanent status for the credit, the number of units placed in service each year, has increased from just fewer than 60,000 in 1994 to slightly over 100,000 in 2002 despite increasing construction costs.

To the extent that corporations lower their willingness to buy the credit, the costs of financing low-income housing will increase, resulting in fewer units coming on-line. This is just at the time that our nation's housing is creating a tremendous problem because rising housing costs are exacerbating affordability issues for low-income families.

Ernst & Young estimate that low-income housing unit production could drop by 40,000 units a year, effecting about 80,000 low-income individuals.

3. Proposed Solutions May Not Mitigate Collateral Effects

In addition to the various tax incentives to encourage corporate investments in low-income areas, states and municipalities benefit from lower capital costs by being able to issue tax-free bonds. While tax policy may not affect aggregate investment decisions, by affecting relative after-tax income, it can influence choices among investment alternatives. To that extent, proposed changes to pass through corporate tax incentives to individual shareholders by changing the excludable dividend amount (EDA) formula would only exacerbate the problems faced by states and municipalities in raising their capital costs.

On the other hand, changing the EDA would lower another collateral effect of the proposed change on corporate investment decisions. The Joint Tax Committee estimates that tax expenditures accounted for by corporate investment in state and local bonds for FY2002 to FY2006 were estimated to amount to: $42 billion on public purpose bonds, $2 billion on private non-profit hospital facility bonds, $1.5 billion on owner-occupied housing bonds, $1 billion on sewer, water and hazardous waste facilities bonds, $1 billion on private airport, docks and mass-commuting facilities bonds, $500 million on rental housing bonds, $500 million on small-issue industrial development bonds, and $500 million for student loan bonds. So, corporations would be neutral on whether to continue these investments.

But, again, passing through the corporate tax benefits to the shareholders in this case could have an ambiguous outcome for the problems faced by state and local governments because it would increase the cost of capital for each of those programs. So, while corporations may continue to make these investments, the costs to tax payers at the state and local level will be higher.

Because the major beneficiaries of this proposal on dividend income are corporate officers and directors, it is not clear how this resolves investor angst about corporate decision-making. Institutional investors, who are major holders of corporate equity, clearly have a different stake in whether dividend income is taxable than do the individual officers and directors for whom the income is taxable. And, whether the officers and directors are acting on behalf of shareholder after-tax income or corporate after-tax income is a conflict from that perspective.

Under the current, or "classic" law treatment of corporate income, it is important to note the difference in the liabilities of the corporation on individual stockholders versus that of partnerships and self-proprietors. In that sense, the income of the corporation is not at all like that of other business forms. Nor is it clear that the proposal's attempt to recreate the notion of corporate income to be that of the collective owners to end the so-called double taxation would lead to tax-free dividend income, as opposed to treating dividends as an expendable item for the corporation like wages and thus retain the tax on the individual shareholder.

4. Conclusion

Finally, changing the EDA, to create a pass through would increase the cost of the proposed tax exemption. This would be disturbing given the inconclusive evidence linking tax policy to aggregate investment. The size of this proposed change is very large. It is enough to support the U.S. Department of Education, following the President's proposed budget, for four years. Or, it could fund the U.S. Department of Labor and the Small Business Administration combined over that same period.

So, we would hope you would carefully weigh consideration of this proposal. Its potential costs are much higher than currently estimated. And, while its private gains are huge, its public gains are murky. The potential damage this does to the federal budget is vitally important, as we are now all called to share the sacrifices of paying for the upcoming resolution of issues in Iraq.

The Washington Post

Tuesday, March 11, 2003

Editorial

A Boon to Ordinary Investors; Eliminating the dividend tax is just what the economy needs.
Charles Schwab

I believe there is an urgent need to pass President Bush's plan eliminating the double taxation of dividends. Such a change would revive investor confidence in equity investing, restore an appropriate balance between the interests of corporate executives and shareholders, and create new jobs.

The need for a bold tax proposal is greater than at any time in the past half-century. For nearly three years, investors have watched the value of their equities shrink as the stock market bubble burst. At the same time, a series of high-profile corporate scandals has evoked outrage and distrust, and investors remain sidelined with concerns about the long-term threat of terrorism and the immediate risk of war with Iraq. With all these factors contributing to the shakiness of the economy, a boost to investor confidence has to be a priority of tax policy.

Bush's call for eliminating the double taxation of dividends is exactly the kind of response that is required. Since it was announced in January, however, the plan has had a mixed reception. Critics have called it a sop to the rich and suggested it won't provide immediate stimulus to the economy.

I disagree. I have been working with investors for more than 40 years. I can't think of any other tax policy that would, at one stroke, be more beneficial to ordinary investors.

The impact would be enormous. In the short term, I would expect to see the stock market rise 10 percent to 15 percent, sending an immediate bolt of renewed confidence through our entire economy.

Over the long term, corporations would go back to focusing on returning money to their investors. Stock ownership would mean more than merely hoping that the share price climbs higher.

At its most basic level, our current dividend tax is unfair. Companies pay a corporate tax when they earn a profit. But then, when they pay out a dividend to shareholders, that same money is taxed again at the individual level. Hence corporations decide that the double tax is inefficient. As a result, they stockpile their cash rather than rewarding shareholders for their investment.

That doesn't make sense. We should encourage companies to reward their shareholders, even when the stock market is flat. If more companies paid dividends, stocks would once again have intrinsic value. Investors could again focus on a company's real cash earnings rather than the up-and-down movements of stock price.

Further, corporations would be forced to become better stewards of their cash and their investments. Under today's system, companies can deduct the cost of debt but must pay a tax if they return cash to stockholders. The consequences are easy to predict. Many companies have used their stockpiled cash to buy back their stock, in the hope of boosting its price and increasing the value of stock options. Others have incurred dangerously excessive debt to pursue ill-advised acquisitions. In each case the tax system has provided the incentive for excessive corporate leverage, putting companies at risk.

The end of the double taxation of dividends would realign and balance the system so that corporate management would no longer face perverse incentives. It would shift management's focus away from debt and toward equity.

The winners would not just be the wealthy who collect dividends. That is a myth. Eliminating the double taxation of dividends would boost the value of equities, and equity investors with money in 401(k)s or with mutual funds in IRAs would benefit directly.

Most important, if the dividend tax penalty were ended, companies would no longer have an incentive to sit on their cash. Instead, entrepreneurs and small businesses would start investing again. That is the only way an economy creates jobs. The president's plan would free the capital necessary to get small business hiring again.

Arguing that this change would be expensive also misstates the facts. The president's total stimulus package, at an estimated annual price tag of $67 billion, costs less than 1 percent of GNP (67 one-hundredths of a percent, to be exact). The elimination of dividend taxes is only half the total. It is a tiny investment relative to its potential impact.

The elimination of dividend taxes would offer ordinary investors a better way of measuring the return on their investments and give companies and entrepreneurs the right incentives to invest and create new jobs.

If we are going to stimulate the economy, we need a tax policy that bolsters confidence, improves corporate governance, unlocks the stagnant capital inside companies and lifts the stock market across the board. Only the elimination of the double tax on dividends achieves all these goals. Congress ought to pass it quickly.

The writer is founder and chairman of the investment company that bears his name.

DEFENDING THE DIVIDEND

by
Frank A. Fernandez

Excerpt from *Research Reports*, Vol. IV, No. 1 (January 31, 2003)

President Bush has proposed ending the double taxation of corporate earnings. To support that worthy goal, this article presents an assessment of the absolute and relative costs and benefits of this significant change in our tax structure. We consider to what degree the specific proposal encourages efficient capital formation, the growth of productivity as well as contributing to long run fiscal stability and moving the tax system towards fundamental reform, such as elimination of distortions and biases. On balance, the benefits of the proposal outweigh the costs.

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Summary

President Bush has proposed ending the double taxation of corporate earnings by eliminating the personal income tax on dividends. To support that worthy goal, an assessment of the absolute and relative costs and benefits of this significant change in our tax structure is presented below. We consider how the specific proposal encourages efficient capital formation, the growth of productivity as well as contributing to long run fiscal stability and moving the tax system towards fundamental reform, such as elimination of distortions and biases. On balance, the benefits of the proposal outweigh the costs in terms of reduced tax revenues and less stimulus of consumption.

The benefits of this change, although gradual, are sustained, providing long-term support for economic growth by encouraging savings and investment, reducing the cost of equity financing, improving corporate profitability (a greater proportion of which would likely flow to shareholders) and boosting share prices. More efficient use of resources, enhanced productivity and higher incomes are some of the expected indirect benefits. By removing the bias that encourages companies to become more highly leveraged and hence more prone to failure, the proposal would also help contain record bankruptcy rates and reduce the sustained, near-record volatility in asset prices seen in recent years.

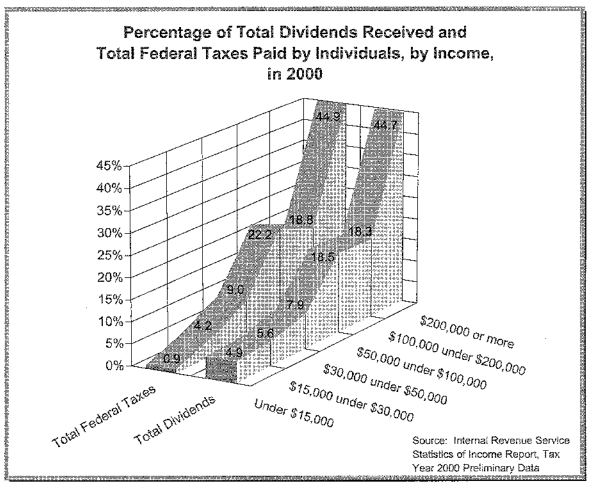
Eliminating the double taxation of dividends would also contribute to efforts to improve corporate governance. Achieving this goal would help restore public trust and confidence, a necessity if sustained economic growth is to ensue. The proposed tax change is expected to lead to: more accurate financial statements; less use of relatively opaque, noncorporate business structures (S-corps, L.P.s, sole proprietors and non-profits, which current tax rules favor over corporate forms); reduced opportunities and incentives for corporate managers to "game the system" (engage in transactions solely to reduce tax liabilities) or to mismanage; and, better alignment of management objectives with shareholder interests. It will encourage managers to focus more on the continuous, profitable operation of a firm, and less on activities that produce often transient stock price appreciation, and to undertake only the most productive investments rather than purchases that do not necessarily increase shareholder value.

Direct Benefits

Everyone will benefit to varying degrees, either directly or indirectly, from the elimination of tax biases that distort corporate and investor decisions, and from the increase in incentives to save and invest. The proposal would benefit the economy (boosting incomes and job growth), the capital markets, and most of all, individual taxpayers, particularly those who invest, to whom the direct benefits flow.

Individuals, rather than corporations, are the direct beneficiaries, and the proposal would reward those who save and invest. Half of all American households (more than 84 million individual investors) own stock directly or through stock mutual funds, and are likely to benefit from the tax cut and the support to equity prices provided by this more neutral tax policy. Stock ownership, and the percentage of those receiving dividends, is expected to rise as this bias against dividend income is removed.

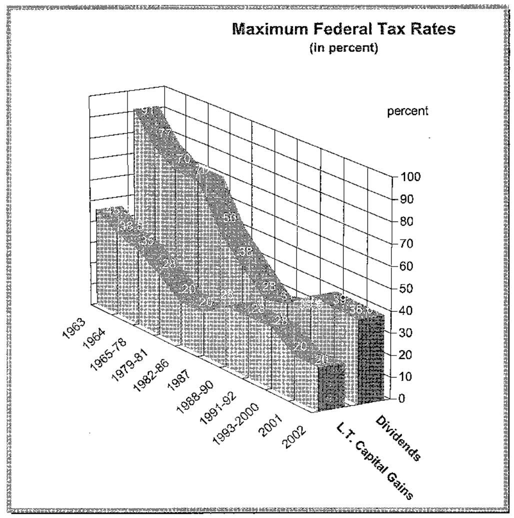
More than 34 million American households (26.4% of the 129.3 million households that filed returns in 2000) that invest in the stock market and receive taxable dividend income will benefit directly, and more than half these dividends go to America's seniors. 15.6 million or 45.7% of these households receiving dividends have adjusted gross income of $50,000 or less. Although this lower income group receives only 16.8% of the value of dividends distributed, this is slightly higher than the percentage of taxes that group pays, and the majority of people in that group are seniors.



Percentage of Total Dividends Received and Total Federal Taxes Paid by Individuals, by Income, in 2000

Source: Internal Revenue Service Statistics of Income Report, Tax Year 2000 Preliminary Data

Overall, the benefits of this tax proposal are largely neutral, in that they are distributed across income groups proportionate to the share of taxes they pay. Dividend recipients tend to be older, relatively wealthier Americans (similar to overall stock ownership patterns), many of them retirees, and many of those dependent on fixed income in part derived from dividends. This is similar to the distribution of tax payments relative to age and income as seen above.



The Current Tax Treatment

Under current law, corporate earnings are subject to two levels of tax: one at the corporate level and one at the shareholder level. Income earned by a corporation is taxed, generally at the rate of 35 percent. If the corporation distributes its after-tax earnings to shareholders in the form of dividends, this dividend income is generally taxed again at the shareholder level at rates as high as 38.6 percent.[1] The combined or effective tax rate on dividends can be as high as 60.1 percent. Alternatively, shareholders pay tax when they realize an appreciation in stock value that arises from retained corporate earnings, rather than earnings paid out as dividends, and reinvested in the corporation at a maximum tax rate of 20 percent.[2] The effective tax rate on income received this way is about 40.9 percent, taking into account the preferential tax rate on capital gains realizations and the benefits of tax deferral.[3] The President's proposal would equalize the effective tax rates confronted by investors receiving four principal types of income: dividends, retained earnings, debt and pass-through income.

Presidents since John Kennedy have proposed ending the double taxation of dividends, and no fewer than five separate legislative proposals were before Congress to accomplish this task when President Bush presented his plan. Virtually all economists would agree (a profession hardly known for unanimity of opinion) that ending the double taxation of dividends is long overdue, providing fundamental reform by removing some of the worst distortions and biases introduced by our tax system.

1 There is no specific "dividend tax" applied to receipt of dividend income, unlike the separate calculation applied to capital gains. Dividends, along with income from pensions, interest, alimony, salaries and wages are added together and deductions are netted in the calculation of adjusted gross income on individual tax returns. The rate of 38.6 percent is the maximum statutory rate on individual income.

2 The statutory tax rate on long-term capital gains held for more than five years is 18 percent, but taxes are deferred until the asset is sold, thereby lowering the effective rate on tax on capital gains. Taxpayers who hold assets until death receive a step-up of basis, and further reduce the effective rate.

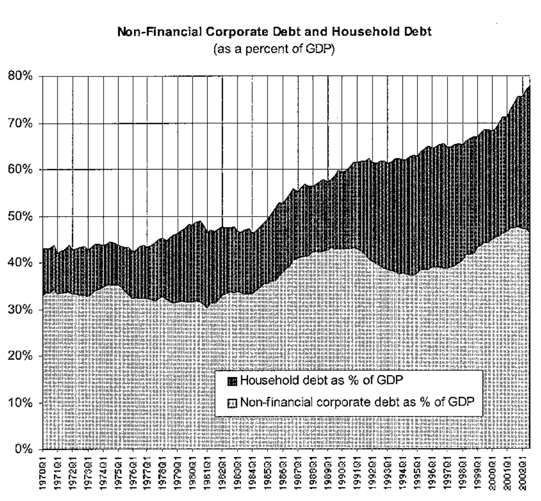
3 Council of Economic Advisers, "Eliminating the Double Tax on Corporate Income", January 7, 2003, p. 3.

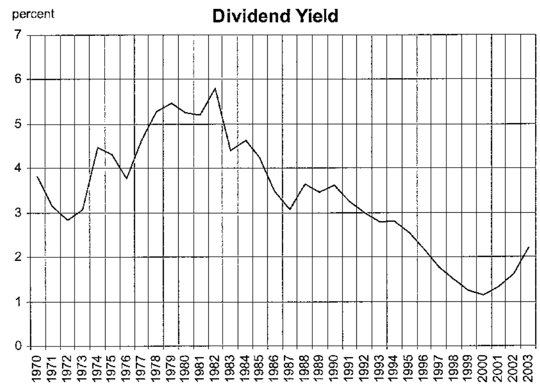
Biases and Distortions

The current tax treatment of dividends introduces a number of biases and distortions. One of the principal concerns is that it can distort corporate financing decisions, which prove to be less efficient for the firm and for the economy in the long run. Corporations raise capital through three principal methods: debt, equity and retained earnings. Current law introduces a tax bias against equity financing and in favor of use of retained earnings and debt financing, both of which are taxed more lightly. Debt receives the most favorable tax treatment. Interest payments are a deductible expense for corporations and hence reduce the amount of corporate profits subject to tax, while dividends are paid out of after-tax funds. Interest payments are taxed once, at most, at the individual level, and more lightly than dividends.

Retained earnings are also taxed twice, but not as heavily as dividends. Retaining earnings for investment purposes tends to push a firm's share prices higher. That additional price appreciation raises shareholders' capital gains taxes by a commensurate amount when the shareholder decides to sell their shares. However, capital gains tax rates are lower than ordinary income tax rates and investors determine when they sell their shares, potentially deferring these taxes almost indefinitely. As a result, retained earnings generate lower taxes at the individual level than dividend payments, which are subject to tax in the year in which the payment was made at individual tax rates.

These biases distort corporate decisions. The bias in favor of debt financing encourages companies to become more highly leveraged. Greater leverage leaves companies more prone to failure when their revenues fall and/or market interest rates rise. A corporation that relies more heavily on equity financing has more flexibility to meet fluctuations in the business cycle, reducing or raising dividends to reflect changes in net income. A heavily indebted company has much less adjustment capability in the face of market forces it cannot influence. Logically, one would expect higher bankruptcy rates and greater volatility in asset prices as a result. Those expectations have been met in a sustained manner.





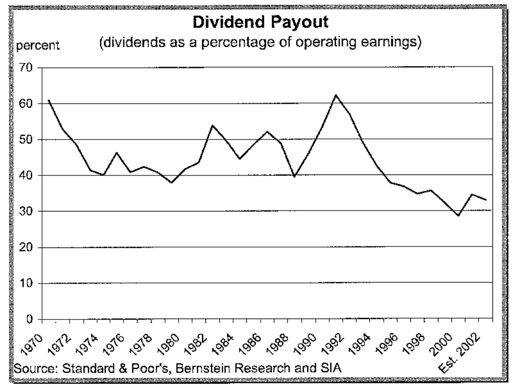
Source: Standard & Poor's; Bernstein Research; and SIA forecast

From the standpoint of the corporation trying to provide the greatest economic benefits to its shareholders, the current tax system favors retaining earnings and using them to buy back stock rather than distribute them in the form of dividends. To the investor, the buyback raises stock prices (or prevents them from falling) and thereby generates a capital gains tax liability only if the investor chooses to sell. To tax-sensitive investors, the lower tax rate on capital gains makes it a preferable way to receive income. A surge in buybacks in the past decade has been coincident with dramatic growth of option-based compensation programs, and, increasingly, retained earnings have been used to fund the repurchase of shares granted through the exercise of these options. This surge has mirrored the decline in the dividend yield. During the 1990s, this form of variable compensation accounted for a greater and greater share of total compensation[4].

Although the evidence is far from clear regarding the impact of the second distortion, some would argue that the tax bias against equity financing and in favor of retained earnings may also distort the value of marginal investment decisions, encouraging investment in less productive projects or ones that do not add to shareholder value or add relatively little. Limiting the amount of funds over which managers have discretion may be one way to impose discipline in corporate investment decisions. Shareholders looking for the best return have far more options than corporate management and will, on average, prove more efficient in reinvesting surpluses. The more efficient "resource allocation" would likely lead to greater productivity and wealth in the economy.

[4] "In 1999, over 34% of publicly traded companies engaged in share repurchases, up from 28% in 1992. More striking is the fact that by 1999, almost 20% of earnings were paid out by share repurchases, nearly triple that of 1992." Statement by Pam Olson, Assistant Secretary for Tax Policy, Department of the Treasury, January 23, 2003. Both percentages continued to rise before peaking in 2001.

These tax biases have discouraged the use of equity as a financing mechanism (except as a method to fund compensation) and discouraged the use of dividends as a method of providing benefits to shareholders. Companies which pay dividends have declined both as a share of the total number of listed firms and as a share of the total market capitalization. As dividends became less and less important in investors' expectations of the total return on investments, an equity holder looks chiefly, if not solely, to price appreciation. This may have encouraged corporate management to focus more than in the past on these and other activities that sustain stock price appreciation and relatively less on ensuring the continuous, profitable operation of the firm required to sustain a long-term dividend stream.



Investors too may have fallen prey to focusing disproportionately on short-term, often transitory, price appreciation, in part due to this tax bias. Removing the tax bias against dividends might encourage individual investors to pursue sounder, more fundamental investment strategies to their long run financial benefit. According to a study by T. Rowe Price, dividends accounted for 50.8 percent of the total return of the Standard & Poor's 500 Index from 1980-2002. Dividends can offset a lack of price appreciation (or outright price declines) and always enhance total return.

Dividend paying companies tend to outperform those that do not pay dividends. In a study by Fama and French[5], which evaluated companies over the period 1963 to 1998, companies that paid dividends offered a higher return on assets (7.8 percent versus 5.4 percent) and a higher return on equity (12.8 percent versus 6.2 percent) than did companies that did not pay a dividend.[6] In a study by Standard & Poor's covering the three bear market years, 2000-2002, dividend payers in the Standard & Poor's 500 Index roughly broke even, while non-dividend paying firms fell significantly[7]. The prices of dividend paying stocks also tend to be less volatile, further enhancing their relative returns on a risk-adjusted basis. Discouraging dividends does little, if anything, to enhance investor returns and may well drive them lower than they would be otherwise.

The current tax biases may also distort the choice of the organizational form of firms. The higher tax on corporations (C-corporations) relative to other businesses (such as S-corporations, partnerships, sole proprietorships and non-profit organizations) may distort the allocation of capital and entail an inefficient use of resources and reduce productivity and income.[8] According to the U.S. Treasury, "from 1980 to 1999, net income of C corporations fell from 78% to 57% of all business income with net income of flow throughs rising by a corresponding amount. Similarly, the gross receipts of C corporations fell from 87% to 72% of all business receipts with the

[5] E.F. Fama, and K.R. French, "Taxes, Financing Decisions and Firm Value," *Journal of Finance* 53, 1998, pp. 819-843.

[6] A recent paper by K. Fuller and M. Goldstein found that over the period 1970-2000, dividend paying stocks outperformed those that did not, by on average 1.4 percent per month versus 0.9 percent per month. L. Kirschner and R. Bernstein of Merrill Lynch found that from the NASDAQ's inception in 1971 through September 2001, the tech-laden index under performed the S&P Utilities index (11.2% p.a. versus 12.0%).

[7] Standard & Poor's *The Outlook*, "Dividends End 2002 on a Strong Note", January 2, 2003. In just 2002, dividend payers in the S&P 500 averaged a decline of 18.4%, compared with a 30.3% average plunge for stocks in the index that did not pay dividends.

[8] This observation provided impetus to past proposals, to reduce this and other economic distortions, including the Report of the U.S. Treasury Department, *Integration of the Individual and Corporate Tax Systems*, January 1992.

gross receipts of flow throughs rising by a corresponding amount."[9] The choice of organizational form may also have a direct bearing on the level of transparency and the degree of disclosure of financial information to investors.

The bias against dividends may also have contributed to the wave of recent corporate governance failures, and some portion of these multi-billion dollar failures should be assigned to the costs of this distortion. Dividend payments constrain the discretionary behavior of managers. Reducing the amount of cash at the discretion of management may reduce opportunities for corporate governance failures and lead management to undertake only the most productive investments and those that increase shareholder value. In addition, the tax biases may encourage managers to engage in transactions and activities solely for the purpose of reducing tax liabilities, incentives that would be reduced under a more neutral tax system.

Often referred to as "discipline of the dividend", payment of dividends forces managers to put less focus on short-term share price movements and more attention to sustainable profitability. A firm cannot pay dividends for any length of time unless it has a continuing stream of earnings to support such payments. Dividend payments also provide a "signaling function", providing management with a channel to inform investors about expectations of the firm's future cash flows and profitability.

The President's Proposal

On January 7, 2003, President Bush formally unveiled a $674 billion job creation and economic growth package that would, among other provisions, exclude dividends paid by corporations to individuals out of previously taxed corporate income from the individual's taxable income. The provision would be effective for dividends paid on or after January 1, 2003, with respect to corporate earnings after 2001, and accounts for the bulk, some $364 billion over the next decade, of the tax cut package.

To ensure that corporate income is taxed once but only once, an excludable dividend account (EDA)[10] would be created. This EDA would be the mechanism to determine the amount of income that has been fully taxed at the corporate level and, thus the amount of distributions to shareholders that would not be taxable. If a corporation made distributions in excess of the amount of earnings and profits that has already been fully taxed at the corporate level the excess distributions would be a taxable dividend to shareholders (or constitute a capital gain or a return of shareholders' investment). According to a Treasury release, the EDA will be computed using a relatively simple formula[11] and provided annually by corporations to shareholders[12].

In order to avoid a bias against retained earnings, (to effectively treat dividends and retained earnings alike) the proposal would allow corporations to make an adjustment that would flow through to their shareholders. The proposal would permit corporations that reinvest their taxed earnings to elect, either through a direct dividend reinvestment plan or through a "deemed dividend distribution"[13], to increase shareholders' stock basis[14] to reflect the taxed income that the corporation was retaining. The change in basis would reduce the amount of capital gains tax liability when shareholders realize those gains through a sale of stock. The proposal would permit a mutual fund or a real estate investment trust that receives excludable dividends to pass those excludable dividends through tax-free to shareholders.

[9] Op.cit. 4.

[10] A similar mechanism exists under current law. Distributions are treated as dividends only to the extent the corporation have earnings and profits.

[11] Annual additions to EDA = (U.S. taxes + foreign tax credits used to offset U.S. tax liability)/ .35 minus U.S. taxes + foreign tax credits used to offset U.S. tax liability + excludable dividend income. A corporation's U.S. taxes would include the total tax amount reflected on its U.S. federal income tax return filed during the calendar year. The first calculation is due September 15, 2003, using 2002 numbers.

[12] A corporation, mutual fund or stockbroker would be required to provide shareholders with the information they need in an end-of-year tax statement sent every January. The statement would indicate: how much of the dividend is tax free; how much of the dividend, if any, is taxable; and how much shareholders can add to what they paid for the stock to determine their tax when they sell their stock. This amount is the adjustment to shareholders' basis.

[13] A company would be required to treat undistributed or retained earnings as giving rise to a "deemed paid EDA" – the amount would be treated as distributed and recontributed to the corporation, with an adjustment to increase the shareholders stock basis, without additional tax at the shareholder level.

[14] Basis in the case of equity is the original cost of purchase of the shares plus transaction costs and adjustments for splits and if this proposal is approved, for deemed dividends. Adjustments to shareholders basis are to be made annually on December 31st by the amount retained per share. Corporations would report to shareholders the amount of Excludable Dividends and basis adjustments annually on IRS Form 1099.

This element of the proposal, which will lower capital gains taxes, balances the views of both sides in a long-running dividend tax debate.[15] The traditional view of dividend taxation holds that lowering dividend taxes would make it easier for companies to raise capital that they could then pour into new plants and equipment. The opposing view holds that it would also make shareholders more demanding. "With lower dividend taxes, investors would expect executives to pay out more of their earnings in the form of dividends rather than pour them into new projects."[16] To incorporate both views, the "deemed dividend" was added to the President's proposal, which will allow a company to pursue investments funded by retained earnings and still pass along tax benefits to the investor through an adjustment of basis similar to those received in a dividend distribution. This will reduce shareholders' incentives to demand dividends from companies and make them more tolerant of re-investment by companies by restoring some of the incentives to focus on capital gains. It will however limit some of the benefits already mention from elimination of the dividend tax that would prevail in the absence of this provision. The balancing of these two effects will likely be determined company by company and vary significantly across industries and sectors. Overall, the net investment impact is positive and significant, but likely will be less than most proponents expect.

Assessing the Economic Effects

Any realistic evaluation of the impact of this proposal must assess how individuals and businesses respond to it, the timing of its implementation and the likely evolution of macroeconomic variables. Thus far, estimates of the costs of this proposal are incomplete, while quantification of its benefits has been more the subject of partisan debate than the object of balanced appraisal. Both appear to be overstated. Overall, it would appear that the conclusion reached by the Treasury a decade ago still holds true: the long run benefits derived from eliminating biases and distortions is roughly comparable to the costs generated by lost tax revenues and resultant higher fiscal deficits. If one includes the long-term benefits of higher growth in incomes and jobs, the balance tips well in favor of the proposal.

Official projections of the impact of this proposal, those provided by the Administration and Congress, employ static analysis, and hence do not include any increase in economic growth likely to arise due to this tax change. This amount would be substantial and appears, in the long term, to outweigh the costs of the proposal. That Treasury study[17] from a decade ago suggested that even in the absence of increased investment eliminating double taxation would eventually raise economic welfare in the United States by about 0.5 percent of consumption, equal to about $36 billion each year (in 2003 dollars). Put differently, the reduced distortion of business decisions would be equivalent to receiving additional income of $36 billion every year forever. In addition, higher investment due to the lower tax on capital income would promote higher wages in the long run. The proposal would also enhance near-term economic growth.[18]

The President's Council of Economic Advisers (CEA) expects the dividend proposal, combined with the President's other proposals, to jointly add 0.4 percent to real GDP growth in 2003 and 1.1 percent in 2004. Over the next five years, GDP growth would be 0.2 percent higher on average. They estimate that the increase in the federal deficit if no impact of faster growth were factored in would total $146 billion for fiscal years 2003 and 2004, and $359 billion cumulatively for the period, 2003 to 2007. Including the impact of faster growth reduces those amounts to $119 billion and $166 billion, respectively, over the next two and five years. Roughly half these amounts are attributable to the dividend proposal, although a separate breakout has not yet been provided. This analysis assumes the proposal has no direct impact on equity markets and that no change in the stance of monetary policy occurs over the forecast period. It also makes relatively conservative assumptions concerning the impact of faster growth on Federal budget receipts (a $1 rise in real GDP generates 20 cents of Federal revenue) given the specific set of tax proposals considered.

[15] See J. Hilsenrath, "Dividend Plan Straddles Academic Debate", *The New York Times*, The Outlook, Economy, January 2003. See also K. Hassett, and A. Auerbach, "On the Marginal Source of Investment Funds", *Journal of Public Economics*, December 2002, p. 205-232.

[16] Ibid.

[17] Report of the U. S. Treasury Department, *Integration of the Individual and Corporate Tax Systems*, January 1992.

[18] Op.cit. 3, p. 1-2.

The President's Proposals and the Economy

Impact of President's Proposals	2003	2004	2003-2007
Faster Real GDP Growth (Q4 to Q4, percentage points) (Year avg to Year avg, percentage points)	1.0 0.4	0.8 1.1	0.2* 0.2*
Additional Employment Growth (Q4 to Q4) (Year avg to Year avg)	510,000 192,000	891,000 900,000	140,000* 170,000*
Lower Unemployment Rate (Q4 level, percentage points) (Annual average, percentage points)	-0.3 -0.1	-0.8 -0.6	-0.5* -0.5*
Change in Fiscal Balance; No Impact of Faster Growth ($ billions, fiscal year)	-33	-113	-359+
Change in Fiscal Balance; Including Impact of Faster Growth/1 ($ billions, fiscal year)	-31	-82	-166+

* Average, 2003-2007
+ Total, 2003-2007
/1 Excludes change in debt service

Most private sector analysts expect the proposals' impact over this period to be somewhat lower,[19] and more in line with the Federal Reserve's economic model, which "suggests that the add-on to GDP growth from a tax cut of this size would be just 0.4% and 0.7% in the first two years after enactment, respectively."[20] Benefits from the dividend proposal are expected to be negligible in the near term. While the proposal might become effective as early as 3Q 2003 and be applied retroactively, it is unlikely to alter consumer or investor behavior markedly before taxpayers begin to file in 2004, and the full benefits of the dividend tax break unlikely to be seen until the end of the second year.

[19] See for example, UBS Warburg, Global Economic Strategy Research, *U.S. Economic Perspectives*: "Time for a Tax Cut", January 10, 2003, which concluded "the lift for the economy looks likely to be smaller than the tax cut, which will total about 0.9% of GDP over the next 16 months.

[20] Ibid, p. 6.

Saving Rates by Income Quintile

Saving rates by income quintile estimated by Federal Reserve				
age group	30-59 (CES)	70-79 (CES)	average (CES)	30-59 (PSID)
quintile 1	-0.23	-0.49	-0.36	0
quintile 2	0.15	-0.34	-0.09	0.02
quintile 3	0.27	-0.14	0.07	0.05
quintile 4	0.35	0.05	0.2	0.05
quintile 5	0.46	0.32	0.39	0.11
Implied weighted average saving and spending rates from Bush tax proposal				
Saving rate	0.42	0.24	0.33	0.09
Spending rate	0.58	0.76	0.67	0.91
Domestic spending rate	0.52	0.68	0.6	0.81

Note: Spending rate equals 1 minus the saving rate. The domestic spending rate is the share of total spending that is allocated to domestically produced goods and services, which we estimate at about 89% of total spending.

Source: Citizens for Tax Justice, Federal Reserve Board, and UBS Warburg LLC estimates

Part of the reason for the lower estimates is that fiscal "stimulus will be stunted by leakage to savings." The boost to growth will be constrained as households save a portion of the increased after-tax income. Average savings rates have risen recently from record lows to about 4.3 percent, "but the 'leakage' from savings in the current tax cut could be larger than usual because the well-to-do will benefit disproportionately from the proposed tax cut" and they save more than low-income households. For example, the top income quintile, on average, can be expected to save as much as 39 percent out of after-tax income, while the next highest income quintile would likely save 20 percent.[21] Savings rates for the bottom two income quintiles are negative. Although savings rates rise with income among elderly households too, savings rates are lower at every income level than in younger households. Using these savings rates and the distribution of dividend receipts across income brackets provided by individual income tax return data for 2000, the latest year for which detailed data are readily available, one can estimated the share of the proposal which will be spent and what proportion will likely be saved.

These estimates indicate that the near term stimulus to growth would be small, in line with the Administration's estimates of a reduction in tax revenues between now and April 2004 of only $20 billion. Even those benefits may be overestimated and are unlikely to arrive until after investors turn their attention to tax matters at the start of 2004. Rather than provide a burst of short-term stimulus to consumption, which would likely prove transitory, it seeks to boost long-term growth by providing incentives to savings and investment. In that respect, it should succeed, in that the benefits flow to those most likely to save and invest the proceeds. Assuming half the benefits of the proposal go to the top two income quintiles, fully one-third of this amount would likely be saved, and the remainder spent.

[21] *Federal Reserve Consumer Expenditure Survey*, 2000 http://www.federalreserve.gov/pubs/oss/oss2/scfindex.html

The estimates of the costs of the proposal may also prove to be high for other reasons. The estimates are based in part on tax data on dividends for 2000, and substantial changes in income impacted by this proposal have occurred since then that suggested the estimates should be lowered. Some portion of the dividend income received by individuals reported in the tax data includes interest payments from money market mutual funds and bond funds, in addition to stock dividend income received outside of retirement plans and other tax-deferred vehicles, for which adjustments were made. However, since that time portfolios have changed. For example, during 2002, there was a net inflow into taxable bond funds of $124 billion, while the first annual net outflow of long term funds from stock mutual funds since 1988 occurred: some $27 billion. Individual investors also reduced their holdings of individual stocks. As a result, the portion of income derived from these interest payments and reported as dividends for calculation of AGI will be higher when tax returns are filed this spring and the adjustments made by those providing estimates should be commensurately raised.

In 2000, corporations paid an estimated $201 billion in dividends out of after-tax incomes.[22] More than half of these dividends were paid to tax-exempt entities - such as pension funds, IRAs, and non-profit foundations - or to individuals that owed no income tax. As a result, only about 46 percent of the dividends paid by corporations to individuals (or $93 billion in dividends) were subject to individual income tax in 2000.[23] These figures include those interest payments mentioned above. Since then, actual dividend payments fell 3.3 percent in 2001 before rising 2.1 percent last year. Equity ownership rose in 2001 in terms of the number of households and individuals holding equities, but fell as a portion of overall financial assets, as flows moved from equity to debt and as equity prices continued their three year decline.

In addition, it would appear that investors in recent years have allocated an increased portion of their equity holdings to tax deferred accounts such as 401(k) plans, IRA's and Keoghs and a corresponding portion of corporate bond holdings to their taxable portfolio,[24] and these trends appear to have continued in the past three years. As a result, the percentage of total dividends paid by corporations to individuals' taxable accounts has fallen significantly, to about 40 percent, from the 46 percent estimated for 2000. This investor behavior appears to be the opposite of what conventional wisdom would predict, but has rational explanations, and is largely induced by distortions introduced by the current tax policy. Stocks are expected to have most of their payout in the form of capital gains, which are taxed relatively lightly, while bonds pay interest, which is more highly taxed. Investors would be expected to choose to put the riskier asset, stocks, in the taxable portfolio and bonds in the tax-deferred account. Just the opposite has occurred in practice. One study notes that "if taxes on dividends were eliminated, there would be greater incentive to hold stocks outside a tax-sheltered portfolio. So we would expect to see investor portfolios shift more in the direction the theory predicts: taxable bonds in tax-deferred accounts, and stocks in taxable accounts to the advantage of lightly taxed capital gains and untaxed dividends."[25] The impact of changes in securities ownership, both actual changes in the last two years and prospective changes if the proposal is approved, need to be added to the analysis.

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[22] The Urban Institute-Brookings institution Tax Policy Center.

[23] William G. Gale, "About Half of Dividend Payments Do Not Face Double Taxation", *Tax Notes*, November 11, 2002.

[24] James M. Poterba, *The Rise of the "Equity Culture:" U.S. Stockownership Patterns, 1989-1998*, Massachusetts Institute of Technology, January 2001, http://econ-www.mit.edu/faculty/poterba/files/aea2001.pdf

[25] H. Varian, "What would be the long-run impact of tax-free dividends on the market?" *The New York Times, Economic Scene*, January 16, 2003, p. C2.

U.S. Household Ownership of Equities, 1999 and 2002

	Percent of All Households		Number of Households (millions)		Number of Indiv. Investors (millions)	
	1999	2002	1999	2002	1999	2002
Any type of equity (net)[1,2]	48.2	49.5	49.2	52.7	78.7	84.3
Any equity inside employer-sponsored retirement plans	31.8	34.0	32.5	36.2	52.0	57.9
Any equity outside employer-sponsored retirement plans	35.5	33.7	36.3	35.9	61.6	57.4
Individual stock (net)[1]	26.1	23.9	26.7	25.4	40.0	38.1
Individual stock inside employer-sponsored retirement plans	10.5	8.3	10.7	8.8	14.0	12.3
Employer stock inside employer-sponsored retirement plans[3]	6.0	5.6	6.1	6.0	8.0	7.8
Non-employer stock inside employer-sponsored retirement plans[4]	8.0	3.5	8.2	3.7	11.4	5.2
Individual stock outside employer-sponsored retirement plans[3]	21.4	19.7	21.9	21.0	32.8	31.5
Stock mutual funds (net)[1]	40.9	44.2	41.8	47.0	66.8	70.5
Stock mutual funds inside employer-sponsored retirement plans	27.9	31.2	28.5	33.2	39.9	46.5
Stock mutual funds outside employer-sponsored retirement plans	27.2	27.0	27.8	28.7	44.4	43.1

[1] Multiple responses included.

[2] The average number of individuals owning equities per household owning equities was 1.6 in 1999 and 2002.

[3] Excludes employer stock options.

[4] The decline in the number of households and individual investors owning non-employer stock inside employer-sponsored retirement plans reflects a change in questionnaire design. In the 2002 survey, respondents owning non-employer stock inside retirement plans had to indicate that their plans provided a brokerge account window. The 1999 survey did not include a question about brokerage account windows.

Note: The U.S. had approximately 106.4 million households in 2001, the most recent estimate available [U.S. Bureau of the Census, Current Population Reports, p. 60-213 (September 2001)].

Source: *Equity Ownership in America 2002*, Investment Company Institute and the Securities Industry Association, www.sia.com/publications/pdf/equity_owners02.pdf

The most tangible economic benefits of the proposal arise from the increased incentives to savings and investment. These additional savings are invested and spur additional capital formation, boosting business fixed investment spending and generating additional output and jobs. This, combined with the likely effects of the additional consumption spending and the additional investment income, provides for substantially lower cost estimates of the proposal, and ones roughly in line with the dynamic estimates provided by the CEA. These benefits generate additional tax revenues sufficient to offset slightly more than half the tax revenues foregone by the proposal.

Other dynamic effects of the proposal, such as the impact on capital markets (including a boost, albeit small, to equity prices) and the long run encouragement of higher rates of savings and investment need to be considered. Estimates of the increase in stockholder wealth generated by the proposal, which range from $600 billion to $1.7 trillion, also appear to be overstated, but still large. These latter effects arrive with substantial lags and are difficult to forecast, but are likely to grow over the long term. This suggests that while the stimulative effects of the proposal are muted in the near term, they will likely expand significantly over time, as investor and consumer behavior changes in response to this fundamental reform.

In conclusion, the President's proposal is worthy of support. Its value rests in the very reasons for which it is most heavily criticized: that it does not provide a short-term stimulus to consumption, nor achieve any redistribution of tax burdens across income groups. Instead it provides a long-term boost to saving and investment, a boost that provides lasting support for growth in jobs and income. This is particularly important now since the recent recession, unlike most in history, was not led by a decline in consumption. Instead, consumption has been sustained, growing in excess of income with the deficit filled by record levels of debt in both the household and corporate sector. This deficit in the corporate sector which reached 6 percent of GDP at its peak in 2000 has since fallen to a more manageable 2 percent last year, while consumers have thus far failed to retrench, encouraged to continue to borrow and spend by recent fiscal and monetary policy.

Prospects for emerging from the economy's current "soft patch"[26] might well be dependent on a revival of sharply reduced and still moribund business fixed investment before consumers inevitably retrench, as they may well be doing in early 2003. The need for longer-term stimulus is even more pressing if America goes to war in the months ahead. Such action could well plunge the U.S. economy into renewed recession late this year, and fiscal stimulus delayed until early 2004 might well prove very timely.

More importantly for our long term economic health and fiscal stability is the direct support for savings provided by the proposal. This represents fundamental reform rather than countercyclical tinkering. Americans do not save enough - not nearly enough and it is not even close. We do not save enough for retirement, which is the principal goal of equity investors, cited by 89 percent of those surveyed,[27] nor enough to meet other primary objectives such as college education. The President's proposal addresses this problem directly and will change savings and investment behavior, slowly over time, but permanently for the better. Americans are too myopic and consumption-oriented to the point of their long-term detriment. If the fiscal cost of altering that (in terms of reduced tax revenues and less stimulus to current spending in the near term) is viewed as too great, it should be an invitation to more, not less, fundamental tax reform to remedy that problem, rather than rejecting a proposal which removes some of the most egregious distortions and biases of our tax system and addresses some of America's most pressing needs. From a broader macroeconomic perspective the long run benefits of the proposal outweigh these costs.

Frank A. Fernandez
Senior Vice President, Chief Economist
and Director, Research

[26] A euphemism for the decline in real GDP growth in Q4 2002 to less than 1 percent and perhaps still lower in the current quarter, in large part due to weak corporate earnings, geopolitical uncertainties and a loss to public trust and confidence arising from corporate governance failures, and other elements of the hangover from one of the worst speculative manias in our history, all factors unlikely to be affected by a short-term stimulus to consumption.

[27] *Equity Ownership in America, 2002*, Investment Company Institute and the Securities Industry Association, www.sia.com/publications/pdf/equity_owners02.pdf.

Report by the Mortgage Bankers Association of America

Estimated Impact of the Major Components of the Bush Administration's Growth and Jobs Plan on Housing and the Economy

March 10, 2003

Mortgage Bankers Association of America

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Executive Summary

The halting and weak nature of the current economic recovery and the related lack of job creation have led to the proposal that fiscal policy be used to encourage greater economic growth. February payroll employment declined by over 300,000 jobs affecting all sectors of the economy. Fourth quarter Gross Domestic Product (GDP) increased a paltry 1.4 percent at an annual rate. House price increases are slowing, increasing the likelihood that the strong support provided by the housing sector will moderate somewhat toward a more historically normal role, but raising the risk of slowing consumer spending. While some signs of strengthening can be observed, the Federal Reserve Board has noted that there is still greater risk of weak economic growth than of resurgent inflation.

The Bush Administration has proposed a defined package of policies for the purpose of increasing economic growth and accelerating job creation. In light of the challenges faced by the economy and the importance of job and income growth to both the residential and commercial real estate finance industries, it is prudent for the Mortgage Bankers Association of America (MBA) to evaluate the impact of the proposal on the economy and real estate.

The two main elements of the administration's proposal are the acceleration and making permanent of the previously enacted marginal tax rate cuts and the elimination of the double taxation of corporate dividends. The MBA incorporated the combined package into a simulation of economic activity for purposes of evaluating the capacity of the proposal to increase job formation and income growth in the next two years, a period of time over which the full effects should play out.

Simulation results produced by MBA, and based on conservative assumptions, show that the effects predicted by the administration's economic advisors are supported, with any differences within the tolerances of such models. Our estimates anticipate an annualized increase of 0.9 percent in GDP growth by year-end 2004 and the addition of 1.0 million jobs in that same time frame. The proposal will have a minimal impact on mortgage interest rates and will generate an additional 130,000 housing starts over the simulation time frame.

As a result of the estimated positive effects on the economy and the related benefits for the commercial and residential real estate sectors, MBA is strongly recommending the adoption and implementation of the proposal as soon as possible.

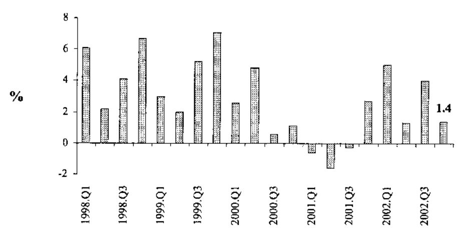
Current Economic Environment

The recovery of the U.S. economy from the recession that began in 2001 has been modest and uneven and has failed to produce a desirable level of job growth. As a result, the Bush Administration has proposed an economic growth package intended to increase both employment and GDP growth.

Growth of Gross Domestic Product (GDP) began decelerating in the second half of 2000 and became negative at the outset of 2001.

Real GDP Growth

(Percent change, Seasonally Adjusted at Annual Rate)

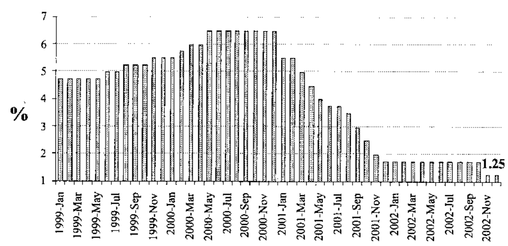


Source: U.S. Department of Commerce

After three consecutive quarters during which the annualized rate of GDP growth was negative, national income growth turned up but at an erratic pace. The preliminary GDP estimates for the fourth quarter of 2002 stand at 1.4 percent, well below the economy's long-run capacity for growth and well under the pace normal for this far beyond what appears to have been the end of a recession and the beginning of an expansion.

Monetary policy has been accommodative since the onset of the recession. The Federal Reserve has lowered the Federal Funds Rate Target both rapidly and to a very low level.

Federal Funds Rate Target
(Percent, End of Period)

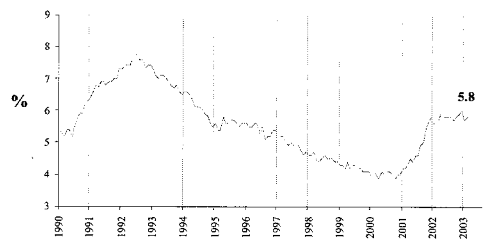


Source: Federal Reserve Board

The most recent cut in the Fed Funds target, November 2002, to 1.25 percent was accompanied by commentary indicating that the observed softening of activity in the manufacturing sector indicated that the risks to the recovery of the economy remained significant and growth-oriented rather than inflationary. The Federal Reserve Board has been very clear that it will retain an accommodative policy stance until such time as it sees a solid footing established under the recovery; something that it does not yet see.

Unemployment, which began to rise in late 2000, has remained stubbornly high, most recently reported in February 2003 at 5.8 percent.

Unemployment Rate
(Percent, Monthly Average)



Source: BLS Household Survey

The February report indicated private nonfarm payroll job losses of 321,000.

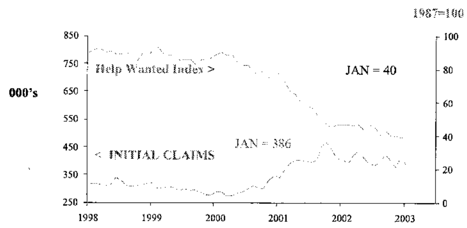
Employment Growth
(Monthly Change in Private Nonfarm Employment, Number of Jobs)

Source: BLS Establishment Survey

These losses were not concentrated but rather were reflected in all broad categories of employment with retail trade and services suffering the largest losses. Manufacturing continued to register job losses. Additionally, the rate of initial unemployment claims have remained relatively high and the Help Wanted Index gives no indication of a trend shift toward improved employment conditions.

Unemployment Insurance Claims and Help Wanted Index

(Seasonally Adjusted)

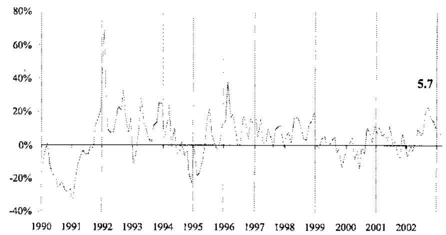


Source: U.S. Department of Labor and The Conference Board

One of the few sectors of the economy that has been adding jobs has been the residential housing real estate finance sector. Mortgage bankers and brokers have added over 120,000 jobs since January of 2001 during which time the U.S. economy has suffered a net loss of 2,531,000 private nonfarm jobs. Record low interest rates have provided an impetus that has allowed the housing sector to stand as one of the most important supports for the overall economy, softening the recession and serving as an engine to support the modest recovery to this point.

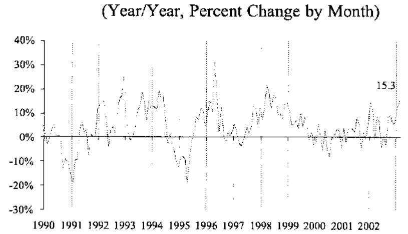
Home sales have set records each of the last two years at 6.19 million new and existing homes sold in 2001 and 6.58 million in 2002.

New Home Sales
(Year/Year, Percent Change by Month)



Source: Census Bureau

Existing Home Sales
(Year/Year, Percent Change by Month)

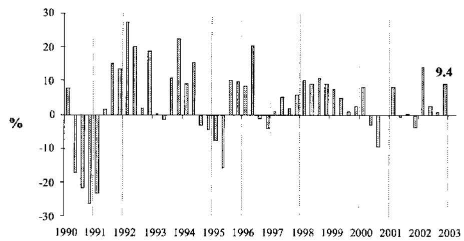


Source: National Associations of Realtors

Real residential fixed investment has remained strong throughout the current recessionary period, in contrast to the 1990-91 recession, providing valuable support to economic activity through sustained employment and materials demand in the residential construction sector as well.

Real Residential Fixed Investment

(Percent change, Seasonally Adjusted at Annual Rate)

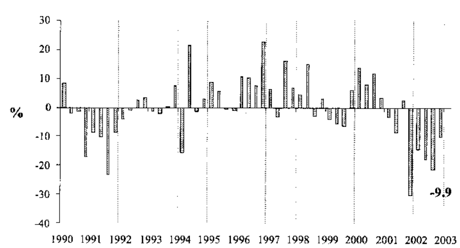


Source: U.S. Department of Commerce

Unfortunately, the economic downturn and its effects on business fixed investment and employment have devastated the real nonresidential or commercial structures sector.

Real Nonresidential Structures

(Percent change, Seasonally Adjusted at Annual Rate)



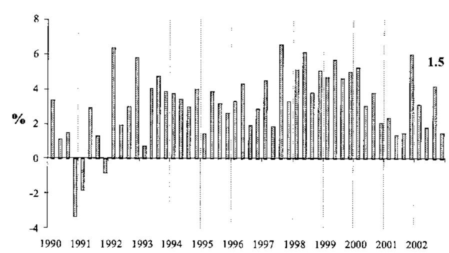
Source: U.S. Department of Commerce

This sector will not return to health until such time as economic growth resumes at a higher level and employment picks up.

Concurrent with home sales increases, residential mortgage originations registered \$2.03 trillion in 2001 and \$2.46 trillion in 2002, both record levels. A significant part of the origination dollar amount was the removal of equity built up by increases in home values. The Federal Reserve estimates that roughly \$200 billion of equity was extracted through "cash-out" refinancing in 2002, slightly higher than that of 2001. Of this cash, a substantial portion was applied to the reduction of other forms of debt but the remainder, perhaps as much as \$75 billion each year was used for consumption of various kinds by households. Once again the housing sector provided support for the economy at a level well above that of the 1990-91 recession.

Real Personal Consumption Expenditures

(Percent change, Seasonally Adjusted at Annual Rate)



Source: U.S. Department of Commerce

The role of residential housing as a support for the economy through both the cash-out refinancing supporting consumer spending and through the consumption boost generated by the sale and financing of new and existing homes is expected to wane slightly in 2003. Refinancings, in particular, will recede from the historic levels of the last few years as the number of households for which there is an economic benefit declines. The housing sector will still be a strong leg for the economy but more in its traditional role of providing between 12 and 20 percent of GDP depending on how it is measured. However, as interest rates rise modestly and refinancing activity declines and provides somewhat less support for consumer spending and the economy, there will need to be an increase in income growth and employment to offset it.

The MBA's forecast for economic growth, employment and housing activity without the implementation of any sort of growth plan is for continued growth below capacity and little recovery in jobs until late 2004. Without a growth plan, we expect GDP growth in the neighborhood of 2.8 percent from fourth quarter to fourth quarter 2003 and 3.4 percent the following year. Furthermore, unemployment is expected to rise to a level of 6.1 percent and remain there through most of 2004. The housing sector is expected to begin a slow decline of modest proportions.

The Bush Administration has introduced a plan intended to boost employment and economic growth to provide the offset to the slowing housing sector. This will potentially be important to the housing industry as the three most important factors for a growing housing industry in the longer term are jobs growth, income growth, and demographic factors. Since the Bush Administration's plan is intended to increase both jobs and economic growth, it is incumbent on the Mortgage Bankers Association of America (MBA) to assess the plan's expected impact on the residential and commercial real estate and real estate finance industries. What follows is a description of the administration's proposal's major elements and their estimated impacts on the economy and real estate finance.

MBA Analysis of the Bush Administration's Growth and Jobs Plan

The MBA has undertaken an analysis of the economic effect of the Bush Administration's proposed economic growth package. The MBA has determined that if the package were passed by the middle of 2003, 1.0 million new jobs would be created by the end of 2004, or within 18 months of the passage of the plan. The MBA estimates that if the plan were passed in its entirety, Gross Domestic Product (GDP) would increase by an additional 0.5 percent during 2003 and by an additional 0.9 percent during 2004. As a result of this analysis, the MBA strongly recommends passage of the plan.

Key Points of the Bush Administration's Plan

The Bush Administration's plan has two key components, the acceleration to January 1, 2003 of the tax cuts passed in 2001 that are now being phased-in over several years, and an elimination of the double taxation of dividends. The proposed accelerated tax cuts include:

- The expansion of the 10 percent tax bracket.
- The reduction in the 27%, 30%, 35% and 38.6% income tax rates to 25%, 28%, 33% and 35% respectively.
- The reduction in the marriage penalty.
- An increase in the child tax credit from $600 to $1,000. In addition, the 2003 increase would be paid to qualifying taxpayers with advance payment checks in July 2003.

In addition to the elimination of the double taxation of dividends, the administration proposes increasing from $25,000 to $75,000 the amount of investment that small businesses can expense immediately and increasing the Alternative Minimum Tax exemption by $8,000 for married taxpayers ($4,000 for single taxpayers) between 2003 and 2005.

Assumptions in Estimating the Effect of the Plan

Estimates of the effects of tax changes on economic growth are always challenging, particularly when we are looking at reversing the effects that the double taxation of dividends has created over many years. For example, the MBA estimates that the removal of the double taxation of dividends would add roughly $30 billion annually to after-tax incomes. Since there is little historical precedent on how much of this will result in additional spending, the MBA made the very conservative assumption that the amount of new spending would be small, and that the principal stimulative effect of the proposal would come from the resulting increase in equity prices. There appears to be little argument that some increase in stock prices would occur; the question is how large it would be. Estimates of private economists put the probable increase in the 5 to10 percent range. The MBA is assuming an increase of 7.5percent in its model.

The experience of the late 1990s clearly indicates that increased wealth in the form of higher equity prices does encourage consumers to spend more and save less, as would be expected. Higher equity prices also reduce the cost of equity capital to businesses, potentially increasing business spending for capital equipment. There is thus good reason to expect positive benefits to economic growth from eliminating taxes on dividends. Indeed, since the weak and erratic nature of the economic recovery that began a year ago probably traces in good measure to the legacy of the bear market in equities, an upturn in stock prices should clearly help strengthen the economy.

The acceleration of the tax cuts should have a major, direct impact on consumer spending. Tax cuts that are permanent have a much larger impact on consumer spending than those that are temporary, such as rebates. Estimates from previous tax cuts are that individuals spend only about one-fifth of any funds received via temporary tax cuts or rebates. On the other hand, spending out of permanent tax cuts, such as those proposed in the administration's plan, runs closer to two-thirds of the increase in disposable income.

One additional but minor point is whether the acceleration of previously scheduled tax cuts might have a slightly different impact on personal consumption than newly scheduled tax reductions. The issue with the accelerated tax cuts in the administration's proposal is whether or not individuals have already increased their spending in anticipation of future tax cuts already enacted into law. While it is theoretically possible that consumers have already begun to spend part of expected future tax cuts, the MBA believes this is highly unlikely and that most consumers have not made the careful calculations that would be necessary to estimate how future tax changes would affect their after-tax income. Even if they had done so, they would probably still be uncertain as to whether future tax cuts would actually be realized, given the desires of some in

Congress to cancel some or all of scheduled future tax cuts. In the estimates of the economic effects of the stimulus package discussed below, the accelerated tax cuts announced in the administration's proposal are treated the same as if they were newly enacted tax reductions.

To estimate the impact on economic growth, simulations were done with the econometric model that the MBA uses for creating its economic forecasts, a model created by Macroeconomic Advisers of St. Louis. The MBA used the following assumptions:

The new tax proposals are assumed to be passed in their proposed form by mid-year 2003 and go into effect during the third quarter.

Stock prices are assumed to increase 7-1/2 percent in response to the elimination of taxes on dividends.

The tax cuts result in a $70 billion increase in income to taxpayers.

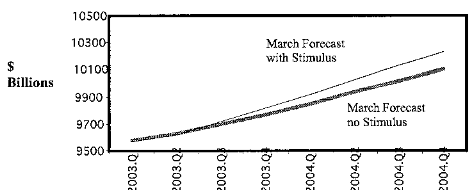
MBA Simulation Results

Impact on GDP and Employment

The results provide general confirmation of the administration's estimates of the near term impact on economic growth. Regarding GDP growth and employment, the simulations suggest the following.

The simulations suggest that 0.5 percent would be added to GDP growth in the last two quarters of 2003, measured year-over-year, and 0.9 percent added to year-over-year growth in 2004.

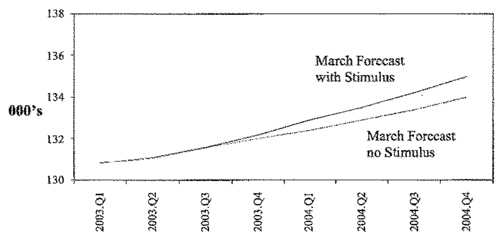
Real GDP
(Billions, Annual Rate)



Source: MBA

By the fourth quarter of 2004, the number of payroll jobs would be boosted by 1.0 million.

Payroll Employment
(Number of Jobs)



Source: MBA

The MBA's current forecast for annualized growth in the latter half of this year is in the 3 to 3-1/4 percent range. The simulations suggest that annualized growth during the third and fourth quarters might be boosted by as much as a full percentage point, raising the growth rate during that period to 4 to 4-1/4 percent.

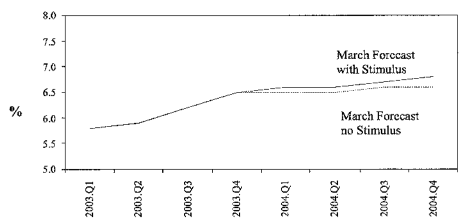
Impact on Interest Rates

The MBA's estimate of the impact of the administration's growth package suggests a bit less growth coming from the stimulus package than what the administration estimates—though the difference is quite small. One possible reason for the difference could be differences in the allowances made for the impact of the stimulus package on interest rates.

Several factors would likely increase interest rates with any stimulus package. First, the demand for funds is likely to increase with any economic recovery, putting upward pressure on rates. Second, if equity prices are boosted, a substantial part of the money flowing into equities might come from investments in fixed income securities, pushing up their yields. Both of these effects would be offset somewhat if the result of elimination of the double taxation of dividends is to make equity funding less expensive and reduce somewhat the corporate demand for debt funding.

How large an effect on interest rates would occur depends importantly on how the Federal Reserve reacts to the impact of the stimulus package on the economy. Given the currently very low rate of inflation, it is MBA's judgement that the Fed would not rush to raise interest rates at the first sign of improved economic growth. From the middle of this year onward, however, the economy could well be growing at a pace that reduces unemployment significantly. The real federal funds rate is now below zero (meaning that the rate is below the rate of inflation), implying a posture of monetary policy that cannot be sustained indefinitely. Solid economic growth would give the Fed the opportunity to move gradually back toward a neutral posture. The simulations allow for this, but suggest that the increase in interest rates would be quite moderate, in the neighborhood of 20 basis points above what they otherwise would have been on the 30-year fixed rate mortgage rate by year-end 2004.

Conventional 30-Year Mortgage Rate



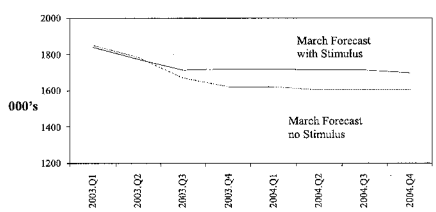
Source: MBA

Impact on Housing Starts

The effect of the administration's proposal on housing starts is to increase them. The increase in employment (which is significant but not so large as to put upward pressure on the price level) and disposable income overrides the minor increase in interest rates. The result is that housing starts are increased by 30,000 units in 2003 and by 100,000 units in 2004 through implementation of the full plan.

Housing Starts

(Thousands, Annual Rate)



Source: MBA

Were the dividends exclusion component of the plan not enacted, the impact on 2003 starts would be a smaller increase of 25,000 units and starts in 2004 would be 60,000 higher rather than 100,000 with the full plan.

Conclusion

The halting and weak nature of the current economic recovery and the related lack of job creation have led to the proposal that fiscal policy be used to encourage greater economic growth. The Bush Administration has proposed a defined package of policies for the purpose of increasing economic growth and accelerating job creation. The two main elements of the administration's plan are the acceleration and making permanent of the previously enacted marginal tax rate cuts and the elimination of the double taxation of corporate dividends.

The MBA incorporated the combined package into a simulation of economic activity for purposes of evaluating the capacity of the proposal to increase job formation and income growth in the next two years, a period of time over which the full effects should play out. Simulation results produced by MBA, and based on conservative assumptions, show that the effects predicted by the Bush Administration's economic advisors are supported, with any differences within the tolerances of such models. Our estimates anticipate an annualized increase of 0.9 percent in GDP growth by year-end 2004 and the addition of 1.0 million additional jobs in that same time frame. The plan will have a minimal impact on mortgage interest rates and will generate an additional 130,000 housing starts over the simulation time frame.

As a result of the estimated positive effects on the economy and the related benefits for the commercial and residential real estate sectors, MBA is strongly recommending the adoption and implementation of the plan as soon as possible.

Appendix 1

Other Benefits of the Bush Administration's Proposal for the Elimination of the Double Taxation on Dividends

In addition to the direct economic benefits of the administration's growth plan discussed in the report, the MBA sees a number of other advantages to improved corporate governance and operations that will ultimately inure to the benefit of the economy by increasing investor confidence and increasing capital market efficiencies.

1) Greater corporate transparency. By removing the tax disincentive not to pay dividends, corporations will be under greater pressure to justify their levels of retained earnings. The justification for retaining funds in a corporation is that the firm has better growth and investment prospects than the individual investor, particularly on an after-tax basis. Once the double taxation of dividends is removed, firms will have to be more open about their investment prospects that justify not paying out dividends.

2) Dividends will be a greater reality check on earnings. Some of the largest corporate collapses in the last two years came as a result of inflated earnings and cash needs supported by increasing levels of debt. Putting a greater emphasis on cash payouts in the form of dividends will serve as a reality check on reported earnings.

3) Lower leverage levels will tend to make corporate balance sheets less fragile. Removing the double taxation of dividends should make equity

financing relatively cheaper to debt financing than is currently the case. By encouraging corporations to have less debt financing, aggregate corporate balance sheets would become less fragile.

4) Reduce the need to sell stocks for current income. The double taxation of dividends has discouraged firms from paying dividends to shareholders. While individuals in need of regular cash income from their stocks have generally concentrated their purchases on higher dividend-paying stocks, others are placed in the position of having to sell their stocks and buy replacements in order to capture the same income in the form of capital gains but at a lower tax rate. The administration's proposal to reduce the volume of stock sales that occur solely to generate regular income at capital gains rates.

Appendix 2

Analysis of the Impact of the Bush Administration's Economic Growth Plan on Low Income Housing Tax Credits

The MBA fully supports the Bush Administration's economic proposal. Some concerns have been raised, however, about the potential impact of the plan on one of the important and successful methods of promoting the development of rental apartments for lower income individuals, the Low Income Housing Tax Credit (LIHTC) program. The reason for the concern is inherent in the mathematics of the calculation of the Excludable Dividend Amount, or the amount of dividends that can be paid tax free to shareholders. The excludable amount is based on the amount of taxes paid by the corporation in the following fashion:

Excludable Dividend Amount = (Federal Tax Paid .35) – Federal Tax Paid

This can be restated as:

Excludable Dividend Amount = 1.85 x Federal Tax Paid

The result is a situation where the amount of tax-free dividends that a corporation can pay is reduced by $1.85 for every dollar reduction in federal tax paid. The issue for LIHTCs then is whether the benefits of LIHTC investing at the corporate level are sufficient to offset any potential negative effects at the shareholder level, given that savings at the corporate level come at the corporate tax rate whereas the potential additional tax exposure is at generally lower individual income and capital gains rates. The MBA's analysis is that, under a range of reasonable assumptions regarding tax rates and dividend payout rates, marginal returns to shareholders from corporate investments in LIHTCs remain positive under the administration's plan. While the marginal shareholder returns from LIHTCs are somewhat lower under the Bush Administration's plan than current law, the differences are driven entirely by assumptions regarding the tax effects of relative changes in capital gains tax basis. Since neither corporate yields nor the amount of tax-free dividends that can be paid are affected by LIHTC investments, under reasonable dividend payout assumptions, it is difficult to predict the degree of any negative pricing impacts. Based on all of the various and sometimes offsetting factors at work, it appears unlikely, that any negative price changes resulting directly from the administration's plan would be significant. Indeed, it can be argued that a failure to pass the administration's growth plan would negatively impact LIHTC prices. A danger to LIHTC pricing is a continued softness in current corporate earnings, combined with a negative outlook for the future. This could result in a reduced appetite for new LIHTC investments and increased secondary market sales of existing credits, both of which would depress LIHTC prices.

In its analysis of the impact of the administration's economic growth proposal on the LIHTC program, the MBA attempted to answer three questions. First, will LIHTCs remain viable investments, that is, will the tax costs to shareholders outweigh the benefits at the corporate level? Second, will prices be affected and to what degree? Third, if any adverse effects of the tax plan are large enough that they need to be mitigated, what form should changes to the plan take?

Will LIHTCs remain viable under the Bush Administration's jobs and growth plan?

The LIHTC program provides benefits at the corporate and shareholder level. While the exact returns will differ based on a broad continuum of corporate and individual income and capital gains tax rates, attached Exhibit 1 shows the marginal benefit of a LIHTC priced to yield 8 percent in the form of tax credits under current law. The assumptions in the model assume that the effective corporate tax rate is 28 percent, the dividend payout rate is 48 percent of after-tax earnings, the marginal individual income tax rate on dividends is 35 percent, and the individual capital gains tax rate is 10 percent. These average tax and dividend payout rate assumptions are reasonable averages of average rates and were used in a recent study on this issue by Ernst & Young. In this particular example, the marginal benefit at the corporate level is $367 and the benefit passed through to shareholders is $287. It is important to note that this benefit is highly dependent on effective tax rates. For example, were it assumed that the effective corporate tax rate is 35 percent, the benefit would jump by 19 percent to $437, of which $341 would be passed on to shareholders. It is reasonable to assume that corporations with higher effective tax rates would be willing to pay more for LIHTCs than those in lower tax brackets. Therefore, any assumptions regarding the pricing impact of the administration's tax proposal must take into consideration the effective tax rates of the purchasers of LIHTCs, not the average of all corporations.

Exhibit 2 uses an identical set of tax rate and dividend assumptions to show the marginal benefit of investing in LIHTCs under the administration's growth package. What is important is that the benefit remains positive overall to shareholders, and, assuming a constant dividend payout ratio, the LIHTC investment increases the amount of tax-free dividends they receive. In addition, the marginal return to shareholders increases by 65 percent if it assumed that companies investing in LIHTCs are those with effective federal tax rates of 35 percent. While the size of the marginal benefit is lower under the administration's proposal, that reduction is entirely in the change in capital gains basis where the applicable rate assumptions are the most open to question.

The purpose of Exhibit 3 is to put the LIHTC issue into some sort of context with the total impact on shareholder returns. While the relative magnitude of the change in returns is based on the relative size of the LIHTC investment, here it is assumed, as in the previous exhibits, that LIHTC investments are 1 percent of a corporation's pre-tax net income. The overall benefits to shareholders from the administration's package dwarf the marginal shareholder effects from LIHTC investments, increasing returns by 24 percent both with and without LIHTCs.

What will be the impact on LIHTC prices?

Absent a detailed analysis of the price elasticities of the demand and supply in the LIHTC market, it is impossible to develop a firm analysis of the impact a change in the relative value of LIHTCs under the administration's plan would have on LIHTC pricing. It would be clearly incorrect simply to establish some baseline hurdle rate and estimate how much LIHTC prices would have to adjust to meet that particular hurdle rate for a set of investors with a particular set of tax and dividend expectations. Given the various reasons for investing in LIHTCs, including CRA considerations, it may be sufficient for some investors to know only that returns do not turn negative for them to continue their investments.

There are a number of factors that influence LIHTC pricing. First, given the long duration of the LIHTC investment commitment (10 years), prices are driven by changes in discount rates, which in turn are driven by changes in underlying interest rates and changes in relative risk. The extent to which interest rates have fallen over the last 18 months has helped support LIHTC prices.

Second, it is not clear the extent to which any corporation can base an investment decision on the tax situation of a particular class of investors. For example, corporations have long paid dividends despite the fact that, for some investors, dividends are taxed at a higher rate than capital gains. If after-tax returns to shareholders in the examples used to discuss the potential impact of the administration's plan on LIHTCs are really a primary motivator, one would have to question why any corporations ever pay any dividends. It should be noted that for shares held in pension funds or 401k accounts where the applicable dividend and capital gains rates are zero, there is no reduction in the marginal shareholder return from LIHTCs.

Third, LIHTC prices are fundamentally driven by supply and demand. In a report for the Millennial Housing Commission, Recapitalization Advisors, Inc. gave a history of LIHTC prices since the inception of the program, and demonstrated how prices improved as the program matured:

Years	Average prices (per dollar)
1987 – 1989	.45
1989 – 1993	.52
1993 - 1997	.65
1998 - 2000	.74
2001 -	.77

In addition to noting the steady increase in LIHTC prices, Recapitalization Advisors notes that at one point in early 2001, LIHTC prices dropped by 10 percent in as little as three months as a result of an apparent 40 percent increase in the supply of LIHTCs hitting the market at one time. Other negative impacts on prices mentioned in the Recapitalization Advisors report include whether the strongest properties have already been financed and the potential overhang of the now sizable secondary market for trading these tax credits.

The point is that LIHTC prices can be volatile absent changes in tax laws, and that any and all effects on supply and demand resulting from the passage of the administration's growth plan must be taken into consideration. It can be argued, for example, that if the economy did not improve, the profits and therefore the tax credit appetites of traditional LIHTC investors would go down. Not only would these firms drop out of the primary market for LIHTCs, they would likely seek to sell their existing credits in the secondary market, further depressing prices. Thus depressed corporate earnings from a sluggish economy could pose the greater risk to LIHTC pricing, particularly since LIHTC shareholder returns remain positive under the proposal and firms will thus not have an incentive to dump their credits on the secondary market.

If any adverse effects on the LIHTC program need to be mitigated, what form should changes in the Bush Administration's growth proposal take?

If it becomes clear that the Administration's growth proposal will have significant negative effects on LIHTC prices due to the relative change in shareholder returns, what form should any change take? Since dividend returns to shareholders are not negatively affected under any reasonable assumptions of dividend payout ratios, there appears to be no need to change the fundamental calculation of Excludable Dividend Account. Instead, because it appears that any potential negative effects would be due solely to the change in capital gains basis and potential additional capital gains taxes, any remedy should be aimed at that issue. The problem would be largely ameliorated by allowing the capital gains tax basis to be increased either by the amount of the LIHTC tax credit or the amount of the LIHTC investment expensed by the investor, or lowering capital gains tax rates.

Conclusion

While it appears that the relative benefits of LIHTC investments may decline for some investors under the administration's proposal, it is unclear what the effect on LIHTC prices might be. Given that the effect of the proposal on shareholder returns is limited to the changes in capital gains basis, the proposal may have limited effect. Indeed, not enacting the plan may have a greater effect on LIHTC pricing if the demand for LIHTC investments declines with lower corporate profits.

In any event, any potential impact on LIHTCs is not a reason to oppose the growth plan but, if necessary, to seek changes to limit any negative effects. It appears that adjusting the capital gains basis to reflect LIHTC investments would be sufficient to offset the capital gains impacts on relative shareholder returns.

EXHIBIT 1

LIHTC Benefits Under Current Law

	Without LIHTC investment	With LIHTC investment	Marginal Benefit of LIHTC
At Corporate Level:			
Net Income	100,000	100,000	0
LIHTC cost	0	1,000	1,000
Taxable Income	100,000	99,000	(1,000)
Corp Inc. Tax before LIHTC	28,000	27,720	(280)
LIHTC Credit	0	1,087	1,087
Corp. Inc. Tax After LIHTC	28,000	26,633	(1,367)
Net after tax earnings	72,000	72,367	367
At Shareholder Level:			
memo: Excludable Dividend Amount	0	0	0
Dividends received:	34,200	34,374	174
Shareholder taxable dividends	34,200	34,374	174
Shareholder dividend tax	11,970	12,031	61
Shareholder after-tax dividends	22,230	22,343	113
Capital gains change from retained earnings	37,800	37,993	193
Retained earnings benefit adjustment	0	0	0
Taxable capital gains	37,800	37,993	193
Future capital gains tax	3,780	3,799	19
Shareholder after-tax capital gains	34,020	34,193	173
After-tax return to shareholders	56,250	56,537	287

Assumptions:	
Corporate Marginal Tax Rate:	35%
Corporate Effective Tax rate:	28%
LIHTC Annual Yield	8%
Dividend payout ratio	48%
Individual income tax rate	35%
Individual capital gains tax rate:	10%

EXHIBIT 2
LIHTC Benefits Under Proposed Law

	Without LIHTC investment	With LIHTC investment	Marginal Benefit of LIHTC
At Corporate Level:			
Net Income	100,000	100,000	0
LIHTC cost	0	1,000	1,000
Taxable Income	100,000	99,000	(1,000)
Corp Inc. Tax before LIHTC	28,000	27,720	(280)
LIHTC Credit	0	1,087	1,087
Corp. Inc. Tax After LIHTC	28,000	26,633	(1,367)
Net after tax earnings	72,000	72,367	367
At Shareholder Level:			
memo: Excludable Dividend Amount	52,000	49,461	(2,539)
Dividends received:	34,200	34,374	174
Shareholder taxable dividends	0	0	0
Shareholder dividend tax	0	0	0
Shareholder after-tax dividends	34,200	34,374	174
Capital gains change from retained earning	37,800	37,993	193
Retained earnings benefit adjustment	17,800	15,087	(2,713)
Taxable capital gains	20,000	22,906	2,906
Future capital gains tax	2,000	2,291	291
Shareholder after-tax capital gains	35,800	35,702	(98)
After-tax return to shareholders	70,000	70,076	76

Assumptions:	
Corporate Marginal Tax Rate:	35%
Corporate Effective Tax rate:	28%
LIHTC Annual Yield	8%
Dividend payout ratio	48%
Individual income tax rate	35%
Individual capital gains tax rate:	10%

EXHIBIT 3

Comparative Gains under Proposed Law

	Without LIHTC, Current Law	Without LIHTC, Proposed Law	Gains	With LIHTC, Current Law	With LIHTC, Proposed Law	Gains
At Corporate Level:						
Net Income	100,000	100,000	0	100,000	100,000	0
LIHTC cost	0	0	0	1,000	1,000	0
Taxable Income	100,000	100,000	0	99,000	99,000	0
Corp Inc. Tax before LIHTC	28,000	28,000	0	27,720	27,720	0
LIHTC Credit	0	0	0	1,087	1,087	0
Corp. Inc. Tax After LIHTC	28,000	28,000	0	26,633	26,633	0
Net after tax earnings	72,000	72,000	0	72,367	72,367	0
At Shareholder Level:						
memo: Excludable Dividend Amount	0	52,000	52,000	0	49,461	49,461
Dividends received:	34,200	34,200	0	34,374	34,374	0
Shareholder taxable dividends	34,200	0	(34,200)	34,374	0	(34,374)
Shareholder dividend tax	11,970	0	(11,970)	12,031	0	(12,031)
Shareholder after-tax dividends	22,230	34,200	11,970	22,343	34,374	12,031
Capital gains change from retained earning	37,800	37,800	0	37,993	37,993	0
Retained earnings benefit adjustment	0	17,800	17,800	0	15,087	15,087
Taxable capital gains	37,800	20,000	(17,800)	37,993	22,906	(15,087)
Future capital gains tax	3,780	2,000	(1,780)	3,799	2,291	(1,509)
Shareholder after-tax capital gains	34,020	35,800	1,780	34,193	35,702	1,509
After-tax return to shareholders	56,250	70,000	13,750	56,537	70,076	13,540
Percentage increase:			24%			24%

Assumptions:	
Corporate Marginal Tax Rate:	35%
Corporate Effective Tax rate:	28%
LIHTC Annual Yield	8%
Dividend payout ratio	48%
Individual income tax rate	35%
Individual capital gains tax rate:	10%

President's Jobs and Economic Growth Plan
The Benefits of Ending the Double Tax on Dividends

President Bush's proposal to eliminate the double tax penalty on dividends is based on a fair and simple idea: Tax corporate income once – and only once. This would make the tax code fairer to shareholders and encourage new capital investment and good corporate governance.

More Jobs

- The President's Council of Economic Advisers (CEA) estimates that this provision will help create 431,000 new jobs by the end of 2004.

Higher Wages

- According to the CEA, the President's plan would reduce the cost of capital investments in equipment by more than 10%. For investment in structures (i.e. plants and equipment) – the weakest part of the economy today – the cost of corporate equity capital would be cut by more than one-third. This reduction will encourage higher levels of corporate investment and capital accumulation, resulting in greater productivity increases and, therefore, higher wages for workers.

Tax Relief – Especially for Seniors

- The effective dividend income tax is as much as 60%, leaving investors with as little as 40 cents of every dollar.
- Within a year of its enactment, the President's proposal would put $20 billion into American pockets that can be spent or reinvested – and investors would know they could count on similar cash flows in the future.
- 26 million taxpayers with dividend income would receive an average tax cut of $704.
- More than half of taxable dividends go to America's seniors.
- More than 9 million seniors would receive an average of $991 in tax relief in 2003.

Positive Impact on the Stock Market

- The CEA predicts eliminating the double taxation of corporate earnings will result in a decrease in corporate debt relative to equity, thereby reducing corporate bankruptcies and capital market instability.
- Studies indicate ending the double taxation of dividends could raise stock values by 10% or more.
- In an $11 trillion dollar stock market, most of which is held by households, directly or through their pension plans, that means upwards of $1 trillion in new wealth.

Corporate Governance

- Under the President's plan, corporate reporting will become more transparent.
- Dividends send a concrete signal to investors of a company's financial health and the credibility of its earnings claims.
- Eliminating the double taxation of corporate earnings will result in a decrease in corporate debt relative to corporate equity. Corporations with less debt are better positioned to survive economic downturns.
- Eliminating double taxation of corporate earnings would improve corporate governance by reducing the incentive for bad actors to misinform investors, increase transparency in corporate accounting, and discourage some of the aggressive corporate tax strategies that have raised concerns in the past.

International Competition

- In recent years, concerns have been raised that U.S. corporations are moving their headquarters to lower-tax countries to reduce their overall tax liability. The President's plan reduces the incentive for U.S. companies to move overseas.
- This puts us on a more equal footing with our biggest trading partners. Most of them provide some relief from the double tax on corporate earnings, so the U.S is now at a disadvantage.

Sources: White House, Treasury, et. al.

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January 21, 2003

Mr. John J. Castellani
President, The Business Roundtable
1615 L Street, NW
Suite 1100
Washington, DC 20036

Dear John:

We have completed research requested by The Business Roundtable regarding national impacts of the Administration's proposal for economic growth. The results are summarized in this communication, which has three attachments.

Our research relates to the six items in the Administration's proposal that involve components of the individual income tax—specifically, marginal tax rates, the 10-percent rate bracket, the AMT exemption, the marriage penalty, the child credit, and exclusion of dividends. These components account for 97 percent of the proposed static effect on the federal budget deficit, according to the Treasury Department's estimates.

We began by estimating the static revenue loss of the program (official, year-by-year estimates from Treasury and the Joint Committee on Taxation are not available at this writing). The static estimates were then fed into a fully elaborated and well-established macroeconomic model—the Inforum LIFT model—that has been maintained by a not-for-profit economic research corporation housed at the University of Maryland for 35 years. After calibrating the Inforum LIFT model to overlay the CBO baseline of August 2002, we entered the Administration's proposed items (incorporating the three assumptions noted below) and let the model do the work without our intervention.

The results are forecasts of how the Administration's proposal would affect the economy and the federal budget. You will find federal budget estimates at Table 2, macroeconomic impacts of the entire proposal at Table 1, and macroeconomic impacts of parts of the proposal at Tables 1a-1c.

As is evident from the tables, the Inforum LIFT model indicates that the Administration's program would be stimulative in the short run and growth-enhancing in the long run. The short-run impacts are a combination of all proposed items and the long-run impacts are due mainly to the proposed exclusion of dividends. The proposal would increase the number of

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civilian jobs by an average of 1.2 million per year during the first five years and an average of 0.9 million per year for the 10-year forecasting period. The proposal would add $738 billion of new income to the economy during the first five years and $1,561 billion during the first 10 years. Because of the stimulus it would impart, the proposal would increase the federal deficit, including the additional interest expense, by just two-thirds of the static revenue loss.

It was necessary to make assumptions about a few things:

First, we assume that the proposed items will expire after 2010, except for the proposed exclusion of dividends. These items originated in the 2001 Tax Act, which is scheduled to expire after 2010.

Second, we assume that the proposal is enacted and ready for implementation on July 1, 2003. The Administration indicates that new withholding tables would be constructed as if tax cuts were effective near the enactment date and that checks would be issued promptly for child credits. Thus, we assume that the percentage of benefit for calendar 2003 that is realized in calendar 2003 is 100 percent for the child credit; 50 percent for reduced marginal income tax rates and a wider 10-percent rate bracket; 25 percent for marriage penalty relief and excluded dividends; and zero for the AMT fix. These assumptions imply that individuals would have a $49 billion cash benefit during 2003, receiving the balance of the benefit for 2003 in 2004.

Third, we adopt the Treasury Department's prediction that the proposed exclusion of dividends would increase the dividend payout rate by four percentage points, with a two-percentage-point increase beginning in 2004 and an additional two-percentage-point increase beginning in 2005. As is well known, the double tax on corporate earnings is currently greater for dividends (taxed as ordinary income at the individual level) than retained earnings (taxed as capital gain at the individual level). According to economic studies discussed at Treasury's 1992 report ("Integration of The Individual and Corporate Tax Systems"), greater payouts of dividends occur when the tax burden on dividends relative to capital gains decreases, and the Administration's proposal would shift the relative tax burden in that manner.

This summary covers a lot of ground. Let's discuss any questions or comments.

Yours truly,

Kenneth L. Wertz

Enclosures

Table 1
Analysis of President's Economic Stimulus Proposal: All Provisions Combined
Changes to U.S. Economy

Calendar Year	Actual	Forecast										Totals/Averages	
	2001	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2003-07	2003-12
Nominal GDP ($billions)	10,082	76	281	200	91	90	125	167	176	176	179	738	1,561
Unemployment rate (percentage points)	6.0*	-0.6	-2.0	-1.2	-0.2	-0.1	-0.3	-0.5	-0.5	-0.4	-0.4	-0.8	-0.6
Total civilian employment (millions)	134.0*	0.8	2.9	1.8	0.3	0.1	0.5	0.8	0.8	0.7	0.7	1.2	0.9

* for December 2002 (Department of Labor, Bureau of Labor Statistics)

Source: PricewaterhouseCoopers LLP and Inforum.

Analysis of President's Economic Stimulus Proposal: Changes to U.S. Economy

Table 1a: Rate and 10% Bracket Adjustment and AMT Hold-Harmless

	Actual	Forecast										Totals/Averages	
Calendar Year	2001	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2003-07	2003-12
Nominal GDP ($billions)	10,082	27	78	63	14	5	15	28	30	8	0	187	267
Unemployment rate (percentage points)	6.0*	-0.2	-0.6	-0.4	0.0	0.1	0.0	-0.1	-0.1	0.0	0.0	-0.2	-0.1
Total civilian employment (millions)	134.0*	0.3	0.8	0.6	0.0	-0.1	0.0	0.2	0.2	0.0	0.0	0.3	0.2

Table 1b: Marriage Penalty Relief and Child Tax Credit Increase

	Actual	Forecast										Totals/Averages	
Calendar Year	2001	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2003-07	2003-12
Nominal GDP ($billions)	10,082	27	83	44	22	19	21	27	19	6	2	195	270
Unemployment rate (percentage points)	6.0*	-0.2	-0.6	-0.3	-0.1	0.0	-0.1	-0.1	-0.1	0.0	0.0	-0.2	-0.1
Total civilian employment (millions)	134.0*	0.3	0.9	0.4	0.1	0.0	0.1	0.1	0.1	0.0	0.0	0.3	0.2

Table 1c: Dividend Exemption

	Actual	Forecast										Totals/Averages	
Calendar Year	2001	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2003-07	2003-12
Nominal GDP ($billions)	10,082	9	85	86	77	82	94	121	139	161	171	339	1,026
Unemployment rate (percentage points)	6.0*	-0.1	-0.6	-0.5	-0.4	-0.3	-0.3	-0.4	-0.4	-0.5	-0.5	-0.4	-0.4
Total civilian employment (millions)	134.0*	0.1	0.9	0.8	0.5	0.4	0.4	0.6	0.6	0.7	0.7	0.5	0.6

* for December 2002 (Department of Labor, Bureau of Labor Statistics)

Source: PricewaterhouseCoopers LLP and Inforum.

Table 2
Analysis of President's Economic Stimulus Proposal:
Changes to Federal Budget
[Changes in $billions]

	Forecast										Total	
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2003-07	2003-12
Calendar Year*												
Static Revenue Effect												
10% Bracket, Rate Cut, AMT fix	-21	-59	-42	-8	-8	-9	-8	-8	0	0	-138	-162
Marriage Penalty and Child Tax Credit	-22	-62	-24	-18	-15	-13	-8	0	0	0	-140	-161
Dividend Exemption	-7	-47	-30	-31	-33	-36	-39	-42	-48	-52	-148	-364
Total	-49	-169	-95	-56	-56	-57	-55	-49	-48	-52	-425	-687
Net Budget Deficit Impact												
10% Bracket, Rate Cut, AMT fix	-14	-37	-28	-13	-15	-12	-6	-5	-4	-6	-106	-139
Marriage Penalty and Child Tax Credit	-14	-39	-18	-20	-19	-14	-7	-1	-5	-5	-109	-141
Dividend Exemption	-4	-20	-6	-14	-19	-20	-17	-17	-20	-24	-64	-162
All combined	-25	-87	-53	-58	-60	-48	-33	-29	-30	-35	-283	-458
Fiscal Year**												
Static Revenue Effect												
10% Bracket, Rate Cut, AMT fix	-14	-46	-48	-19	-8	-8	-8	-8	-3	0	-135	-162
Marriage Penalty and Child Tax Credit	-14	-48	-37	-20	-16	-14	-10	-3	0	0	-135	-161
Dividend Exemption	-4	-33	-36	-30	-32	-35	-38	-41	-46	-51	-136	-346
Total	-32	-127	-121	-70	-56	-57	-56	-51	-49	-51	-406	-669
Net Budget Impact												
10% Bracket, Rate Cut, AMT fix	-9	-29	-31	-18	-14	-13	-8	-5	-4	-6	-101	-137
Marriage Penalty and Child Tax Credit	-9	-30	-25	-19	-19	-16	-9	-3	-4	-5	-102	-139
Dividend Exemption	-3	-14	-11	-11	-18	-20	-18	-17	-19	-23	-57	-154
All combined	-16	-65	-65	-56	-59	-52	-39	-30	-30	-34	-262	-446

* Assumes that 7/1/03 is the date of enactment. Assumes, therefore, that the percentage of benefit for calendar year 2003 that is realized in 2003 is 50% for the 10% bracket expansion, 50% for lower income tax rates, 25% for marriage penalty relief, 100% for the child tax credit increase, 25% for the dividend exclusion, and 0% for the AMT fix.

** Fiscal year estimates assume a 65-35 split between the current and following fiscal years.

Source: PricewaterhouseCoopers LLP and Inforum.

REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES, AND POLICY RECOMMENDATIONS

VOLUME I: REPORT

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

At the Request of
Senator Max Baucus
and
Senator Charles E. Grassley
of the
SENATE COMMITTEE ON FINANCE

February 2003

JCS-3-03

C. Tiered Preferred Securities

1. Brief overview

Between 1993 and 1997, Enron raised over $800 million through the issuance of hybrid financial instruments that combined characteristics of both indebtedness and equity ("tiered preferred securities"). By synthesizing these characteristics into a single financial instrument, Enron was able to report the financing as indebtedness for Federal income tax purposes, while reporting the same financing as a minority ownership interest on its financial statements. Consequently, these transactions enabled Enron to deduct the yield on its financings as interest expense for tax purposes without increasing the amount of liabilities reported in financial statements. Although the individual transactions varied in their details, they shared several common elements, primarily the issuance of securities by a special purpose entity to public or private investors and the transfer of the proceeds from such issuance to Enron in the form of a loan.

2. Background

Reported tax and financial statement effects

With regard to its tiered preferred securities, Enron took the position for Federal income tax purposes that it had issued a debt instrument to the special purpose entity, which Enron treated as a separate entity that was not part of the Enron consolidated group. Accordingly, Enron claimed interest expense deductions of the yield payments on the purported debt instrument.

For financial reporting purposes, Enron disregarded the purported debt instrument because the special purpose entity was consolidated with Enron on its financial statements.[887] Instead, Enron reported the preferred securities as though Enron had issued the preferred securities directly to the outside investors (rather than through the special purpose entity). These securities received equity credit from rating agencies because the borrowing by Enron from the special purpose entity that supported the preferred securities exhibited certain equity characteristics, including a long-term maturity, deep subordination, and an option for Enron to defer the payment of interest for the first several months (or years) that the borrowing was outstanding. Thus, Enron denominated the preferred securities as mezzanine equity, rather than indebtedness, on its balance sheet.[888] Enron reported yield payments to the holders of the preferred securities as "Dividends on Preferred Stock of Subsidiary".

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[887] As amended by Statement of Financial Accounting Standards No. 94, Accounting Research Bulletin No. 51, requires companies to consolidate majority owned subsidiaries unless control of the subsidiary is likely to be temporary, or the majority owner does not actually control the subsidiary. Because of the common ownership interest retained by the ultimate borrower, special purpose entities that issue tiered preferred securities generally satisfy the financial accounting requirements for consolidation with the borrower.

[888] Specifically, Enron's financial statement balance sheets referred to the tiered preferred securities as "Preferred Stock of Subsidiary" in 1993 and 1994, and thereafter have

Development of tiered preferred securities

In 1993, Goldman, Sachs & Co. began marketing a new financial instrument, dubbed monthly income preferred securities ("MIPS"), that was designed to be treated as a debt instrument (with deductible interest payments) for Federal income tax purposes, while simultaneously providing equity treatment for financial reporting and rating agency purposes.[889] Other investment banks subsequently marketed their own version of MIPS, such as trust originated preferred securities ("TOPrS") introduced by Merrill Lynch.[890] Whereas the special purpose entity involved in MIPS is characterized as a partnership for Federal income tax purposes, the special purpose entity involved in TOPrS is characterized as a grantor trust.[891] Regardless of the particular classification of the special purpose entity, the common feature of these transactions in this respect is that the special purpose entity is not classified as a taxable corporation under the entity classification rules.

In general, these financial instruments involve the creation of a special purpose entity by the ultimate borrower.[892] The special purpose entity is treated as a separate entity from the

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referred to the securities as "Company-Obligated Preferred Securities of Subsidiaries". This is consistent with the guidance provided in SEC Regulation S-X, Article 5, Rule 5-02.27.

[889] The issuance of debt instruments containing certain features that are characteristic of equity, such as subordination and deferred interest arrangements, allows borrowers to obtain capital with less impact on their credit rating than straight debt financing because such instruments receive "equity credit" from rating agencies. In addition, the Federal Reserve Board has stated that certain tiered preferred securities can qualify as Tier 1 equity capital for banks. *See* Federal Reserve Press Release, Oct. 21, 1996 ("To be eligible as Tier 1 capital, such instruments must provide for a minimum five-year consecutive deferral period on distributions to preferred shareholders. In addition, the intercompany loan must be subordinated to all subordinated debt and have the longest feasible maturity."); *Capital Briefs--Rule on Cumulative Preferred Stock Eased*, American Banker, Oct. 22, 1996; Padgett, *Surge of New Issues Seen as Fed Approves Use of Hybrid Security*, American Banker, Oct. 24, 1996.

[890] Goldman Sachs also began marketing a variation on MIPS, called quarterly income preferred securities ("QUIPS"), which differ materially from MIPS only in that payments on QUIPS are made quarterly instead of monthly. *See, e.g.*, BFGoodrich Capital 83% Cumulative Quarterly Income Preferred Securities (June 30, 1995).

[891] By using a grantor trust rather than a tax partnership as the special purpose entity, TOPrS significantly reduce the SEC reporting burdens associated with the securities. *See* John C. Reid, *MIPS Besieged--Solutions in Search of a Problem*, 76 Tax Notes 1057, 1058 (Dec. 1, 1997).

[892] Special purpose entities involved in earlier transactions usually were formed offshore. However, with the enactment of limited liability company laws in several States and the issuance by the SEC of "no action" letters exempting the entities from registration under the Investment Company Act of 1940, special purpose entities involved in more recent transactions have been formed as domestic pass-through entities.

borrower for tax purposes, but is not itself subject to tax. For financial reporting purposes, the special purpose entity is disregarded as separate from the borrower because it is consolidated with the borrower. In general, the special purpose entity issues its voting securities (with a nominal value) to the borrower, and issues nonvoting preferred securities to investors. The special purpose entity then lends the proceeds from the preferred securities issuance (along with any cash contributed by the borrower) to the borrower in exchange for a long-term (typically, 30-year) debt instrument. Distributions on the preferred securities closely correspond to the interest payments on the debt instrument issued to the entity by the borrower. When the loan from the special purpose entity to the borrower ultimately matures, the special purpose entity redeems the MIPS for cash.

For tax purposes, the debt instrument issued to the special purpose entity by the ultimate borrower is respected because the entity is treated as separate from the borrower. Thus, the borrower claims interest deductions on the debt instrument. For financial reporting purposes, the debt instrument is disregarded because the special purpose entity is not treated as separate from the borrower. Instead, the borrower is considered to have issued preferred securities directly to the investors. As mentioned earlier, these securities receive equity credit from rating agencies because the debt instrument issued by the borrower that supports the securities is long term, deeply subordinated, and provides the borrower an option to defer the payment of interest for an extended period of time (typically, the first five years) during which the debt instrument is outstanding. Thus, the preferred securities tend to be denominated as mezzanine equity, rather than indebtedness, on the financial statements of the borrower.

Issuance of Enron tiered preferred securities

As indicated, Enron raised over $800 million through several issuances of tiered preferred securities, including MIPS, TOPrS, and adjustable-rate trust securities ("ACTS").[893] In general, the ACTS were substantially similar to TOPrS, except that ACTS provided for a variable (rather than fixed) yield.

Table 2 on the next page summarizes the tiered preferred securities that Enron entered into between 1993 and 1997.

[893] *See, e.g.*, Minutes, Meeting of the Board of Directors, Enron Corp., December 10, 1996 at 5-6 (approving the 1996 Enron TOPrS issuance), EC 000045039 through EC 000045067; Minutes, Meeting of the Executive Committee of the Board of Directors, Enron Corp., December 18, 1996 (approving proposed resolution authorizing 1997 Enron TOPrS issuance), EC 000045073 through EC 000045079; Minutes, Meeting of the Executive Committee of the Board of Directors, Enron Corp., June 5, 1997 (approving proposed resolution authorizing 1997 ACTS issuance). EC 000045650 through EC 000045655. The structured financing materials in Appendix B contain these minutes.

Table 2.–Enron Tiered Preferred Securities Issuances

Issuance	Year of issuance	Proceeds of issuance (millions of dollars)[1]	Stated yield (percent)	Initial term to maturity[2] (years)	Extended term to maturity[3] (years)	Interest payment deferral period (months)
MIPS	1993	$200	8.00	50	50	18
MIPS[4]	1994	75	9.00	30	19	60
TOPrS	1996	200	8.30	20	n/a	18
TOPrS	1997	150	8.125	20	n/a	18
ACTS	1997	200	Variable[5]	49	n/a	60

__Notes__:

1 Amount of proceeds is based upon the amount indicated in the prospectus of each issuance. Actual amount of proceeds from each issuance may differ somewhat from the amount indicated due to over-allotments.

2 Based upon the loan from the special purpose entity (e.g., Enron Capital LLC) to Enron.

3 Based upon the loan from the special purpose entity (e.g., Enron Capital LLC) to Enron, not including the initial term to maturity.

4 This issuance was not formally an issuance of MIPS because the lead underwriter was Merrill Lynch & Co., not Goldman, Sachs & Co. However, this issuance was substantially similar to a MIPS issuance. Thus, this issuance is referred to as MIPS only for purposes of convenience.

5 The ACTS issuance provided for yield payments at an initial rate of 5.813 percent through September 5, 1997, with subsequent quarterly resets of the yield based upon a Dutch auction process to obtain a yield reflective of current market conditions.

1993 Enron MIPS

On September 27, 1993, Enron convened a special meeting of its Board of Directors primarily for the purpose of hearing a management presentation concerning the issuance of perpetual preferred stock.[894] In its presentation, management stated that Enron would continue to require cash infusions because of its ongoing growth and expansion. However, management also indicated that maintaining Enron's credit quality was a high priority. Management then presented two options that had been proposed to Enron: (1) issuance of standard perpetual preferred stock underwritten by Merrill Lynch & Co.; and (2) issuance of tax deductible perpetual preferred stock underwritten by Goldman, Sachs & Co. According to management, Arthur Andersen & Co. had indicated to Enron that neither option would be treated as indebtedness for financial accounting purposes. In addition, the credit rating agencies had indicated that they would reach the same conclusion. Management also said that the law firm Sullivan & Cromwell had issued a letter confirming the tax deductibility of the option proposed by Goldman, Sachs & Co., but noting that future tax law changes could negate deductibility. Based upon the presentation by management, the Board adopted a resolution that authorized the registration, issuance and sale of up to $250 million of either standard or tax deductible perpetual preferred stock, and authorized the appointment of a special preferred stock committee to determine the terms of the issuance.

On October 12, 1993, the Finance Committee of the Enron Board of Directors met to discuss further the issuance of perpetual preferred stock by Enron.[895] At this meeting, management indicated to the committee that the "determination of the question of whether or not the preferred stock offering would be tax deductible was key to management's decision to proceed."[896] The committee concluded its consideration of perpetual preferred stock by agreeing to recommend that the Board restate its previous resolution and authorize the registration, issuance and sale of: (1) up to $575 million of perpetual preferred stock if the yield on the stock was determined to be tax deductible and the credit rating agencies would treat the stock as equity for debt rating purposes; or (2) up to $350 million of perpetual preferred stock if the yield on the stock was not determined to be tax deductible.[897]

On October 13, 1993, the Enron Board of Directors heard the recommendation of the Finance Committee and approved a resolution authorizing a shelf registration of fixed rate

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[894] Minutes, Special Meeting of the Board of Directors, Enron Corp., September 27, 1993 at 1. EC2 000055435 through EC2 000055450. The structured financing materials in Appendix B contain these minutes.

[895] Minutes, Meeting of the Finance Committee of the Board of Directors, Enron Corp., October 12, 1993. EC2 000055452 through EC2 000055456. The structured financing materials in Appendix B contain these minutes.

[896] *Id.* at 2.

[897] *Id.*

perpetual preferred stock in the amount of either $575 million (if tax deductible and rated as equity) or $350 million (if not tax deductible).[898]

Pursuant to the resolution, Enron formed Enron Capital LLC under the law of Turks and Caicos Islands for the sole purpose of issuing shares and lending the net proceeds to Enron.[899] Enron acquired the common shares of Enron Capital LLC for approximately $53.165 million.[900]

In November 1993, Enron Capital LLC authorized the issuance of $9.2 million shares of cumulative guaranteed MIPS with a cumulative preferred dividend rate of 8 percent ("1993 MIPS").[901] The MIPS became redeemable (at the option of Enron Capital LLC) on or after November 30, 1998, at a redemption price of $25.00 per share plus accumulated and unpaid dividends. Following the issuance of the shares and as part of the prearranged transaction, Enron Capital LLC loaned to Enron both the $53.165 million proceeds from the issuance of its common shares to Enron, and the $200 million proceeds from the sale of the MIPS, for an aggregate principal amount of $253.165 million.[902] The loan from Enron Capital LLC to Enron provided a stated interest rate of 8 percent until maturity, payable on the last day of each calendar month of each year beginning on November 30, 1993.[903]

Under the terms of the loan from Enron Capital LLC to Enron, Enron was permitted to defer payment of the monthly interest up to 18 months (provided Enron was not in default on the loan), during which time Enron would not be permitted to declare dividends on any of its capital stock. During any such period of interest payment deferment, Enron Capital LLC would continue to accrue the interest income being deferred, and the deferred interest income would be allocated (but not distributed) to the holders of the MIPS.[904]

The loan provided a maturity date of November 30, 2043 for repayment of the entire principal amount, together with any accrued and unpaid interest, or on any earlier date if Enron

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[898] Minutes, Meeting of the Board of Directors, Enron Corp., October 13, 1993. The structured financing materials in Appendix B contain these minutes.

[899] Prospectus Supplement, Enron Capital LLC 8% Cumulative Guaranteed Monthly Income Preferred Shares (Nov. 4, 1993) at S-6 [hereinafter "1993 Prospectus"].

[900] 1993 Prospectus at S-14.

[901] Terms of the 8% Cumulative Guaranteed Monthly Income Preferred Shares of Enron Capital LLC (Nov. 4, 1993) at 1. Of the total authorized MIPS, Enron Capital LLC issued 8,000,000 shares at $25.00 per share, for a total of $200 million. The remaining unissued 1,200,000 shares of MIPS were reserved for the underwriters' over-allotment option. 1993 Prospectus at S-6.

[902] 1993 Prospectus at S-14.

[903] 1993 Prospectus at S-15.

[904] 1993 Prospectus at S-20.

or Enron Capital LLC was dissolved, wound up or liquidated. The loan could not be prepaid prior to November 30, 1998. Upon repayment by Enron, the loan provided that the repaid principal could be reloaned to Enron under certain conditions, with a final maturity date of the new loan not later than the 100th anniversary of the issuance of the MIPS.[905] The loan was subordinate to all present and future senior indebtedness of Enron.

Enron guaranteed the payment of dividends by Enron Capital LLC to the holders of the MIPS. However, the guarantee agreement constituted an unsecured obligation of Enron and ranked: (1) subordinate and junior in right of payment to all liabilities of Enron; (2) *pari passu* with the most senior preferred or preference stock of Enron; and (3) senior to Enron's common stock. In the event of the bankruptcy of Enron (among other events), Enron Capital LLC automatically would dissolve and be liquidated.[906] In the event of the bankruptcy of Enron (among other events), the holders of a majority in liquidation preference of the outstanding MIPS were entitled to appoint and authorize a trustee to enforce the creditor rights of Enron Capital LLC against Enron, and to declare and pay dividends on the MIPS.[907]

Enron evidently used the loan proceeds to repay other indebtedness, and for general corporate purposes.[908] In its filings with the SEC, Enron stated that "the average cost of long-term debt declined to 8.2 percent at December 31, 1993 from 8.9 percent at December 31, 1992. The decline was accomplished primarily through the retirement of additional higher coupon long-term debt which was subject to call provisions during [1993]."[909]

Role of outside advisers

In the case of the 1993 MIPS, Goldman, Sachs & Co. was the lead underwriter, while Merrill Lynch & Co. was the lead underwriter for the 1994 Enron tiered preferred securities and the 1996 and 1997 TOPrS. The lead underwriter for the 1997 ACTS was Deutsche Morgan Grenfell.

For each transaction except the ACTS transaction, Vinson & Elkins LLP provided a tax opinion letter that analyzed the tax implications of the transaction. For the ACTS transaction, Skadden, Arps, Meagher & Flom LLP provided a tax opinion letter that analyzed the tax implications of the transaction.

With regard to the 1993 MIPS, Vinson & Elkins LLP concluded that:

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[905] 1993 Prospectus at S-7. The repaid principal may not be reloaned to Enron if (among other things) Enron is in bankruptcy.

[906] 1993 Prospectus at S-8.

[907] 1993 Prospectus at S-8 to S-9.

[908] 1993 Prospectus at S-5.

[909] 1993 Enron Form 10-K at 32.

(1) the proceeds received by Enron from Enron Capital LLC "should" be classified as loans for Federal income tax purposes;

(2) Enron Capital LLC "would" be treated as a partnership rather than a corporation or taxable mortgage pool for Federal income tax purposes; and

(3) interest paid by Enron on the proceeds received from Enron Capital LLC "would" qualify as portfolio interest within the meaning of section 1441(c)(9) and, thus, Enron "would" not be required to deduct and withhold tax with respect to such interest.[910]

Vinson & Elkins LLP subsequently issued a second tax opinion letter concerning the 1993 MIPS, in which the law firm concluded that:

(1) Enron "would" be liable for any tax that should have been withheld to the extent such tax is not paid by the holders of the Enron Capital LLC preferred shares;

(2) because of the "reasonable cause" exception, Enron "should not" be liable for penalties or additions to tax by reason of any failure to withhold in respect of a payment (of interest) on the proceeds received by Enron from Enron Capital LLC; and

(3) Enron "would" be liable for interest on any tax that should have been withheld during any calendar year, but that such interest "should not" start to accrue until March 15 of the following year and "should" cease to accrue upon payment of the tax against which such withholding tax may be credited by the holders of the preferred shares issued to investors by Enron Capital LLC (which may be as early as April 15 of such following year).[911]

Arthur Andersen provided an accounting opinion letter that analyzed the financial accounting implications of a hypothetical MIPS transaction and concluded that: (1) the special purpose entity issuing the securities (i.e., the MIPS) should be consolidated with the company that formed the entity; and (2) the securities should be reflected in the company's financial statements as minority interests.[912]

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[910] Vinson & Elkins LLP tax opinion letter to Enron, dated November 4, 1993. EC2 000036276 through EC2 000036289. The structured financing materials in Appendix B contain this opinion letter.

[911] Vinson & Elkins LLP tax opinion letter to Robert J. Hermann, Vice President - Tax, Enron, dated December 17, 1993. EC2 000036290 through EC2 000036302. The structured financing materials in Appendix B contain this opinion letter.

[912] Arthur Andersen opinion letter to Goldman Sachs & Co., dated September 13, 1993. With regard to the accounting treatment of the outside investors as minority interests, the opinion letter states that "[w]hile some may argue that where [sic] a subsidiary's only role is to loan funds to others in the consolidated group and the non affiliated stockholders of the subsidiary can

Table 3 summarizes that amounts of fees and expenses that Enron paid in connection with the tiered preferred share issuances:[913]

Table 3.–Enron Tiered Preferred Securities Issuance Fees and Expenses

Issuance	Year of issuance	Lead underwriter	Lead underwriter fees	Other estimated expenses
MIPS	1993	Goldman, Sachs & Co.	$14,390,000	$300,000
MIPS	1994	Merrill Lynch & Co.	$11,800,000	$400,000
TOPrS	1996	Merrill Lynch & Co.	$37,500,000	$400,000
TOPrS	1997	Merrill Lynch & Co.	$22,000,000	$400,000
ACTS	1997	Deutsche Morgan Grenfell	Not available	$200,000

IRS review of Enron tiered preferred shares

Based upon its audit of Enron's tax returns for the 1993 and 1994 tax years, the IRS issued a statutory notice of deficiency, dated March 4, 1998, in which the IRS determined that Enron improperly deducted interest expense relating to the 1993 MIPS and the 1994 MIPS.[914] In response, Enron filed a petition with the Tax Court on April 1, 1998 contesting the deficiency.[915] Enron also requested consideration of the deficiency determination by the Appeals Division of the IRS, and the IRS assigned the case to the Appeals Division on June 17, 1998.

On May 6, 1998, IRS District Counsel (Midstates Region) sent a memorandum to the IRS National Office requesting technical assistance concerning the proper tax treatment of the 1993 MIPS and 1994 MIPS transactions. On August 12, 1998, the IRS National Office responded with a field service advice memorandum in which the National Office addressed three issues: (1) whether the MIPS securities constituted equity, rather than debt, for tax purposes; (2) whether

gain control of [the company's] Board in the event of default on the loan [from the special purpose entity to the company], the non affiliate stockholders of the subsidiary should be treated as creditors in the consolidated financial statements of the [company], this is not practice." The structured financing materials in Appendix B contain this opinion letter.

[913] This information is based upon a review of the prospectus for each issuance and information provided to the Joint Committee staff by Enron. Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003.

[914] The assessment disallowed interest expenses claimed by Enron in the amounts of: (1) $2,137,497 in 1993 with respect to the 1993 MIPS; (2) $21,645,569 in 1994 with respect to the 1993 MIPS; and (3) $3,512,658 in 1994 with respect to the 1994 MIPS.

[915] *Enron Corp. v. Commissioner*, Docket No. 6149-98. The petition also contested several other deficiencies asserted by the IRS for the 1992-1994 audit cycle, all of which were settled shortly after the filing of the petition.

the MIPS transactions overall lacked economic substance; and (3) whether the special purpose entities issuing the MIPS securities should be treated as taxable corporations, rather than partnerships, for tax purposes.[916]

With regard to whether the MIPS constituted debt or equity, the IRS National Office analyzed the issue by applying the debt-equity characterization factors listed in Notice 94-47[917] to the securities, and concluded that "we do not recommend recharacterizing the debt as equity." The National Office acknowledged that its analysis focused on the proper characterization of the loans from the special purpose entities to Enron, rather than the proper characterization of the MIPS securities themselves as debt or equity. However, the National Office stated that, even if the special purpose entities were not respected as partnerships for tax purposes, "the conclusions would not be different, and the [MIPS] instruments would still be properly characterized as debt."

In determining whether the MIPS transactions overall lacked economic substance, the IRS National Office noted that the transactions decreased the average cost of Enron's long-term debt and decreased Enron's debt-to-equity ratio from 1.2:1 to 1:1. Consequently, the National Office concluded that, "[i]n the balance, it appears from the available information that [Enron] entered into the transactions to obtain loans at lower interest rates and at lower costs generally and, therefore the underlying transactions possess economic substance. Thus, the interest deduction should not be disallowed."

With regard to whether the special purpose entities should be treated as taxable corporations, rather than partnerships, for tax purposes, the IRS National Office determined that the entities appeared to have a "reasonable basis" for their classification as partnerships under the entity classification regulations that were in place at the time of the transactions.[918] Therefore, IRS National Office concluded that the partnership treatment of the entities should be respected.

After receiving and reviewing the field service advice memorandum, the Appeals officer assigned to the case drafted an Appeals Transmittal and Case Memorandum. In the memorandum, the Appeals officer voiced strong disagreement with the analysis and conclusions set forth in the field service advice memorandum. Specifically, the Appeals officer indicated his view that the field service advice memorandum should have analyzed the proper characterization of the MIPS securities as debt or equity. In addition, the Appeals officer argued that the field service advice memorandum "addressed what Enron's business purpose (a partner) was for the MIPS transaction but fail[ed] to provide a business purpose for the partnership itself."

Contrary to the conclusion reached in the field service advice memorandum, the Appeals officer argued strenuously that the special purpose entities should not be respected as

[916] The structured financing materials in Appendix B contain the field service advice that the IRS National Office provided to the IRS District Counsel in connection with the 1993 MIPS and 1994 MIPS issued by Enron.

[917] 1994-1 C.B. 357.

[918] *See* Treas. Reg. sec. 301.7701(f)(2).

partnerships on economic substance grounds, and that disregarding these entities as partnerships and treating the MIPS as having been issued directly by Enron would require the MIPS to be characterized as equity, rather than debt, for tax purposes. Finally, the Appeals officer raised a non-tax public policy concern that, in a more general context, would become central to Enron's bankruptcy a few years later:

> Here the taxpayer is admitting that they [sic] are skirting well regulated areas by designing a transaction to avoid the standard investor/creditors warning signals: Too much debt and dilution of their ownership rights.
>
> The taxpayer has designed a transaction that avoids both indicators by becoming debt that comes from equity. That is, this is in the bottom of the debt tier, but it takes its payment source from the top of the dividend class of securities. A bottom feeder if you will. Thus, there appears to be a public policy issue as to whether or not IRS should allow a deduction on a payment that is designed to frustrate some clear combination of GAAP, SEC regulations and regulators, and the regulated debt which is relied on by creditors in indicating too much debt.

Notwithstanding the conclusions reached by the National Office in the field service advice memorandum, the Appeals officer recommended litigating the validity of the interest deductions claimed by Enron in 1993 and 1994 with regard to the MIPS transactions.

On October 20, 1998, representatives from Enron and IRS Appeals met in a conference to discuss the MIPS issue. Notes of the conference taken by the Appeals officer indicate that Enron acknowledged "the MIPS were finely crafted to walk that fine line that does exist between debt and equity," but also argued that the mezzanine treatment of MIPS for financial reporting purposes allowed Enron to raise capital for expansion without eroding its credit rating (because the MIPS were not reported as indebtedness) or earnings per share (because the MIPS were not reported as shareholder equity). Thus, according to Enron, issuing the MIPS served a business purpose that was independent of tax considerations. In a revised version of his Appeals case memorandum, the Appeals officer responded to this point as follows:

> Should the IRS condone this treatment of debt to "fool" both GAAP and SEC reporting where both consider the MIPS as having substantial equity features?
>
> Look at it this way: No debt treatment fools creditors, [n]o equity treatment fools the market investors, the extendibility of the LLC and notes in the years at issue allow gradual conversion to actual equity (it seems to me), the continued drain on cash flow without disclosure to the public seems to set up, in [m]acroeconomic terms, a lot of corporations with debt/equity not displayed on they're [sic] books.
>
> If things turn south and payments are suspended:
>
> (1) A lot of investors will be unhappy
>
> (2) A lot of corporations may be required to make mandatory payments after 18 or so months (in the depths of a recession) which will endanger shareholders rights and

(3) If enough corporations are required to do this it could materially affect the nation[']s economy by reducing corporate capital available for operations.

This entire matter seems to be "leveraging" just like buying stocks on margin or leveraging your way to success... . [I]t works great in good times but in economic recessions it leads to bankruptcy. Potential non-tax shareholder derivative questions present in both years...should be considered in a public policy review by counsel. This is beyond IRS jurisdiction but important public policy implications may be present if the MIPS structure violates the [Enron] Board's duty to its shareholders to maximize shareholder value.

Nevertheless, Enron and the IRS subsequently reached a settlement of the issues concerning the 1993 and 1994 MIPS. In the settlement, the IRS conceded the deductibility of the stated interest payments made by Enron. Specifically, the IRS conceded that: (1) the loan from the special purpose entity to Enron in each transaction constituted indebtedness of Enron for Federal income tax purposes; (2) Enron was entitled to deduct stated interest accrued on such indebtedness; and (3) the special purpose entity was a valid entity that was separate and distinct from Enron for Federal income tax purposes.[919]

Because the settlement of the case (including settlement of the other asserted deficiencies) would result in refunds of overpaid taxes to Enron in excess of $1 million, the IRS referred the settlement to the Joint Committee on Taxation on July 26, 1999 for review as required under the Code.[920] On September 28, 1999, the Joint Committee staff reviewed the settlement and did not raise an objection to it.

The Tax Court approved the settlement on October 1, 1999.[921]

Subsequent developments

Although the offering materials for the tiered preferred securities issued by Enron provided for the dissolution and liquidation of the special purpose entity in the event of the bankruptcy of Enron, the tiered preferred securities remain outstanding except for the securities issued as part of the ACTS transaction.[922] However, the outstanding tiered preferred securities

[919] First Supplemental Stipulation of Settled Issues, *Enron Corp. v. Commissioner*, Docket No. 6149-98, filed Dec. 24, 1998. *See also* Counsel Settlement Memorandum, MIPS Issues, In re: Enron Corporation & Consolidated Subsidiaries, Docket Number 6149-98, approved July 26, 1999. The structured financing materials in Appendix B contain the counsel settlement memorandum.

[920] Sec. 6405, as in effect at the time of the settlement.

[921] Decision, *Enron Corp. v. Commissioner*, Docket No. 6149-98, entered Oct. 1, 1999.

[922] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003. EC2 000055434.

currently trade over the counter for under $1 per share, down significantly from their $25 initial offering price and liquidation preference per share.

3. Discussion

In general

Under present law, taxpayers have significant flexibility in structuring a financial instrument as debt or equity. Frequently, taxpayers may characterize instruments with very similar economic terms selectively either as equity (for example, if the issuer intends to market them to corporate holders that would benefit from a dividends received deduction) or as debt (if the issuer intends to claim a corporate interest deduction or achieve certain other benefits of debt status).

In general, the characterization of a financial instrument as debt can be based on a number of factors, including the presence (or absence) of an enforceable and unconditional promise to pay a specified amount on a specified date,[923] and the length of the term to maturity of an instrument.[924]

Tiered preferred securities

Tiered preferred share transactions such as MIPS and TOPrS have their genesis in the fundamental principle that leverage generally is favored for tax purposes (because of the deductibility of interest and the non-deductibility of dividends) but disfavored for financial accounting purposes (because reported debt tends to depress marginal share price and credit ratings relative to outstanding equity). Thus, companies generally prefer to obtain equity financing for financial accounting purposes, but prefer to obtain debt financing for tax purposes. Because the financial accounting rules for characterizing financing as either debt or equity do not correspond with the tax rules for determining such characterization, companies have taken advantage of opportunities to arbitrage the financial accounting and tax rules in order to achieve

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[923] *See, e.g., John Kelley Co. v. Commissioner*, 326 U.S. 521 (1946); *Estate of Mixon v. United States*, 464 F.2d 394 (5th Cir. 1972); *United States v. Title Guarantee & Trust Co.*, 133 F.2d 990 (6th Cir. 1943).

[924] *See, e.g., Reef Corp. v. Commissioner*, 24 T.C.M. 379 (1965), *aff'd*, 368 F.2d 125 (5th Cir. 1966); *United States v. Snyder Bros. Co.*, 367 F.2d 980 (5th Cir. 1966). Other factors may include (but are not limited to) a fixed maturity or mandatory redemption date, priority over general creditors of the issuer, rights to participate in the management of the issuer (including voting rights), the level of capitalization of the issuer, and the intent of the parties (although this last "factor" arguably is actually the fundamental question that the other factors attempt to answer as to the characterization of a financial instrument). However, the IRS has indicated that the right to receive a sum certain at maturity "is a *sine qua non* of debt treatment under the Code." Field Service Advice 199940007 (June 15, 1999). *See also Gilbert v. Commissioner*, 248 F.2d 399 (2nd Cir. 1957); *Johnson v. Commissioner*, 108 F.2d 104 (8th Cir. 1939). Section 385(b) provides a non-exclusive list of several traditional factors that Treasury regulations might take into account in determining the classification of an interest in a corporation.

an ideal objective--financing that can be reported on financial statements as equity and on tax returns as indebtedness. Tiered preferred shares are the financial instruments with which many companies have accomplished this result.[925]

Absent more definitive guidance concerning the characterization of the tiered preferred securities themselves, it generally has been believed that certain conditions must be satisfied in order for the tax benefits of tiered preferred share transactions to be realized by the ultimate borrower. Specifically, the special purpose entity that is used in such transactions must be respected for tax purposes as an entity separate from the borrower, and the debt instrument issued by the borrower to the entity in exchange for the proceeds from the issuance of preferred securities by the entity must be respected as indebtedness for tax purposes.

Because the special purpose entity issues two separate classes of securities to two different parties (i.e., the voting securities issued to the borrower and the nonvoting preferred securities to the investors), borrowers take the position that the entity cannot be disregarded as separate from the borrower for tax purposes. With regard to whether the debt instrument issued by the borrower to the special purpose entity should be respected as indebtedness for tax purposes, borrowers take the position that the debt characteristics (in particular, the repayment of a sum certain on a fixed maturity date) of the instrument outweighs its equity characteristics (i.e., long term to maturity, subordination, and the option to defer interest payments) and, thus, it should properly be characterized as indebtedness for tax purposes.

In response to the growth of hybrid financial instruments "that combine long maturities (greater than 50 years) with substantial equity characteristics" (including MIPS and other similar securities), the IRS issued Notice 94-47.[926] In the notice, the IRS listed eight factors to be taken into account in determining whether a security constitutes debt or equity for tax purposes:

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[925] The tax benefits of tiered preferred securities can permit companies to offer securities with a higher yield to investors than they might otherwise offer for comparable conventional preferred securities with non-deductible dividend yield payments. For example, General Motors Corporation ("GM") announced a tender offer in June 1997 to exchange certain classes of its outstanding preferred stock for a new issue of TOPrS. In exchange for an outstanding class of preferred stock that yielded a 7.92 percent dividend, GM issued a class of TOPrS that yielded 8.67 percent to tendering shareholders. In exchange for an outstanding class of preferred stock that yielded a 9.12 percent dividend, GM issued a class of TOPrS that yielded 9.87 percent to tendering shareholders. *See* General Motors Amendment No. 4 to Form S-4, filed June 2, 1997. Although the 75 basis point increase in the yield paid to the tendering shareholders of each class of preferred stock reportedly cost GM an additional $2.7 million per year before taxes, the deductibility of the TOPrS yield payments (as opposed to the nondeductible dividends paid on the tendered preferred stock) reportedly provided GM a tax savings of approximately $9 million per year. Interestingly, the rating agencies gave the GM TOPrS the same equity credit rating as they had given to the preferred stock that TOPrS replaced. *See* Lee A. Sheppard, *GM's Tax-Deductible Preferred Exchange Offer*, 75 Tax Notes 1458 (June 16, 1997).

[926] 1994-1 C.B. 357.

(1) whether there is an unconditional promise to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future;

(2) whether holders of the securities possess the right to enforce the payment of principal and interest;

(3) whether the rights of the holders of the securities are subordinate to the rights of general creditors of the issuer;

(4) whether the securities give the holder the right to participate in the management of the issuer of the securities;

(5) whether the issuer of the securities is thinly capitalized;

(6) whether there is identity between holders of the securities and stockholders of the issuer;

(7) the labels placed on the securities by the parties; and

(8) whether the securities are intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial purposes.

In the notice, the IRS warned that it "will scrutinize [instruments that combine both debt and equity characteristics] to determine if their purported status as debt for federal income tax purposes is appropriate." However, the notice did not specifically mention MIPS.

Notice 94-47 did not appear to have any discernible impact on the appetite of taxpayers to obtain financing through the issuance of MIPS. In response, the Treasury Department in 1996 proposed an amendment to section 385(c) that would have required an issuer to treat an instrument as equity if the instrument: (1) has a maximum term of more than 20 years; and (2) is not shown as indebtedness on the separate balance sheet of the issuer. In the case of an instrument with a maximum term of more than 20 years issued to a related party (other than a corporation) that is eliminated in a consolidated balance sheet that includes the issuer and the holder, the proposal would have treated the issuer as having characterized the instrument as equity if the holder or some other related party issues a related instrument that is not shown as indebtedness on the consolidated balance sheet. For this purpose, an instrument would not have been treated as shown as indebtedness on a balance sheet merely because it is described as such in financial statement footnotes or other such narrative disclosures. The proposal would have applied only to corporations that file annual financial statements (or are included in financial statements filed) with the SEC.[927] The proposal generally was interpreted as an effort by the Treasury Department to combat tiered preferred securities such as MIPS and TOPrS.

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[927] *See* Department of the Treasury, *General Explanations of the Administration's Revenue Proposals*, March 1996; Office of Management and Budget, *Budget of the United States Government, Fiscal Year 1997: Analytical Perspectives*, H. Doc. 104-162/Vol. 3, at 35-48; Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 1997 Budget Proposal (Released March 19, 1996)* (JCS-2-96), March 27, 1996 at 65.

In 1997, the Treasury Department again proposed amending section 385(c) to foreclose debt characterization of tiered preferred securities.[928] The 1997 proposal was the same as the 1996 proposal, except that the 20 year term that would have triggered the application of the 1996 proposal was reduced to 15 years in the 1997 proposal. Proponents of this proposal took the view that corporations should not be permitted to characterize a financial instrument as indebtedness for tax purposes but not for financial reporting purposes. Furthermore, the extent to which tiered preferred securities such as MIPS and TOPrS have displaced preferred stock may suggest that the securities are viewed in the marketplace as having features closely similar to those of preferred stock.[929] However, others point out that financial statement characterization has not traditionally governed the characterization of items for tax purposes because the goals of generally accepted accounting principles and income tax rules are often different.[930] Indeed, many believe that the purported characterization of tiered preferred securities as indebtedness by the tax rules--not the characterization of such securities for financial statement purposes as equity--is the correct characterization.[931]

Congress did not enact either version of the Treasury proposal and, in fact, the IRS later issued a 1998 technical advice memorandum concluding that a taxpayer that issued tiered preferred securities (apparently, a MIPS transaction) was entitled to the interest deductions claimed in connection with the securities.[932] Specifically, the IRS applied the factors initially set forth in Notice 94-47 and ruled that: (1) loans made to the taxpayer by a foreign limited liability company ("LLC") that it formed constituted debt (rather than equity) for tax purposes; and (2) in any case, the preferred securities issued by the LLC to fund the loans constituted debt, even if the

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[928] *See* Department of the Treasury, *General Explanations of the Administration's Revenue Proposals*, February 1997; Office of Management and Budget, *Budget of the United States Government, Fiscal Year 1998: Analytical Perspectives*, at 45-60.

[929] Joint Committee on Taxation, *Description and Analysis of Certain Revenue-Raising Provisions Contained in the President's Fiscal Year 1998 Budget Proposal* (JCS-10-97), April 16, 1997 at 7.

[930] *Id.*

[931] *See, e.g.*, John C. Reid, *MIPS Besieged--Solutions in Search of a Problem*, 76 Tax Notes 1057, 1068 (Dec. 1, 1997) ("In an all-or-nothing world of the tax law, where an instrument must be debt or equity, MIPS must come down on the debt side of the scale. If an error has been committed in analyzing MIPS, it was committed by the rating agencies, not the tax lawyers."); Victor Fleischer, *Enron's Dirty Tax Secret: Waiting For the Other Shoe to Drop*, 94 Tax Notes 1045, 1046 (Feb. 25, 2002) ("It's never easy to draw a coherent line between debt and equity, but most people agree that the IRS was right to concede, and that MIPS should be treated as debt."). However, Mr. Fleischer also observes that, during the bankruptcy of Enron, the Enron MIPS have been trading significantly lower than Enron traditional debt. Consequently, "now that Enron is in trouble, the deep subordination of MIPS means that the market is treating MIPS more like common stock than debt." *Id.*

[932] Priv. Ltr. Rul. 199910046 (Nov. 16, 1998).

transaction was recast or the separate existence of the LLC was disregarded for tax purposes such that the preferred securities were treated as having been issued directly by the corporation.

The IRS also concluded that the LLC's issuance of the preferred securities and the subsequent loans to the corporation had economic substance because the transaction served non-tax business purposes, including: (1) the provision of funds for working capital and general corporate purposes, including the repayment of outstanding indebtedness; (2) a reduction in the corporation's overall cost of capital; and (3) a reduction in the corporation's debt/equity ratio. In spite of the statutory requirement that partnerships must be formed for the purpose of sharing business profits,[933] the tax transparency of the LLC (which the taxpayer treated as a partnership for tax purposes) apparently did not particularly concern the IRS, which stated:

> The fact that LLC earns no profit on the issuance of the Preferred Securities and the subsequent loans made to Corporation A does not imply the transactions lack economic substance. Although LLC is a "tax-transparent" investment vehicle that acts to pass through the interest earned on the loans to the Preferred Securities holders, the underlying transactions have economic substance.

The remarkable evolution in the reaction of the IRS and the Treasury Department to tiered preferred securities such as MIPS and TOPrS highlights the longstanding and pervasive tax policy dilemma of distinguishing between debt and equity--a problem that one Supreme Court justice presciently identified almost sixty years ago:

> Tax liability should depend upon the subtle refinement of corporate finance no more than it does upon the niceties of conveyancing. Sheer technicalities should have no more weight to control federal tax consequences in one instance than in the other. The taxing statute draws the line broadly between "interest" and "dividend". This requires one who would claim the interest deduction to bring himself clearly within the class for which it was intended. That is not done when the usual signposts between bonds and stock are so obliterated that they become invisible or point equally in both directions at the same time.
>
> Dividend" and "interest," "stock" and "bond," "debenture" or "note," are correlative and clearly identifiable conceptions in their simple and more traditional exemplifications. But their distinguishing features vanish when astute manipulations of the broad permissions of modern incorporation acts results in a "security device" which is in truth neither stock nor bond, but the half-breed offspring of both. At times only the label enables one to ascertain what the manipulator intended to bring forth. But intention clarified by label alone is not always legally effective for the purpose in mind. And there is scarcely any limit to the extent or variety to which this kind of intermingling of the traditional features of stock and bonds or other forms of debt may go, as the books abundantly testify. The taxpayer should show more than a label or a hybrid

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[933] Sec. 761(a).

security to escape his liability. He should show at the least a substantial preponderance of facts pointing to "interest" rather than "dividends."[934]

The either/or approach taken by the present-law tax rules (i.e., a financial instrument generally must be characterized in its entirety as either equity or indebtedness) is a principal contributor to the difficulties that have long plagued the tax rules concerning the characterization of financial instruments.[935] This rigidity in the tax rules stands in contrast to the analysis of financial instruments undertaken by credit rating agencies, which employs a more flexible scaled approach that can accommodate and give recognition to the presence of both equity and debt characteristics in the same instrument.[936]

With regard to companies that choose to finance their activities with tiered preferred securities rather than traditional indebtedness (or, as in Enron's case, replace existing indebtedness with newly issued tiered preferred securities), it may be argued that such securities do not raise tax policy issues surrounding the distinction between debt and equity,[937] at least to the extent that questions of corporate governance do not fall within the purview of tax policy. On the other hand, it may be the case that companies more commonly have used tiered preferred securities to largely supplant preferred stock (rather than debt) financing, which more directly implicates tax policy concerns to the extent that the tax rules influence the behavior of corporate taxpayers and the financial markets.[938]

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[934] *John Kelley Co. v. Commissioner*, 326 U.S. 521, 534-35 (1945) (Rutledge, J., dissenting) (citations omitted).

[935] Although section 385(a) permits Treasury to issue regulations that characterize certain interests in a corporation as "in part stock and in part indebtedness," no such regulations exist currently.

[936] *See* John C. Reid, *MIPS Besieged--Solutions in Search of a Problem*, 76 Tax Notes 1057, 1065 n.70 (Dec. 1, 1997) ("[T]he tax administrators are making a binary inquiry; an instrument is either debt or it is equity. The rating agencies on the other hand, are placing the instruments somewhere in the range between pure debt and pure equity.").

[937] *Id.* at 1059 ("To the extent that corporations issue MIPS when they would otherwise issue debt, Treasury has no reason to be concerned with the tax treatment of MIPS because interest paid on conventional debt is deductible.").

[938] *See* Joint Committee on Taxation, *Description and Analysis of Certain Revenue-Raising Provisions Contained in the President's Fiscal Year 1998 Budget Proposal* (JCS-10-97), April 16, 1997, at 6 (noting that tiered preferred securities such as MIPS and TOPrS "are reportedly largely replacing regular preferred stock issuances in today's market," and citing Bary, *Preferred Vehicle--How Goldman, Merrill Altered an Entire Market*, Barron's, August 21, 1995, at 13); Norris, *Bush's Plan Taxes Certain Dividends, Fine Print Reveals*, New York Times, January 9, 2003, at A1 (noting that 72 percent of existing preferred stock is actually comprised of hybrid securities that are treated as equity for financial statement purposes but as indebtedness for tax purposes, according to a Merrill Lynch analyst).

The hindsight that the Enron bankruptcy provides may be useful in further evaluating the role that the tax rules play in fostering the development and marketing of tiered preferred securities and other similar hybrid financial instruments that are treated as equity for financial reporting purposes but indebtedness for tax purposes. Consequently, Congress may wish to consider whether such a role raises policy concerns that should outweigh the supposed importance of ensuring that the tax rules in isolation provide the appropriate characterization of such instruments.

4. Recommendations

The proper characterization of financial instruments for Federal income tax purposes as either debt or equity has been a longstanding problem. This problem has been exacerbated in recent years by the escalation in the amount and variety of hybrid financial instruments that have characteristics of both debt and equity. Therefore, the Joint Committee staff recommends the rules concerning the Federal income tax characterization of financial instruments as either debt or equity should be reviewed in a comprehensive way. There are several possible alternative approaches that are available in considering such changes to present law, including:

(1) Conform the tax characterization of hybrid financial instruments to the characterization that is used for other reporting purposes, such as financial accounting, so that the non-tax characterization determines the tax characterization. This approach would largely eliminate opportunities to arbitrage the various tax and non-tax criteria for determining the character of hybrid financial instruments.

(2) Strengthen the requirements for debt characterization, similar to the approaches proposed by the Treasury Department in 1996 and 1997, which may include altering or more precisely articulating the debt-equity factors listed in section 385. This approach also could involve changing the manner in which such factors are applied so that certain financial instruments that exhibit (or lack) certain features are presumptively characterized as equity rather than indebtedness. While more definite debt-equity factors ideally would be self-executing (rather than executed through Treasury regulations), developing an appropriate statutory framework for the application of such factors may be exceedingly difficult.[939]

(3) Provide restrictions on the proportionate amount of yield payments on hybrid financial instruments that may be deducted as interest. The proportionate amount of deductible yield payments could be determined under such an approach by reference to one or more key factors (or some combination thereof), such as the length of the term to maturity of the instrument or the number of months that the issuer could defer yield payments. Similar to the approach used by credit rating agencies in evaluating hybrid financial instruments, this approach would provide

[939] In any event, section 385 should be amended to apply more broadly to interests in non-corporate entities, as well as corporations.

an alternative to the existing binary debt-equity characterization of financial instruments in appropriate circumstances.

(4) Reduce or eliminate the disparate taxation of interest and dividends (for both issuers and holders of financial instruments) that creates the market for hybrid financial instruments.[940] By providing more equivalence in the tax consequences of debt and equity, this approach would eliminate tax considerations from the process by which corporate taxpayers decide to obtain financing. This approach also recognizes the diminishing usefulness of the continuing debate among commentators concerning which regulatory or statutory regime provides the so-called "correct" characterization of financial instruments as debt or equity.

[940] In fact, it has been observed that tiered preferred securities may already achieve effective equivalence in the tax treatment of interest and dividends under present law, which may explain the apparent preference of issuers for such securities over conventional preferred stock. *See* Victor Fleischer, *Enron's Dirty Tax Secret: Waiting For the Other Shoe to Drop*, 94 Tax Notes 1045, 1046 (Feb. 25, 2002) (noting that "Enron has engaged in a sort of self-help corporate integration, getting the equivalent of a dividends-paid deduction, which some reformers would want to give out anyway").

A Recommendation for Integration
of
The Individual and Corporate Tax Systems

Department of the Treasury

December 1992

December 11, 1992

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

Enclosed is a description of our recommended approach to integrating the corporate and individual income tax systems. This material is a follow-up to the *Report of the Treasury on Integration of the Individual and Corporate Income Tax Systems--Taxing Business Income Once* (released in January 1992, hereafter the *Treasury Integration Report*). The Treasury Integration Report identified the distortions caused by our current system for taxing corporate profits and the substantial benefits to the economy that would result from integration, and described four alternative integration prototypes. At that time, we committed to recommending a specific integration system in late 1992.

1. **Recommended prototype.** Although each of the prototypes described in the *Treasury Integration Report* has merit, we are recommending a system similar to the *dividend exclusion prototype* for the following reasons:

- Relative to the shareholder allocation and imputation credit prototypes of relieving the double taxation of corporate equity income, the dividend exclusion approach is the most straightforward and easily administered.
- While there are strong arguments that some version of the Comprehensive Business Income Tax (CBIT) prototype may be preferable from a long-term policy and administrative perspective, the dividend exclusion approach can be implemented much more rapidly, with far less potential for disruption of financial markets and many fewer transition issues.
- The dividend exclusion approach is preferable to the shareholder allocation and imputation credit prototypes because it is consistent with our policy view that, over the long-term, it may be

desirable to move the tax system in the direction of a schedular tax on enterprise activity (e.g., the CBIT prototype or some version of a business cash flow tax or business transfer tax).

The dividend exclusion model we recommend is simple and will generally tax corporate income once. A corporation will compute its taxable income and pay tax as under current law. Any distribution out of the corporation's income that remains after paying tax and after making certain limited adjustments to taxable income (adjusted taxable income or ATI) is treated as a dividend and is excludable from gross income when received by shareholders. Distributions in excess of ATI are treated as a return of capital to the shareholders (or capital gain to the extent the distribution is in excess of basis).

ATI is defined as corporate taxable income reduced by U.S. federal income taxes and creditable foreign taxes paid or accrued and increased by excludable dividends received and by items that are permanently excluded from income (e.g., tax-exempt interest and percentage depletion in excess of basis). Because distributions in excess of ATI will be treated as a return of capital, no distributions are ever treated as taxable dividends. Thus, under the proposal, earnings and profits (E&P) accounts will no longer be relevant for determining the character of distributions from U.S. corporations. Similarly, the dividends received deduction will no longer be necessary because dividends will be excludable.

While the capital gains tax on the sale of stock will be retained, the proposal allows corporations to adopt Dividend Reinvestment Plans (DRIPs). Through the DRIP, a corporation will deem that a cash dividend was paid to its shareholders out of its ATI and immediately reinvested by the shareholders. The shareholders will pay no tax on the deemed dividend (because dividends are excludable), but will increase their bases in their shares by the amount of the deemed dividend. The effect will be to reduce the capital gains (or increase the capital losses) realized when shareholders sell their stock by an amount equal to the corporation's retained previously-taxed earnings.

2. **Modifications to Treasury Integration Report Version of Dividend Exclusion Prototype.** The principal differences between our current recommendation and the prototype described in the *Treasury Integration Report* are: (a) we treat all distributions in excess of ATI as returns of capital (even if the corporation has E&P); (b) we extend integration to foreign source income (by "flowing-through" creditable foreign taxes); and (c) we recommend an immediate effective date (with limited, elective transition relief for corporate shareholders). We have made these modifications for the following five reasons:

(1) They are more consistent with our stated policy goals.

(2) They create fewer character of income and timing distortions, result in a system that is more easily administered, and permit other significant simplifying changes in the tax law.

(3) We believe that any objection to existing tax law preferences should be addressed directly, rather than through continued reliance on an E&P-based measure of dividends.

(4) We believe that revenue concerns are more properly addressed in a policy-neutral manner (e.g., by scaling back underlying preferences; raising revenue elsewhere in the system; or, if necessary, by scaling back the dividend exclusion).

(5) While extending the benefits of integration to creditable foreign taxes is clearly justified on policy grounds, it also is based on the assumption that reciprocal treatment will be provided by our major trading partners. This recommendation should be reconsidered, and alternatives should be explored, in the absence of reciprocity.

3. **Interaction with Other Tax Policy Issues.** In developing our recommendations, it has become increasingly clear that an integration regime should not be developed in isolation (or under the assumption that other structures in the tax law will remain unchanged). Rather, the design of an integration system should be considered in the context of--and be addressed in a manner consistent with--long-term policy goals relating to the compelling case for international reform, the AMT and corporate preferences, the accumulation and investment of capital by tax-exempt entities (including non-U.S. and taxpayers and companies with substantial net operating losses), and the overriding need for tax simplification and the reduction of taxpayer burden.

4. **Setting priorities.** We recognize that other fiscal and tax policy issues may be given higher priority in the near term, that many of the specific technical issues arising under any integration proposal are yet to be resolved, and that any specific legislation would require off-setting tax law changes to deal with revenue and distributional concerns.

Nonetheless, we remain convinced that integration should be a high-priority, tax policy objective. Current tax law distortions--which encourage debt financing by the corporate sector, penalize businesses conducted in corporate form, discourage dividend distributions, and leave us out of step with our primary international trading partners--impose very real costs on the economy. We believe that these costs are likely to increase in the years ahead and that the case for some form of corporate integration will be all the more compelling.

I urge you to give the recommendation careful consideration in your deliberations on reform of the U.S. tax system. I am sending similar letters to Senator Lloyd Bentsen, Chairman of the Senate Committee on Finance; Senator Bob Packwood; Representative Bill Archer; and Representative Charles Rangel, Chairman of the Subcommittee on Select Revenue Measures.

Sincerely,

Nicholas F. Brady

Nicholas F. Brady

Enclosure

A Recommendation for Integration of the Individual and Corporate Tax Systems

CURRENT LAW

Two levels of income tax are generally imposed on earnings from investments in corporate equity. First, tax is imposed on the corporation's taxable income. Second, if the corporation distributes earnings to shareholders, the earnings are taxed at the shareholder level, either as ordinary income in the case of dividend distributions, or as capital gain in the case of non-dividend distributions in excess of the shareholders' stock bases. Retained earnings are taxed at the shareholder level through the capital gains tax on stock sales.

By contrast, the income on debt investments in corporations is taxed only once because interest expense is generally deductible by the corporation and includable in income by the creditor. In addition, the income on equity investments in unincorporated businesses (such as proprietorships and partnerships), qualifying small business corporations (i.e., S corporations), and certain types of investment corporations (such as regulated investment companies) is generally taxed only once, at the investor level. Distributions from those types of businesses are generally tax-free to the extent they represent earnings that were previously taxed to the investors or are treated as a return of capital to the extent of any excess over previously taxed earnings.

REASONS FOR CHANGE

The disparities between the taxation of income from corporate equity investments and income from other types of investments cause three serious inefficiencies:

- A tax disincentive to incorporate, which causes many businesses to forego the non-tax benefits of operating a business in the corporate form, and a penalty on businesses that must operate in corporate form.
- A tax-motivated preference to use debt rather than equity capital, which encourages corporations to operate with higher debt-equity ratios than they otherwise would choose for non-tax reasons.
- A tax-motivated preference to retain rather than distribute corporate earnings to shareholders.

As discussed in Chapter 13 of the *Report of the Treasury on Integration of the Individual and Corporate Tax Systems — Taxing Business Income Once* (January 1992) (the *Treasury Integration Report*), these biases reduce corporate investment, encourage artificially high debt-equity ratios, and discourage dividend payments, all of which lead to significant inefficiencies and competitive disadvantages to the U.S. economy. An integrated tax system, in which corporate earnings generally are taxed only once, will reduce these distortions and thus provide significant economic benefits. It also will bring our tax system more in line with those of our major trading partners, many of whom have adopted some form of integration of their individual and corporate tax systems.

RECOMMENDATION

Overview

We recommend a corporate/shareholder tax integration scheme that will generally tax corporate income once. Under our recommendation, a corporation computes its taxable income and pays tax as under current law. Any distribution out of the corporation's income that remains after paying tax and after making certain limited adjustments (adjusted taxable income or ATI) is treated as a dividend and is excludable from gross income when received by shareholders. Distributions in excess of ATI are treated as returns of capital to the shareholders (or as capital gain to the extent the distribution exceeds their basis).

ATI is defined as corporate taxable income reduced by U.S. federal income taxes and creditable foreign taxes paid or accrued and increased by excludable dividends received and by items that are permanently excluded from income (e.g., tax-exempt interest and percentage depletion in excess of basis). Because distributions in excess of ATI will be treated as returns of capital, no distributions are ever treated as taxable dividends. Thus, under our recommended approach, earnings and profits (E&P) accounts will no longer be relevant for determining the character of distributions from U.S. corporations. Similarly, the dividends received deduction will no longer be necessary because dividends will be excludable.

The capital gains tax on the sale of stock will be retained. Standing alone, the combination of a dividend exclusion regime and a capital gains tax on stock sales would create artificial incentives to distribute previously taxed income (because dividends would be excludable but increases in stock value that represent retained earnings would be taxed to the selling shareholders) and would comparatively disadvantage corporations that retain earnings for further investment by raising their cost of capital. To minimize this distortion, corporations will be allowed to adopt Dividend Reinvestment Plans (DRIPs). Through the DRIP, a corporation will deem that a cash dividend was paid to its shareholders out of its ATI and immediately reinvested by the shareholders. The shareholders will pay no tax on the deemed dividend (because dividends are excludable), but will increase their bases in their shares by the amount of the deemed dividend. The effect will be to reduce the capital gains (or increase the capital losses) realized when shareholders sell their stock by an amount equal to the corporation's retained previously-taxed earnings. DRIP dividends may be declared at any time during the year.

The ATI system will be fully effective for each corporation in its first taxable year beginning after the date of enactment. A special rule will allow corporations to continue to claim the dividends received deduction for five years.

Discussion

Our major goal in devising a system of integration is to reduce the distortions caused by the current two-level tax system while avoiding a system that was difficult to administer or overly complex. While the ATI system does not eliminate all the distortions under current law, we believe it significantly reduces many of them. The ATI approach treats corporations more like other forms of business and thus reduces the tax disincentive to incorporate. It treats equity more favorably than does current law, reducing the disparity between debt and equity. Finally, it reduces the tax incentive to retain earnings, because dividend distributions will be excludable by shareholders.

In addition, the ATI system is both administrable and understandable. By drawing heavily from existing rules, the ATI system reduces the need to implement new sets of rules where existing law is well established. The recommended changes to current law should simplify the corporate tax system (e.g., ATI is easier to compute than E&P, the concept it largely replaces). All distributions are either dividends (and therefore excludable) or returns of capital, simplifying shareholder level treatment as well. The DRIP provisions add some complexity because the DRIP allows upward adjustments of shareholder basis, but the DRIP rules are necessary to avoid creating tax incentives to distribute income. Finally, a number of existing tax rules will be repealed as unnecessary, further simplifying the tax laws. Thus, we believe that the ATI system reduces current law distortions within the context of an administrable system.

Although each of the prototypes described in the *Treasury Integration Report* has its merits, the system we recommend is similar to the dividend exclusion prototype described in Chapter 2 of the *Treasury Integration Report*. Relative to the shareholder allocation and imputation credit prototypes, the dividend exclusion system is the most easily administered approach to relieving the double taxation of equity earnings. While there are strong arguments that the Comprehensive Business Income Tax (CBIT) prototype may be preferable from a long-term policy (and administrative) perspective, the dividend exclusion approach can be implemented much more rapidly, with far less potential for disruption of financial markets and many fewer transition issues. In addition, the dividend exclusion system is preferable to the shareholder allocation and imputation credit prototypes because it is consistent with our policy view that, over the long term, it may be desirable to move the tax system in the direction of a schedular tax on enterprise activity (e.g., the CBIT approach or some version of a business transfer tax).

There are two principal differences between the system we now recommend and the dividend exclusion system described in the *Treasury Integration Report*. First, our recommended system treats all distributions in excess of previously taxed income as returns of capital (even if the corporation has E&P). Second, our recommended system extends integration to foreign source income by flowing through creditable foreign taxes although this extension of integration benefits to foreign taxes is predicated on the assumption that our major trading partners will, over time, provide reciprocal treatment.

The dividend exclusion system in the *Treasury Integration Report* would have treated distributions in excess of previously taxed income (up to the amount of available E&P) as taxable dividends. Two basic considerations were implicit in that decision. First, to the extent that E&P is viewed as reflecting economic income, the *Treasury Integration Report* reasoned that the distribution of that income from corporate solution should trigger a tax at the investor level if a domestic corporate level tax had not already been imposed. Second, the *Treasury Integration Report* gave significant weight to the revenue cost of repealing the E&P-based measure of dividends.

Although these concerns remain valid, we are now placing greater emphasis on simplicity and economic efficiency, and therefore have concluded that the E&P-based measure of dividends should be eliminated and replaced with the ATI approach. Compared to the E&P approach, the ATI system (i) more closely parallels a schedular tax on enterprise activity, (ii) reduces tax-based distortions among different forms of business enterprise, and (iii) reduces artificial incentives to retain earnings. In addition, the ATI approach creates fewer character and timing distortions, is more easily administered, and permits other significant simplifying changes in the tax law. We also believe that any objection to existing tax preferences should be addressed directly, rather than through reliance on E&P. Finally, we recommend addressing revenue concerns in a policy-neutral manner (e.g., by scaling back the underlying preferences, raising revenue elsewhere in the system, or, if necessary, by allowing only a partial exclusion of dividends), rather than by retaining the E&P regime.[1]

Thus, we recommend a dividend exclusion system based on ATI rather than E&P.[2] Under this system, preference income will receive one of two possible treatments depending on whether the preference is a timing preference or a permanent exclusion. Corporate distributions attributable to a timing preference, such as accelerated depreciation, will reduce shareholder basis. If the shareholder holds the stock until the timing preference reverses, basis can be restored through a DRIP dividend when the corporation recognizes the deferred income. If the shareholder sells the stock before the timing preference reverses, the preference will be recaptured through a capital gains tax on the stock sale, approximating the result that would have

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[1] A partial dividend exclusion system would treat distributions out of ATI as part excludable and part returns of capital to shareholders. If the revenue cost of such a partial dividend exclusion system is still too high, an alternative partial exclusion would treat distributions out of ATI as partially excludable and partially taxable to shareholders. If the revenue cost needs to be reduced even further, we would recommend an E&P-based system modeled after the dividend exclusion prototype in the *Treasury Integration Report*.

[2] We also considered a regime that retained the E&P measure of dividends, but provided that all distributions from E&P would be excluded from income at the shareholder level. We rejected this alternative for some of the same reasons that we decided not to retain E&P as a measure of taxable dividend distributions (e.g., retention of the same tax base for all purposes; minimization of timing and character distortions; and ease of administration). Moreover, we were concerned that the E&P approach would further exacerbate the distinctions between inside and outside basis. The basis reduction approach we have adopted is admittedly rough justice, and will result in distortions in a number of real-world cases. While an exclusion based on E&P would mitigate some of these concerns, it would create other more troublesome distortions (e.g., a significant shifting in the nominal incidence of taxation on disposition of shares following distributions from E&P in excess of ATI).

followed if the corporation had sold a portion of the asset that created the preference. When the corporation eventually pays the deferred tax, the new shareholders will receive an offsetting basis adjustment. Distributions attributable to permanent exclusions will not reduce shareholder basis, because reducing basis would result in a recapture of preferences that were meant to be permanent. Thus, these preferences are made excludable by including them in ATI.

The *Treasury Integration Report* also recommended against extending the benefit of integration to creditable foreign taxes. While we are continuing to study this issue as part of our International Tax Study, we believe that passing through foreign tax credits is consistent with the fundamental goals of integration. It also furthers the goal of capital export neutrality, because equivalent integration treatment applies to corporations earning foreign source income and corporations earning U.S. source income. We therefore recommend extending integration to creditable foreign taxes, provided that our major trading partners grant reciprocal treatment. At present, other countries with integrated tax systems generally do not pass through foreign tax credits.[3] If this continues to be the case, we will reconsider our recommendation.[4] An alternative would be to pass through foreign tax credits by treaty in cases where the treaty partner grants reciprocal benefits, although this could entail a significant level of complexity. The ATI system can be modified so that it does not extend integration to foreign taxes by providing for either a basis adjustment or shareholder-level income inclusion upon the distribution of income sheltered by foreign tax credits.

TECHNICAL EXPLANATION

Recommendation 1: Retention of Current Law

(a) Corporations will continue to calculate their income under current law rules and will pay tax according to the existing graduated rate schedule. Credits, including foreign tax credits, will offset corporate tax as under current law.

(b) Distributions in excess of basis will continue to be taxed as gains from the sale or exchange of property. The distinction under section 302 between redemptions that are treated as section 301 distributions (i.e., generally as dividends) and redemptions that are treated as in exchange for stock (i.e., generally as capital transactions) will remain. The rules governing corporate transactions, such as acquisitive and divisive reorganizations, liquidations, and taxable acquisitions will

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[3] The Ruding Committee, however, has recommended that countries within the European Community with integrated tax systems extend integration benefits to foreign taxes levied by other members of the European Community. See Commission of the European Communities, *Report of the Committee of Independent Experts on Company Taxation* (1992).

[4] Excluding the pass-through of creditable foreign taxes from our integration recommendation could also be justified on revenue grounds. On balance, however, we recommend addressing revenue concerns in other ways.

generally be the same as under current law. Corporations will continue to be eligible to file consolidated returns as under current law, although the consolidated return regulations will be amended to conform to the integrated corporate tax.

Discussion: The desire to retain current law was a major reason for choosing a dividend exclusion system. Retaining current law significantly simplifies the transition to integration by relying on established principles and rules. To the extent current law is modified, the changes generally result in simplification or repeal of existing rules and a reduction in taxpayer burdens. Recommendation 1 summarizes the major components of corporate tax law that are retained.

Recommendation 2: Definition of Adjusted Taxable Income

(a) In General: Each year, corporations will compute their addition to ATI. The addition to ATI is equal to taxable income (calculated after the application of any loss carryforward), reduced by (i) the regular U.S. federal income tax liability before the application of any minimum tax credits and (ii) creditable foreign taxes paid, deemed paid or accrued during the taxable year, and increased by (i) excludable dividends received and (ii) items that are permanently excluded from income. Permanent exclusions include tax-exempt interest under section 103 and percentage depletion in excess of basis.

(b) Special Rule for the Alternative Minimum Tax: Corporations paying alternative minimum tax (AMT) increase ATI by the amount of their AMT liability, grossed-up by a factor of 66/34, and decrease ATI by an amount equal to 20 percent of the amount by which they increased ATI for permanent exclusions, grossed-up by a factor of 66/34. In addition, corporations must decrease ATI by minimum tax credits used during the taxable year, grossed-up by a factor of 66/34.

Discussion: By starting with taxable income, ATI does not initially include any preference income. ATI is then adjusted downward by U.S. federal income taxes paid after the application of credits other than the minimum tax credit. Creditable foreign taxes reduce the amount of after-tax income available for distribution, so ATI is reduced by all creditable foreign taxes, including foreign taxes in excess of the amount that can be used to reduce U.S. tax liability for the taxable year. ATI is then adjusted upward by certain permanent exclusions. In general, the practical effect of this definition is that preference income other than income sheltered by credits and by permanent exclusions will not be included in ATI. By including permanent exclusions and credits in ATI, Recommendation 2 allows shareholders to exclude distributions attributable to those items without a reduction in basis. This treatment is appropriate because basis reduction for permanent preferences would make the preferences temporary.[5]

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[5] We realize that ATI may not accurately reflect all of the current rules that govern income and basis (e.g., sections 108 and 167(e)(3)). Nevertheless, to keep the system simple, we did not adjust ATI for these items. If significant distortions result, the ATI rules can be amended.

The calculation of ATI begins with taxable income (which cannot be less than zero) and adds permanent exclusions. Thus, if the corporation has an overall loss for the year but has permanently excluded earnings, the corporation may still distribute excludable dividends during the year. For example, a corporation with a loss of $100 and tax-exempt interest of $10 has $10 of ATI and can distribute $10 of excludable dividends. The net operating loss of $100 can be carried forward against other years' taxable income.

As previously announced, we are studying the effects of the corporate AMT. While our study is not complete, it is clear that the AMT creates economic distortions, and that substantial reform or outright repeal of the AMT may be warranted. The AMT also complicates the calculation of ATI because the AMT operates on a separate, parallel tax base (alternative minimum taxable income). We considered using alternative minimum taxable income for determining ATI for AMT taxpayers, but this would add complexity, allow AMT taxpayers to pass through timing preferences without a basis reduction, and cause discontinuities whereby a modest change in items of income or deduction could cause an extraordinary fluctuation in ATI. We also considered ignoring the AMT and the minimum tax credit for purposes of computing ATI, both for reasons of simplicity and on the theory that the AMT is essentially a prepayment of regular tax. We rejected this approach because some taxpayers are subject to the AMT for many years. For these taxpayers, the AMT becomes their corporate-level tax regime. Ignoring AMT paid would inappropriately deny these taxpayers the benefits of integration.

We opted for an approach whereby AMT paid is grossed-up and added to ATI.[6] The amount of permanent exclusions added to ATI is reduced for corporations that pay AMT, so that permanent exclusions are not double counted in computing ATI. The 66/34 gross-up factor insures that dividends will be paid only out of fully taxed income. The alternative was to gross up AMT at the AMT rate (i.e., by a factor of 80/20). An 80/20 gross-up, however, allows the corporation to distribute preference income without a shareholder basis reduction. For example, suppose a corporation has no regular taxable income and $100 of alternative minimum taxable income due to timing preferences. The corporation pays no regular tax and $20 of AMT. If the gross-up were 80/20, the corporation would generate $80 of ATI and could pay $80 of excludable dividends to its shareholders. The earnings would not be taxed at a 34 percent rate until the preferences reversed and the corporation were subject to the regular tax, regardless of whether the shareholders sold their stock. With a 66/34 gross-up, the $20 of AMT will generate $38.82 of ATI. If the corporation makes an $80 distribution, the remaining $41.18 will reduce the shareholders' bases. If the shareholders are taxable at a 34 percent rate, the difference between the 20 percent rate imposed through the AMT and the 34 percent rate of the regular tax will be recaptured if the shareholders sell their stock before the preferences reverse (34 percent

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[6] Minimum tax credits are grossed up and subtracted from ATI in the year they are applied to reduce regular tax liability. We considered not reducing ATI by minimum tax credits that were earned before the effective date of the integration system. This would require all corporations to maintain a pre-enactment minimum tax credit account and apply a stacking rule (e.g., FIFO) to determine when the pre-enactment credits were used and would result in significant complexity. Our recommendation of an immediate effective date necessarily creates detriments to some taxpayers and windfalls for other taxpayers, and we are not generally recommending any correction for those losses or gains.

of \$41.18 is \$14). This treatment is consistent with our general rule that distributions from earnings that have not been fully taxed reduce basis.

Recommendation 3: Dividends

(a) Distributions will be classified as dividends to the extent they are paid (or deemed paid) out of current or accumulated ATI. E&P no longer controls the treatment of distributions from U.S. corporations and all distributions not out of ATI are treated as returns of capital. If distributions in a given year exceed available ATI, ATI will be allocated first by the priority of the classes of stock on which distributions were paid during the taxable year. For classes of equal priority, or for multiple distributions paid within a single class of stock, ATI will be allocated under a "first-in-time" rule.

(b) Shareholders will exclude all dividends from gross income. As under current law, shareholders will not reduce their share bases when dividends are received.

(c) Distributions in excess of ATI will not be classified as dividends, and will instead be treated as returns of capital.

Discussion: The highest priority, first-in-time allocation of ATI to distributions reduces potential uncertainty about the amount of a distribution that is treated as a dividend. Moreover, the allocation rule is consistent with non-tax rules governing priorities and claims, and as a practical matter allows preferred stock generally to continue paying non-taxable dividends.

The disadvantage of the highest priority, first-in-time rule is that it may allow a corporation to "stream" its dividends by creating multiple classes of stock, some of which receive dividends (and are held by taxable shareholders) and some of which receive non-dividend distributions (and are held by tax-exempt shareholders). While the same issue arises under current law, its practical significance would increase substantially under the integration regime we are recommending because the dividend base will be reduced (ATI will often be less than E&P on a year-to-year basis and, as noted below, the "nimble dividend rule" will be eliminated).

In theory, this concern could be addressed by allocating ATI pro rata among all distributions made during the taxable year. A pro rata approach would reduce the possibility of streaming in the case of routine distributions with respect to multiple classes of stock, but would create other problems. The amount of any given distribution that is a dividend would depend on the amount of distributions made later in the year. This would raise uncertainty and would make declaring DRIP dividends difficult, except where there is a sufficiently large amount of ATI. On balance, we chose to use a highest priority, first-in-time rule and to address streaming concerns with other rules (many of which are in place under existing law) and a general anti-abuse rule.

We chose to allow dividends out of estimated ATI for the current year. Any other rule would require dividends to be paid out of ATI one year in arrears, a requirement inconsistent with the goals of our recommended approach.

We did not adopt the nimble dividend rule of current law (which allows dividends out of current E&P notwithstanding a deficit of accumulated E&P). We recognize that eliminating the nimble dividend rule may mean that corporations with large net operating loss carryforwards will be unable to pay dividends until the losses are used up because taxable income, the starting point for ATI, is calculated after the application of loss carryforwards. Nevertheless, where the estimated current year's taxable income, after the application of any loss carryforwards, is zero, the corporation has not produced any taxable income for distribution as a dividend. Consequently, a distribution under those circumstances is more properly treated as a return of capital.

We considered imposing a surrogate tax in cases where a corporation informs shareholders that a dividend is excludable but later finds that it has insufficient ATI to support the dividend. The tax would have been refundable when the corporation produced ATI and would have offset ATI (when refunded) by a grossed-up amount. The effect would have been an interest charge on the reduced tax that shareholders would have paid if they had sold during the period between the erroneous dividend and the refund of the surrogate tax. We opted not to impose a surrogate tax because of the problems with determining the appropriate blended rate for the tax. Instead, the Commissioner will have the authority to impose a surrogate tax at the maximum shareholder tax rate (currently the 34 percent corporate tax rate) where ATI has not been reported in good faith (e.g., where ATI is not reported consistently with estimated tax payments).

Although the amount of a distribution that is considered a dividend is determined by a corporation's ATI, not its E&P, we do not recommend eliminating E&P for all purposes. In particular, E&P will be retained for various computations relating to foreign corporations. We are studying ways in which E&P computations under these other provisions can be simplified or eliminated.

Recommendation 4: Treatment of Redemptions

(a) In General: The distinction between a redemption that qualifies as a payment in exchange for stock under section 302(b) and a redemption that is treated as a section 301 distribution will remain as under current law. Redemptions that qualify under section 302(b) will generally not reduce ATI even though such redemptions reduce a pro rata portion of E&P under current law.

(b) Significant Redemptions: Section 302(b) redemptions of stock from significant shareholders, defined as those shareholders holding at least five percent of a corporation's equity (with attribution rules), will reduce ATI pro rata and give rise to a corresponding increase in the basis of the redeemed shares. In addition, a corporation that redeems more than five percent of its stock (by vote or value) from any group of shareholders in section 302(b) redemptions will be subject to the same pro rata ATI reduction, basis increase rules. All redemptions that take place within a one-year period will be aggregated for purposes of this rule.

(c) Special Rule: Corporations will be allowed to assume that there are no section 318 relationships (which might cause redemptions that would otherwise qualify under section 302(b) not to qualify) among small shareholders (defined as those that hold less than one percent of the corporate equity). In addition, corporations will be allowed to assume that small shareholders are not purchasing stock at the time of a redemption in a manner that could cause a redemption to fail to qualify under section 302(b).

(d) Treatment of Shareholders: Shareholders will treat redemptions that qualify under section 302(b) as a sale or exchange of their stock. Shareholders will receive a statement from the corporation if they are entitled to a basis increase in connection with such sale or exchange (whether by reason of the significant redemptions rule described above, or because the corporation has declared one or more DRIP dividends prior to the redemption).

Discussion: We chose generally to treat section 302(b) redemptions of stock like sales of stock and to retain the existing rules of section 302(b) for distinguishing a true redemption from a corporate distribution.[7] A selling shareholder in a widely-held corporation generally will not distinguish between selling shares to a third party and selling shares to the corporation. Given this fact and our preference for retaining current law, we believe that sales of stock to the corporation that qualify under section 302(b) should generally be treated the same as sales to third parties.

Nevertheless, some section 302(b) redemptions should be treated as a pro rata distribution of ATI plus a return of capital to the redeemed shareholders. This rule is needed to prevent corporations from streaming through a combination of redemptions of tax-exempt shareholders and dividend payments to taxable shareholders.[8] Thus, in redemptions of large shareholders and

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[7] We recognize that the rules of section 302 reflect a bias towards treating redemptions as dividend distributions, a result that has historically been unfavorable to individual shareholders, but favorable to corporate shareholders. Under our recommended system, all taxable shareholders will prefer dividend treatment, a result not contemplated by the drafters of section 302. Nevertheless, the section 302 rules generally should produce the correct result under our recommended system.

[8] For example, consider a corporation with two shareholders, one taxable and one tax-exempt, each contributing $500 to the corporation. If the corporation earns $100 of after-tax profits (and therefore has $100 of ATI), it can redeem the tax-exempt shareholder for $550. This will leave the taxable shareholder with $500 of basis in a corporation with a value of $550 and ATI of $100. The corporation can pay a $100 dividend and the taxable shareholder can sell its stock for a $50 loss.

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in large redemptions, a corporation's ATI is reduced and the selling shareholders' stock bases are correspondingly increased. For example, if a corporation redeems two percent of its stock from a five percent shareholder, the corporation will reduce its ATI by two percent and the shareholder will correspondingly reduce its amount realized. Similarly, a successful public self-tender for seven percent of a corporation's stock will reduce the corporation's ATI by seven percent and the shareholders will correspondingly reduce their amounts realized.

This treatment of significant redemptions may appear to be more favorable than the treatment of small redemptions of small shareholders. A corporation can equalize the treatment of redemptions, however, by declaring a DRIP dividend before purchasing its own stock. Moreover, because ATI is not reduced in small redemptions of small shareholders, ATI is retained in the corporation to support excludable dividends to all other shareholders.

We recommend special rules allowing a corporation to assume that there are no section 318 relationships among small shareholders because of the new corporate level distinction between redemptions that qualify under section 302(b) and those that do not (i.e., the former generally will not reduce ATI while the latter will).

Recommendation 5: Sections 305 and 306

(a) Section 305: Distributions of stock of the corporation to existing shareholders generally will not affect ATI. Nevertheless, the rules under section 305 for classifying certain stock distributions as distributions of property under section 301 will remain. To the extent that, under section 305, stock dividends are characterized as distributions to which section 301 applies, shareholders receiving stock will be treated accordingly and the corporation will make appropriate adjustments to ATI.

(b) Section 306 will be repealed.

Discussion: We chose to retain section 305 to prevent streaming by paying excludable dividends on one class of stock (held by taxable investors) and stock distributions on another class (held by tax-exempt investors). In such a transaction, the distribution of stock would dilute the class receiving cash, creating a loss on that class when sold. The loss is theoretically offset by gain on the sale of the distributed stock, but if that stock is held by tax-exempts, the gain will never be taxed. Section 305 reduces this possibility by treating certain stock distributions as distributions of property under section 301.

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[8](...continued)

The pro rata ATI reduction rule will not allow corporations to stream through the opposite transaction of redeeming taxable shareholders and reducing ATI in the redemption. In the above example, if the corporation redeems its taxable shareholder, ATI will be reduced by $50 and the shareholder will recognize no gain or loss on the redemption. The tax-exempt shareholder will be left with $500 of basis in a corporation with a value of $550 and ATI of $50.

Section 306 will be repealed because preferred stock bailouts will not offer the same benefits under the ATI system as when dividends were taxable as ordinary income.

Recommendation 6: Adjustments to Tax and Refunds

(a) Adjustments to a corporation's taxable income for a prior year will be reflected as adjustments to the corporation's ATI in the current year. An increase in a prior year's taxable income, therefore, will increase the ATI (by an amount net of the increased taxes paid) in the year the adjustment is made and the additional tax is paid.

(b) ATI may not be reduced below zero. To the extent that ATI would be reduced below zero by a downward adjustment to taxable income that would give rise to a refund, the refund will not be paid to the corporation. Instead, adjustments to the corporation's taxable income in excess of the amount necessary to reduce ATI to zero will be carried forward to reduce future taxable income.

Discussion: Adjustments to a corporation's tax liability for a prior year must be reflected in ATI in the year the adjustment is made because of the practical problems with recharacterizing distributions made in prior years. If, for example, when a corporation agreed in 1998 to report additional net taxable income for 1993, the corporation's ATI were increased for 1993, actual 1993 distributions that were reported as returns of capital to shareholders would become excludable dividends. The corporation's shareholders might have to amend their returns for 1993 (or for subsequent years prior to 1998, if they disposed of their shares during that period). The obvious problems with this approach led to the rule requiring ATI to be adjusted in the year the additional taxes are paid or refunded.

ATI cannot be reduced below zero by losses or downward adjustments to taxable income. Allowing ATI to be reduced below zero would be the equivalent of a loan from the Treasury to the shareholders who had received excludable dividends. The loan would be repaid by the corporation only if and when it had paid sufficient corporate taxes to increase its ATI to zero. If the corporation ceased doing business, the loan might never be repaid. We considered allowing corporations to receive tax refunds in excess of ATI at the cost of reducing current shareholders' stock bases. We rejected this approach because of problems where the stock has changed hands between the initial distribution of ATI and the subsequent refund of tax. We therefore recommend requiring corporations to use the net operating loss or downward adjustment to taxable income against future taxable income.

Recommendation 7: Dividend Reinvestment Plans

(a) In General: If a corporation has an ATI account with a balance greater than zero, the corporation may declare a DRIP dividend. The corporation will be deemed to have paid a cash dividend and the shareholders will be deemed to have received the cash and recontributed it to the corporation. Because a corporation may only declare DRIP dividends to the extent of ATI, DRIP dividends are always excludable by the shareholders. The only effects of a DRIP dividend are to increase the shareholders' share bases by the amount of the DRIP dividend and to reduce the corporation's ATI by an identical amount.

(b) Method of Declaring a DRIP Dividend: Corporations will declare DRIP dividends in the same manner that they declare actual dividends, including the amount of any such DRIP dividend and the class or classes of stock on which the DRIP dividend will be deemed paid. Allocations of ATI to DRIP dividends are the same as allocations of ATI to cash dividends.

Discussion: We considered a number of ways to equalize the treatment of those corporations that choose to retain earnings and those that choose to distribute earnings. As noted in Chapter 8 of the *Treasury Integration Report*, reducing or eliminating the tax on capital gains when stock is sold introduces other problems into the system. We therefore chose to allow corporations to declare DRIP dividends. While the DRIP mechanism adds complexity to our recommendation, it is needed for two reasons. First, it prevents a tax law bias favoring the current payout of dividends. Second, it equalizes the treatment of widely- and closely-held corporations (because the latter could replicate the DRIP result using actual dividend, recontribution transactions).[9]

We chose to allow corporations the same flexibility in declaring DRIP dividends that they possess in declaring actual dividends. Although it may increase opportunities for streaming, this flexibility is consistent with the corporation's ability to determine its own dividend policy under current law, and is necessary to permit corporations to implement cost-efficient capital structures.

We considered requiring corporations to declare DRIP dividends with respect to otherwise undistributed ATI, at the latest, during the year following the year in which the ATI was generated (a mandatory DRIP). The practical effect of this rule would have been to limit ATI accumulations to not more than the amount produced in the last two years. A mandatory DRIP would prevent large accumulated ATI accounts in most cases, and thus would reduce corporations' interest in and opportunity for dividend stripping, streaming, "trafficking" in ATI, and other similar transactions.

We concluded that a mandatory DRIP would not eliminate the need for anti-abuse rules, and that it might interfere with the attempts of corporations in cyclical businesses to maintain level dividend payment policies. As a result of the mandatory DRIP, shareholders during upturns

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[9] Unlike DRIP dividends, which increase the basis of shares pro rata, actual cash dividends followed by a purchase of new shares concentrate basis in the recently-purchased shares. This is similar to the result under dividend reinvestment plans that some corporations have in place under current law. We considered allowing corporations to declare pro rata stock dividends instead of DRIP dividends, and thereby concentrate basis in the distributed shares. We rejected this approach because of mechanical complexities and because corporations can achieve similar results under section 305.

could receive both cash dividends and DRIP dividends resulting in basis increases, while shareholders during downturns could receive return of capital distributions.

A second concern about mandatory DRIPs relates to the broader issue of net operating losses (NOLs).[10] The practical effect of a mandatory DRIP, coupled with the rule limiting tax refunds attributable to adjustments and tax losses to available ATI, would be to eliminate the 3-year NOL carryback period. While the same result would follow if the corporation voluntarily declared sufficient actual or deemed dividends, there is a difference between voluntary and mandatory imposition of this regime.

On balance, we believe that the benefits of a mandatory DRIP (particularly in reducing the potential for streaming or other tax-motivated transactions) are outweighed by its detriments. We chose to address concerns about streaming and other tax-motivated transactions through a combination of existing law and a new general anti-abuse rule (see Recommendation 19).

Recommendation 8: Corporate Transactions

(a) Distributions of Appreciated Property: Current law rules of section 311(b), requiring recognition of gain on corporate distributions of appreciated property, will continue to apply.

(b) Liquidations: Liquidations will be taxed to the corporation as under current law. Upon a section 331 liquidation, the corporation may declare actual or DRIP dividends and thereby allocate its ATI among its classes of stock. Liquidations that qualify under section 332 will continue to be tax-free, with appropriate adjustments to ATI for minority shareholders.

(c) Taxable Acquisitions: Taxable acquisitions will be treated as under current law and section 338(h)(10) will remain available. As a result, a stock acquisition will not affect the target corporation's ATI.

(d) Acquisitive Reorganizations: Current law rules that treat a qualifying corporate reorganization as tax-free at the corporate level and at the shareholder level will remain available. Section 381, providing for the carryover of certain corporate attributes, will be extended to provide for the carryover of the target's ATI balance.

(e) Divisive Reorganizations: Current law rules governing tax-free divisive reorganizations will remain, except that the device restriction of section 355 will be repealed. Under current law, E&P of the distributing corporation in a division

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[10] As discussed above, distributions from corporations with NOL carryforwards will generally represent returns of capital.

that qualifies as a reorganization under section 368(a)(1)(D) are divided between the distributing corporation and the controlled corporation based on the relative fair market values of their assets. Rules for the division of ATI will follow these rules.

Discussion: We chose to continue to impose a corporate level tax on distributions of appreciated property. The alternative was allowing a carryover or substituted basis for distributions of appreciated property, as under the partnership rules. Following the partnership rules would defer the tax and collect the tax at the shareholder rate. Collecting the tax at the corporate level rather than the shareholder level, however, is consistent with the policy of collecting a single level of tax at the corporate rate. While a comprehensive carryover basis regime governing the transfer of assets can be justified on policy grounds, it would be inappropriate (and unadministrable) to take a limited step in that direction solely in the context of corporate distributions to shareholders.

Liquidations are treated as under current law, except that the corporation may allocate all of its ATI to shareholders during the liquidation. The ability of corporations to allocate ATI upon a liquidation may present opportunities for streaming, but these opportunities should be no worse upon liquidation than for ongoing corporations. Moreover, the general anti-abuse rule will discourage tax-motivated allocations in liquidation.

Under a dividend exclusion system, existing section 338(a) is of minimal use because it imposes a tax on the buyer, not the seller. A rule modeled after section 338(h)(10) would be more effective, because the ATI produced by the deemed asset sale could be used immediately by the selling shareholders. We considered extending section 338(h)(10) to all targets (instead of just targets in consolidated groups) and all buyers (instead of just corporate buyers). For now, we recommend retaining the existing limits on section 338(h)(10) because of the complexity of extending section 338(h)(10) to all targets and all buyers. We are studying ways to broaden section 338(h)(10).

We recommend repealing the device restriction of section 355, because it is no longer necessary where dividends are not taxed. We retained the rest of section 355 because of the important distinction between divisive reorganizations and section 311 distributions.

Recommendation 9: Consolidated Returns

Affiliated groups of corporations will continue to be allowed to file consolidated returns. ATI, like E&P under current law, will be calculated separately for each member of a consolidated group. As under the current consolidated return regulations governing E&P, ATI will flow up to the common parent. Special rules will apply to ensure that ATI is not duplicated when a member leaves the consolidated group.

Discussion: We continue to believe that affiliated groups of corporations should be permitted to file consolidated returns to reduce any remaining distortions between operating as separate divisions and operating as separate corporations. We are continuing to study what adjustments to the consolidated return regulations would be necessary under the ATI system. This review is taking place in the context of our ongoing, broad-based reconsideration of the consolidated return regulations, as reflected in the recently proposed investment adjustment regulations, the forthcoming deferred intercompany transaction regulations, and our overall movement in the direction of a single entity approach for affiliated groups, as evidenced by the loss disallowance regulations.

Recommendation 10: Pass-through Entities

> The current treatment of S corporations, partnerships, and other pass-through entities, such as regulated investment companies, real estate investment trusts and real estate mortgage investment conduits, will be retained.

Discussion: We recognize that retaining current law treatment of S corporations, partnerships, and other pass-through entities is somewhat inconsistent with our long-term policy preference for a schedular tax on enterprise activity and our goal of tax simplification. Nonetheless, we believe that these alternative regimes should be retained at present. As a practical matter, they are so deeply embedded in the system that any effort to require uniformity of business forms would be exceedingly disruptive and require elaborate transition rules. In addition, certain of the passive conduit regimes (RICs, REITs, and REMICs) are mechanical devices for permitting risk pooling and portfolio diversification. As such they should be retained as part of any system. Finally, to the extent partnerships are viewed as permitting parties to tailor their economic arrangements, with the tax consequences merely reflecting those arrangements, their continued availability (at least in certain circumstances) is warranted.

Recommendation 11: Stock Sales

> Shareholders will be taxed on sales of their stock, as under current law.

Discussion: By increasing share basis, DRIP dividends prevent tax on that portion of the appreciation in stock value attributable to previously taxed income that the corporation has chosen to retain rather than distribute. The capital loss limitation will remain as under current law.[11]

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[11] Some commentators have suggested that a rule disallowing losses to the extent of basis attributable to DRIP dividends may be necessary to prevent certain abuses. We have rejected this approach in favor of the more general anti-abuse rule described below as Recommendation 19.

Recommendation 12: Corporate Shareholders

> Corporate shareholders will no longer be entitled to a deduction for dividends received. Excludable dividends received by a corporation will increase the recipient corporation's ATI and will, therefore, remain excludable when distributed by the recipient corporation.

Discussion: We recommend eliminating the dividends received deduction, because it is no longer needed to reduce the multiple levels of corporate tax that can be imposed under current law. To the extent that earnings have been taxed to a corporation, there will be ATI to support dividends paid to corporate shareholders. The corporate shareholders will exclude the dividends from their income and will increase their own ATI by the amount of excludable dividends received. To the extent that the distribution is in excess of ATI, the corporate shareholders will reduce their bases, which is consistent with the general treatment of preferences under the ATI system.

Recommendation 13: Shareholder AMT

> The alternative minimum tax will be retained, but excludable dividends are not an AMT adjustment or preference.

Recommendation 14: Accumulated Earnings Tax

> The accumulated earnings tax will be repealed, because it is of diminished importance in a system that does not tax dividends.

Recommendation 15: Personal Holding Companies

> The personal holding company rules will be retained.

Discussion: While in general corporate tax rates are higher than individual tax rates and, therefore, there is no tax benefit to incorporation, graduated rates remain available to corporations. To the extent that the graduated rates are lower than the individual rates applicable to a specific taxpayer, an integrated tax system still presents the opportunity to use the corporate form to shelter personal income. Indeed, repeal of what amounts to a toll charge on distributions of that income may exacerbate the problem. Thus, the personal holding company rules will be retained.[12]

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[12] Because the determination of whether a corporation is a personal holding company is based on the corporation's gross income, dividends received under our recommendation will not affect whether a corporation is considered a personal holding company.

Recommendation 16: Shareholder Level Debt

> Section 246A will not be extended to cover excludable dividends and is therefore repealed, and section 265 will not be extended to the purchase of corporate stock. Section 163(d) will continue to apply to individual shareholders.

Discussion: The decision not to extend sections 246A and 265 is consistent with our decision not to recommend modifications to the rules governing debt, and our policy bias against rules that are complex and difficult to administer.

Section 163(d) limits individual interest deductions to net investment income. Because dividends are excludable, dividends will never result in investment income, so interest on debt used to purchase stock will be deductible only to the extent of other investment income. This is consistent with the purpose of section 163(d), to preclude the use of interest deductions to shelter personal expenses.

Recommendation 17: Limitations on Dividend Exclusion

> Rules similar to those in section 246(c) will apply to all shareholders that receive dividends (including DRIP dividends). Section 1059 will be repealed.

Discussion: We recommend a section 246(c)-type rule to prevent dividend stripping. Without such a rule, tax-exempt shareholders could sell their stock to taxable shareholders immediately before a dividend is paid. The taxable shareholders would receive the excludable dividend and immediately sell the stock for a loss. This is the same problem faced under current law with the dividends received deduction, except that many more shareholders could take advantage of dividend stripping under the ATI system. If the shareholder does not meet the holding period requirements, the shareholder also will be denied an increase in basis if a DRIP dividend is declared. Section 246(c) must be extended to DRIP dividends to prevent tax arbitrage through the combination of a DRIP dividend (causing a basis step-up), an actual cash distribution in excess of ATI (reducing basis by the amount of the step-up), and a sale of the stock at a loss.

Retaining section 1059 would prevent payment of excludable dividends of pre-acquisition earnings followed by sale of the stock for a loss. We recommend repealing section 1059, however, because section 246(c), other elements of current law, and our general anti-abuse rule should adequately police this problem.

If the current rules prove inadequate to prevent dividend stripping in particular cases (e.g., where the selling shareholder is a foreign person seeking to avoid U.S. withholding tax or where the corporation is privately held) and those cases cause significant distortions, we will consider additional rules.

Recommendation 18: Section 1014

> Section 1014 generally will continue to apply to stock held at death. Nevertheless, for decedents who owned at least five percent of the corporation's equity on the date of death, the amount of the section 1014 basis step-up is reduced (but not below zero) by the decedent's pro rata share of any increase in the corporation's undistributed ATI while the decedent owned the stock (as determined on the close of the taxable years that include the date of acquisition and the date of death).

Discussion: This recommendation prevents heirs from receiving the double benefit of a basis step up and excludable dividends, which would result in a capital loss (or reduced capital gain) when the heirs sell the stock. The capital loss would effectively offset corporate tax paid prior to death, which would be an unwarranted extension of section 1014. We considered prohibiting heirs from claiming capital losses on inherited stock for several years after the date of death, but that alternative would deny heirs any tax benefit for post-death economic losses. We also considered treating dividends received by heirs as returns of capital for several years after the date of death, but that alternative was similarly arbitrary. Our recommendation requires significant shareholders to ascertain the corporation's ATI in the year they acquired a five percent interest in the corporation and forces the estate to ascertain the corporation's ATI in the year of death, but it retains the benefit of section 1014. If the heirs desire a full basis step-up, the corporation can declare a DRIP.

Recommendation 19: General Anti-abuse Rule

> If a corporation creates multiple classes of stock or engages in a transaction (or series of transactions), a principal purpose or effect of which is to allocate dividend distributions to taxable shareholders and parallel return of capital distributions to tax-exempt shareholders (including foreign shareholders and shareholders with substantial NOLs), the Commissioner may treat all such distributions as having been made pro rata out of the corporation's ATI and, to the extent such distributions exceed ATI, as returns of capital. The Commissioner may impose a surrogate tax at the maximum shareholder rate (currently 34 percent) on the corporation or its successors, or, in the absence of sufficient corporate assets, on significant shareholders as transferees.

Discussion: Neither the section 246(c)-type rules described above nor other specific rules may be sufficient to address the potential for tax-motivated transactions. Our general anti-abuse rule effectively codifies application of the step transaction and substance-over-form doctrines to streaming transactions and provides additional protection. By providing for collection at the corporate level of a surrogate tax at the maximum shareholder tax rate, the rule deters schemes that purport to generate a significant portion of their return by manipulating the integration rules. The surrogate tax applies to the incremental return of capital distribution that the Commissioner allocates to taxable shareholders.

Because corporations may seek to engage in tax-motivated transactions as part of a liquidation, the rule assigns transferee liability for the surrogate tax to successors and significant shareholders (i.e., those that hold at least five percent of the corporation's equity at the time of the abusive transaction), including tax-exempt shareholders.

Recommendation 20: "Trafficking" in ATI

> Section 382-type rules will not apply to limit the use of ATI following an ownership change.

Discussion: To the extent that section 269 prevents tax-motivated acquisitions, it will continue to apply. Should ATI-motivated acquisitions become a problem, a section 382-type rule can be added at that time.

Recommendation 21: Foreign Shareholders

(a) Integration benefits will not extend to foreign shareholders by statute. Thus, nonresident aliens and foreign corporations will continue to be subject to withholding tax on dividends. In addition, foreign corporations will continue to be subject to the branch profits tax. Integration benefits may, however, be granted to foreign shareholders by treaty.

(b) DRIP dividends will generally have no tax consequences to foreign shareholders. A DRIP dividend will not increase the bases of foreign shareholders' stock, but will reduce the corporation's ATI.

(c) Corporations will maintain an account of DRIP dividends paid (the deemed dividend account). Distributions in excess of ATI will be considered made out of this account. To the extent distributions are out of the deemed dividend account, they will be considered dividends for withholding tax purposes (regardless of whether the foreign shareholder receiving the distributions was a shareholder at the time the DRIP dividend was declared). Distributions to foreign shareholders out of the deemed dividend account will not reduce stock basis for foreign shareholders.

(d) A distribution to a foreign shareholder will reduce corporate ATI. Distributions (to any shareholder) in excess of ATI will reduce the deemed dividend account.

Discussion: We would like to extend integration benefits to foreign shareholders on a reciprocal basis with other nations. Nevertheless, in contrast to our recommendation on foreign taxes, we recommend that integration treatment be provided to foreign shareholders only by treaty, for two principal reasons. First, unilaterally extending the benefits of integration to foreign shareholders by statute may not achieve the intended purpose, because the tax policies of a shareholder's country of residence will ultimately determine the shareholder's total tax burden. Second, addressing the tax treatment of nonresidents through the treaty process is generally consistent with international norms concerning source-country taxing rights. Other countries, in certain cases, have extended integration benefits to nonresidents through bilateral income tax treaties. We are continuing to study foreign tax issues relating to integration as part of our International Tax Study.

Under the recommended system, DRIP dividends will not be treated as dividends to foreign shareholders, because it would be administratively difficult and arguably unfair to impose withholding tax where no cash or other property is actually distributed to shareholders. We considered but rejected other methods of addressing this problem. One alternative (modeled after the taxation of original issue discount accruing to foreign persons under section 871(a)(1)(C)) would be to permit a basis increase for stock held by foreign shareholders and to collect a deferred withholding tax at the time the foreign shareholder either sells his stock or receives distributions from the corporation. We rejected this alternative in part because of potential administrative difficulties in collecting withholding tax at the time of sale and because imposing that tax arguably would contravene the general U.S. policy of exempting foreign shareholders from tax on capital gains.

A foreign shareholder will be eligible for the benefits of DRIP dividends if the shareholder qualifies for integration benefits by treaty. Additional rules will be necessary to implement the general exclusion of foreign shareholders from DRIPs, such as rules governing basis adjustments in connection with the transfer of stock by a foreign person to a U.S. person in a nonrecognition exchange.

Recommendation 22: Compliance and Administration

(a) Corporations will be required to keep ATI accounts and deemed dividend accounts and will report the balance of those accounts to the IRS annually on their income tax returns. All information necessary to keep the accounts should be available to corporations in the ordinary course of preparing their income tax returns. Corporations also will be required to include additional information on Forms 1099. Revised Forms 1099 will indicate the amounts by which actual or deemed distributions are excludable, reduce basis, or increase basis.

(b) Shareholders will keep track of increases in basis as well as decreases in basis. Each shareholder will receive a revised Form 1099 to assist with this recordkeeping burden.

Discussion: Minimizing recordkeeping was a significant goal in designing our integration system. Although shareholders will now have to track basis increases as well as basis reductions, this additional recordkeeping requirement should not be overly burdensome because it is augmented by information reporting. Recordkeeping at the corporate level should not be significantly increased.

Recommendation 23: Transition Rules

(a) In General: The ATI system will be effective for a corporation in its first taxable year beginning after the year of enactment.

(b) Dividend Received Deduction: During their first five taxable years beginning after the date of enactment, corporations may elect to continue reporting their E&P to their shareholders. Corporate shareholders may elect, for each class of stock in a corporation that reports E&P, to treat all distributions out of E&P as taxable dividends and claim a dividends received deduction, as under current law. The ATI regime would continue to apply for all other purposes to electing corporations and their non-electing shareholders. Neither pre-enactment nor post-enactment E&P will affect the treatment of distributions by corporations that do not elect to report E&P.

Discussion: The *Treasury Integration Report* recommended a phase-in period for its prototypes. For several reasons, we are now recommending an immediate effective date. First, the substantial benefits that will flow from integration can be realized more quickly through an immediate effective date. We believe that these benefits outweigh the potential adverse impact of short-term disruptions in the market. Second, an immediate effective date minimizes distortions in taxpayer behavior that might otherwise occur during a five year transition period. Finally, we believe that an immediate effective date minimizes complexity and taxpayer burdens. Retention of taxable dividends during a phase-in period would require a complex set of interim rules, in effect requiring a complete and separate integration system during the phase-in. Based on these reasons, we believe that an immediate effective date is warranted.

We recognize that the value of certain stocks may be dependent on the dividends received deduction. We therefore recommend a special rule to phase out the dividends received deduction in a manner intended to reduce the volatility in the value of stock held by corporations.

REVENUE COST

	Fiscal Years					
	1993	1994	1995	1996	1997	1993-97
Cost (billions of dollars)	17	31	33	34	35	150

Strengthening America's Economy

The President's Jobs and Growth Proposals

Council of Economic Advisers

February 4, 2003

The Economic Situation

The economy continues to recover from the effects of the slowdown that began in the middle of 2000 and led to the subsequent recession. The past three years have presented a number of challenges to the American economy, including the terrorist attacks of September 2001, the long decline in the stock market, and the effects of corporate governance scandals. The long-run economic outlook remains solid—with low inflation, low interest rates, and strong productivity gains that suggest that the post-1995 acceleration in productivity will continue to raise real incomes and living standards.

Yet the pace of the expansion has not been satisfactory, with business investment and job creation remaining key weak spots in the economy. A plunge in investment that began in the third quarter of 2000, along with the declines in equity markets that began in the first quarter of that year, were important forces in the recession. Purchases of equipment and software picked up modestly in the latter three quarters of 2002, but new orders for non-defense capital goods—a forward-looking indicator of investment—stagnated in the middle of the year and then declined in the last quarter. Moreover, high office and industrial vacancy rates continue to depress investment in commercial structures.

Household spending, notably on autos and housing, has played a key role in the recovery thus far. Spending has been supported by the continued growth of real personal income, which has been more resilient than in previous business cycles, as a result of both the 2001 tax cut and supportive monetary policy. Low interest rates have contributed to special financing incentives for automobile purchases and low mortgage interest rates. New home sales were at record levels in November and December. These developments in part reflect the fact that household income growth has been more stable than in the typical postwar recession, in which incomes and net worth have moved together. In contrast, net worth has fallen dramatically relative to income over the past three years. While stock price declines have eroded household wealth, the appreciation of equity prices before 2000 would have been expected to increase consumption over the subsequent period. Some of the drop in consumption expected to result from the post-2000 declines may thus simply represent a "cancellation" of an implied consumption increase that had not yet taken place. The positive influences on consumption from current income and the continuing appreciation in housing wealth might thus have offset the stock market's negative effects on personal spending, leading to the continuing buoyancy of household spending. Even so, the possibility that consumers might pull back represents a risk to the recovery in the near term.

Declining equity prices also have important effects on businesses by raising the cost of financing new investment. Lower share prices mean that firms must sell a larger share of the company to raise a given amount of new equity to finance new investment. In addition, lower stock prices mean higher leverage—the ratio of the market value of outstanding debt to equity—possibly increasing firms' cost of raising debt-financed capital. Higher costs of raising new capital inhibit reduce investment spending.

A stronger recovery depends on a robust rebound in business investment. This is the key factor to creating more jobs—when companies build new factories, they hire workers and boost employment in capital-goods industries. Thus far in the recovery, the labor market remains a weak spot, with the unemployment rate reaching 6.0 percent in November and December.

In this setting, the goal of the President's proposals is to provide near-term support for the economy while enhancing long-term efficiency and growth. The proposals can further be seen as providing insurance against potential risks to the recovery, including an investment recovery that is delayed or more anemic than currently anticipated by professional forecasters. Threats to the investment recovery include weaker-than-expected profit growth, high required rates of return arising from geopolitical and other risks, and a prolonged period of balance-sheet repair.

More general risks to the recovery include an increased sense of caution that leads families to pull back on their spending plans, and the potential for further terrorist attacks. Indeed, some of these risks could become linked; for example, if firms become uncertain about the strength of consumer demand, they may put investment plans on hold.

The President's Proposals

The President's proposal targets the areas that are most fundamental to the continued health of the current recovery—investment, consumption, and job growth. Specifically, the proposal will:

1. Accelerate to January 1, 2003 features of the 2001 tax cut currently scheduled to be phased-in: the reductions in marginal income tax rates, additional marriage penalty relief, a larger child credit, and a wider 10 percent income tax bracket.

2. Eliminate the double taxation of corporate income, whether paid to individuals as dividends or retained by firms. Dividend income will no longer be taxable on the individual level, while a step-up in cost basis will reflect the effect of retained earnings on share prices.

3. Increase to $75,000 from $25,000 the amount that small businesses may deduct from taxable income in the year that investment takes place.

4. Provide $3.6 billion to fund Personal Reemployment Accounts. These accounts provide up to $3,000 to assist unemployed workers who are likely to need help in finding or training for a new job. If a new job is found quickly, the unspent balance in the account can be kept as a "reemployment bonus."

The President's proposals support investment in three ways: ending the double taxation of corporate income, raising the expensing limits for small businesses, and lowering individual marginal tax rates (which are the relevant tax rates for small businesses that pass through their income to their owners). Ending the double taxation of corporate income will make corporate equities more attractive to investors and lower the implicit cost that firms pay for equity-financed investment. As an example, the cost of capital for equity-financed equipment investment in the corporate sector would fall by more than 10 percent. For investment in structures – the weakest part of the investment outlook today – the decline in the cost of corporate equity capital would be more than one-third. For equipment investment, this decline in the cost of capital is equivalent to an investment tax credit of four to seven percent.

Accelerating the tax relief that has already been enacted will support household consumption by putting more money in the pockets of consumers this year—when it is needed most. The Treasury estimates that calendar-year tax liabilities will be reduced by almost $100 billion in 2003, with around $52 billion infused into the economy in 2003. Moreover, acceleration of the marginal tax reductions in the 2001 tax cut is likely to result in significant spending increases, because the acceleration is done in the context of long-term tax relief. In contrast, tax policy based on temporary changes to tax rates, or one-time tax rebates, would be expected to have much smaller effects on spending and thus provide less near-term support for the economy.

Macroeconomic Impacts of the President's Proposals

Enacting the President's proposal would provide important near-term support for the recovery and have a significant effect on the rate of long-term economic growth. The discussion and table that follow provide projections of the effect of the proposal as a whole on real GDP growth, employment growth and the unemployment rate, and the federal budget. To be cautious in forecasting the effects of the proposal, the projections were made using several assumptions that would be expected to moderate the expansionary effect of the package:

- No supply-side effects on effort and efficiency. The lower marginal income tax rates and other provisions of the proposal are assumed not to affect labor supply.

- No stock market effect of the dividend tax exclusion or basis adjustment for retained earnings. Ending the double-taxation of corporate income (dividends and retained earnings) would be expected to directly increase equity prices even leaving aside the effects of higher growth. CEA projections, however, consider only the effects of higher growth on the stock market, not the direct effects of the dividend tax cut on stock prices.

- The proposal takes effect in July, with no effect on the economy until the third quarter.

Indeed, the absence of supply-side effects means that the model forecasts are most useful over only the first few years of the projection period, since after perhaps two years the increased efficiency effects of lower tax rates would be expected to provide additional impetus to growth that is not captured by the model framework. The stock market effects of the corporate income tax relief might have important near-terms effects on demand, and through capital gains, on fiscal revenues. The assumptions in our model thus would lead to a conservative assessment of both the near-term and medium-run effects of the proposal on the economy.

Assuming that the package is enacted by mid-year, the projected effects on the economy would be as follows:

Output

Measured from the end of 2002 to the end of 2003 (fourth quarter to fourth quarter over the course of 2003), GDP growth would be 1.0 percentage point higher as a result of the proposal than would have been the case absent the proposal. Average annual GDP growth measured year-over-year would be 0.4 percentage points higher in 2003 as a result of the package. The difference between the fourth quarter to fourth quarter figure and the year-over-year figure reflects in large part the conservative assumption that the package will have no effect on the economy for the first two quarters of 2003. GDP growth over 2004 would be 0.8 percentage points higher measured fourth quarter to fourth quarter as a result of the package and 1.1

percentage points higher on a year-over-year basis. Over the five-year period from 2003 through 2007, GDP growth would be 0.2 percentage points higher on average per year as a result of the proposal.

Employment

Stronger GDP growth would lead to an estimated 510,000 new jobs expected to be created as a result of the proposal over the course of 2003. Another 891,000 new jobs would be created in 2004. On average, the level of employment in 2003 would be 192,000 higher than without the proposal and 900,000 higher in 2004 than in 2003. As with GDP, the much smaller year-over-year figure in 2003 compared to the fourth quarter to fourth quarter figure reflects the conservative assumption that the package creates zero new jobs in the first half of 2003. This means that the average change in employment over the entire year includes two quarters in which the proposal has not taken effect and thus is projected to create no new jobs. To show this graphically, the difference between year-average and fourth quarter to fourth quarter employment growth is depicted in the chart at the end of this paper.

On average over end-2002 to end-2007, job creation as a result of the package would be 140,000 higher than otherwise. This indicates that the proposal would bring forward a good deal of the job creation that would otherwise have occurred in 2005 and beyond (and add some as well). As noted above, the statistical model used for the projections does not include any supply-side effects under which lower tax rates would be expected to boost labor supply and further improve job creation. Corporate income tax relief would likewise be expected to lead to positive supply-side effects through improved allocation of capital across the economy and thus higher growth and job creation—again, however, this is not reflected in the numerical projections.

Federal Budget

The table includes two estimates of the impact of the President's proposals on the Federal budget. The first estimate follows conventional budget scoring and assumes that the overall level of GDP would be unchanged by the policy. The second estimate incorporates the impact of faster economic growth on overall Federal receipts. This latter figure assumes only that the faster growth resulting from the package leads to higher revenues—in all cases, it is still assumed that there is no supply-side effect of the proposal on labor supply.

The President's Proposals and the Economy

Impact of President's Proposals:	2003	2004	2003-2007
Faster Real GDP Growth			
(Q4 to Q4, percentage points)	1.0	0.8	0.2*
(Yr avg to Yr avg. percentage points)	0.4	1.1	0.2*
Additional Employment Growth			
(Q4 to Q4)	510,000	891,000	140,000*
(Year avg to Year avg)	192,000	900,000	170,000*
Lower Unemployment Rate			
(Q4 level, percentage points)	-0.3	-0.8	-0.5*
(Annual average, percentage points)	-0.1	-0.6	-0.5*
Change in Fiscal Balance; No Impact of Faster Growth ($ Billions, fiscal year)	-33	-113	-359¯
Change in Fiscal Balance; With Impact of Faster Growth /1 ($ Billions, fiscal year)	-31	-82	-166¯

*Average, 2003-2007.
¯Total, 2003-2007.
/1 Excludes change in debt service.

Modeling Details

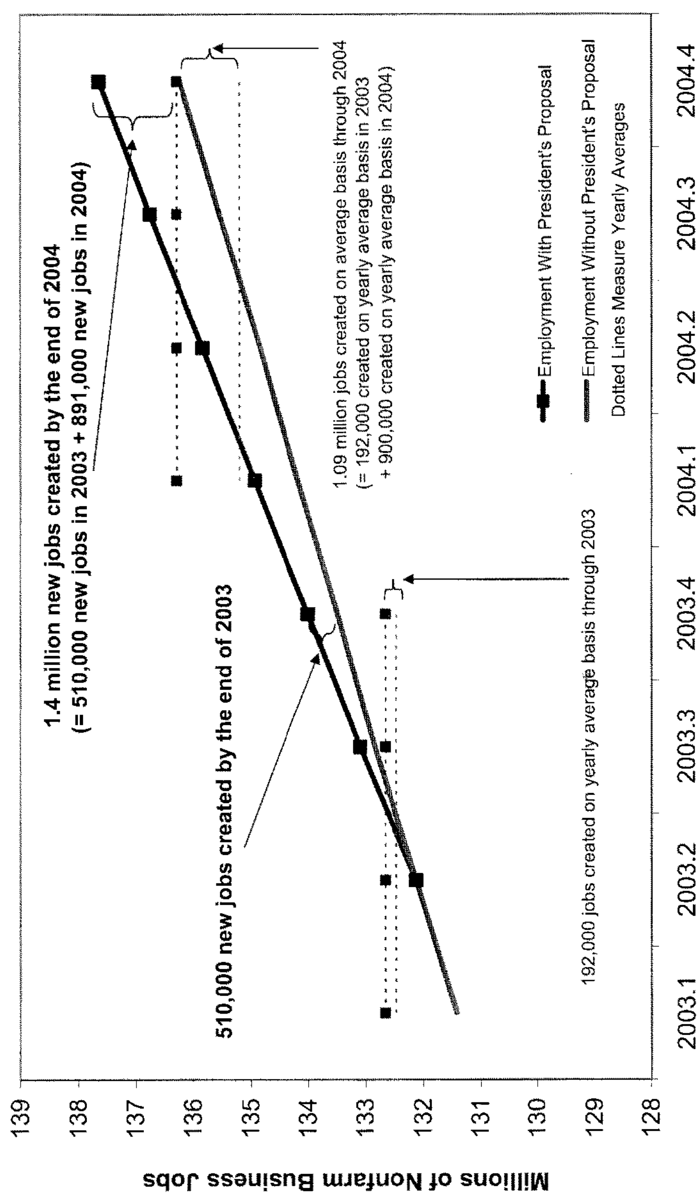
The particular values of the numerical estimates presented reflect judgments regarding the implementation of the proposals. As noted above, the assumption is made that the policies are enacted and begin to affect the economy only at the beginning of the third quarter of 2003.

Many commentators have argued that eliminating the double taxation of dividends would provide a substantial boost to stock prices, perhaps raising consumption spending and adding to the short-term support for the economy. In the interests of being conservative in the analysis, however, CEA has assumed that the proposals have no direct impact on equity values.

Another important assumption is that the numerical estimates discussed above assume no changes in the stance of monetary policy. Although the exact path of future policies cannot be forecast, the President's proposals will be most valuable in the event that downside risk scenarios come to pass, which are also circumstances in which it is least likely that the effects of the policy would face offsetting interest rate movements. To the extent, however, that this fiscal insurance proves unnecessary, any potential tightening of monetary policy would partly offset the impacts shown below.

Finally, when computing the impact of faster growth on Federal budget receipts, CEA followed the historical evidence and assumed that a $1 rise in real GDP generates 19 cents of Federal revenue. In contrast, to the extent that GDP rises strictly due to higher prices (with unchanged real output), only 15 additional cents are received in nominal Federal revenues for each $1 increase in nominal GDP. This calculation is meant to be illustrative, and not necessarily reflect the view of the CEA or the Administration as to the merits of such an exercise for budget policy.

Employment Effects of President's Proposal



tax break

by William G. Gale and Peter R. Orszag

The Administration's Proposal to Cut Dividend and Capital Gains Taxes

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Overview

In the United States, some corporate income is never taxed, some is taxed once (either at the individual or the corporate level), and some is taxed twice. Many economists — ourselves included — would prefer a system that taxed all corporate income, but taxed it once and only once, at nonpreferential tax rates. Such a system would modify the tax incentives for various types of corporate behavior in important ways. In this article, we focus on two crucial dimensions of corporate incentives affected by the tax system: The incentive to shelter corporate income from taxation and the incentive to retain corporate earnings rather than pay dividends.[1]

> ***The administration's recent proposal may not even reduce to a significant degree the incentives that exist under the current system to shelter corporate income from taxation and then to retain the earnings.***

We show that the administration's recent tax proposal does not eliminate, and may not even reduce to a significant degree, the incentives that exist under the current tax system to shelter corporate income from taxation and then to retain the earnings. Thus, in our judgment, despite the administration's rhetoric to the contrary, its proposal does not represent tax reform. The administration's proposal does the "easy" part of tax reform: It cuts taxes. It fails, however, to do the difficult part of any serious tax reform effort: Broadening the tax base and eliminating the share of corporate income that is never taxed (or taxed at preferential rates). That difference is what distinguishes "tax reform" from "tax cuts."

I. Introduction

The most prominent component of the administration's new tax plan is something described as a dividend tax cut. In reality, the provision would represent a significant tax cut for both dividends and capital gains on corporate stocks. In simplest terms, under the administration's proposal, dividends paid out of corporate earnings that were already taxed at the corporate level would not be subject to the individual income tax. In addition, earnings that were already taxed at the corporate level and that were retained by the corporation would generate a basis adjustment for shareholders. Such a basis adjustment means that, when the stock is ultimately sold, the increase in stock price due to retained earnings taxed at the corporate level would not generate a capital gains tax liability at the individual level.

Vice President Cheney has claimed that the administration's proposal would "transform corporate behavior in America and encourage responsible practices."[2] Likewise, the Treasury Department claims that "Corporations will have good reason to pay taxes and not to engage in aggressive tax sheltering. A dollar in taxes saved by a corporation no longer translates into more cash for their shareholders." Also, the proposal ". . . will reduce huge distortions and ineffeciences, allowing corporations to make decisions based on what makes good business sense instead of what makes good tax sense."[3] Other officials and analysts have similarly claimed the plan represents an important tax reform that will substantially reduce or eliminate the incentives for corporate tax sheltering and for retaining earnings. In this article, we develop a simple model that implies that such claims are unlikely to be correct. Our analysis reaches several conclusions. First, a substantial share of corporate equity

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[1]Other important dimensions of the incentives created by the tax system involve the effect on organizational form and corporate financing, but we focus here on the incentives to shelter funds and to retain earnings.

[2]"Remarks by the Vice President on the Economy," U.S. Chamber of Commerce, January 10, 2003.

[3]"Fact Sheet: The President's Proposal to the End of the Double Tax on Corporate Earnings," Office of Public Affairs, Department of Treasury, Jan. 14, 2003, KD-3762.

is held by investors that are not subject to individual dividend and capital gains taxes. To the extent that firms are owned by these shareholders, the administration's proposal provides literally no incentive to reduce sheltering or pay out earnings. Second, to the extent that firms are owned by taxable shareholders, firms would maximize shareholders' after-tax return by sheltering corporate income from taxation and then retaining the earnings — the same strategy that maximizes shareholders' after-tax returns under current law. Third, the administration's proposal would create at least one massive new loophole that we describe below, and possibly many more.

As a result, the administration's proposal would not eliminate the incentives for corporate tax shelters. This crucial aspect of its proposal betrays the administration's tax reform rhetoric.

We also show that if the administration truly wanted to tax all corporate income once and to eliminate any tax-related incentives to shelter and retain earnings, it would have to modify its proposal to tax all of the following at the same statutory tax rate:

- Earnings that the corporation chose not to shelter;
- Dividends paid out of nontaxable corporate earnings (more technically, dividends that are not paid out of the Excludable Distribution Accounts that the administration's plan would create); and
- The change in market value of the company less retained earnings that come from the Excludable Distribution Account (more technically, the change in the market value less the part of the EDA that is not paid out in dividends).

If the administration modified its proposal to meet this condition, dividends paid out of EDAs and capital gains due to the retention of funds in EDAs would not be taxed at the individual level, just as under the administration's current proposal. The crucial difference, however, is that this modification (which would require taxing dividends and accruing capital gains at the full corporate tax rate to the extent such capital gains or dividends reflected income not already taxed at the corporate level) would ensure that all corporate income was taxed once at a nonpreferential rate. The administration's proposal does not produce such a result.

We emphasize that the goal of this article is not to advocate that the administration adopt this particular change to its proposal; there are many ways to tax all corporate income once and only once. Modifying the administration's proposal in this manner may not be the best way. Rather, the goal of the paper is to demonstrate what would be required to tax all corporate income once, only once, and at a nonpreferential rate within the administration's framework, and to show that the administration's proposal does not achieve this objective.

Moreover, because the administration appears to be opposed to tax increases (including base broadening) of almost any kind, it is important to realize that any reasonable prospect for bona fide corporate reform will be lost if the dividend and capital gains tax cut is enacted without simultaneous base-broadening measures.

II. Background

The United States is often said to tax corporate earnings twice, once at the corporate level when the earnings are obtained, and again at the individual level when the earnings are paid out as dividends (and taxed at the individual level) or kept as retained earnings that generate capital gains (which are eventually taxed, albeit at preferred rates, at the individual level if the shareholder sells the stock before death). In fact, however, most corporate income is not taxed twice:

- A substantial share of corporate income is not taxed at the corporate level, due to shelters, corporate tax subsidies, and other factors.[4] Recent evidence suggests growing use of corporate tax shelters.[5]
- Half or more of dividends are effectively untaxed at the individual level because they flow to pension funds, 401(k) plans, and nonprofits.[6]
- A substantial share of capital gains on corporate stocks is never taxed because of the basis step-up at death. The share of capital gains that is subject to taxation, furthermore, is taxed at preferred rates relative to ordinary income and taxed only on a deferred basis; both factors reduce the effective tax rate on these gains.[7]

As a result of these features of the tax code, some corporate income is not taxed at either the corporate or individual level, some is taxed once (at either the firm or individual level), and some is taxed twice. Although data limitations make definitive judgments difficult, the component of corporate income that is not taxed (or is preferentially taxed) appears to be at least as large as the component that is subject to double taxation. That is, the nontaxation or preferred taxation of corporate income is arguably at least as big of a concern as double taxation.

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[4]Robert McIntyre, "Calculations of the Share of Corporate Profits Subject to Tax in 2002," January 2003.

[5]Mihir Desai, "The Corporate Profit Base, Tax Sheltering Activity, and the Changing Nature of Employee Compensation," NBER Working Paper 8866, April 2002.

[6]William G. Gale, "About Half of Dividend Payments Do Not Face Double Taxation," *Tax Notes*, Nov. 11, 2002, p. 839. Although taxes are due on pensions and 401(k) plans when the funds are paid out or withdrawn, the effective tax rate on the return to saving in such accounts is typically zero or negative because the present value of the tax saving due to the deduction that accompanies the original contribution is typically at least as large as the present value of the tax liability that accompanies the withdrawal.

[7]The taxation of nominal (as opposed to real) capital gains exerts an upward bias in the effective tax rate on capital gains. Given recent trends in inflation and real returns, however, this effect is relatively minor in the current environment.

Table 1: After-Tax Returns From $100 in Pre-Tax Corporate Income for a Taxable Investor

	Shelter $100 in corporate earnings/ do not pay corporate tax		Do not shelter $100 in corporate earnings/ pay corporate tax	
	After corporate tax	After individual tax	After corporate tax	After individual tax
Current law				
Pay dividend	$100	$74	$65	$48
Retain earnings	$100	$90	$65	$59
Administration's proposal				
Pay dividend	$100	$74	$65	$65
Retain earnings	$100	$90	$65	$65
Administration's proposal modified to tax at 35 percent dividends and accruing capital gains based on income not taxed at corporate level				
Pay dividend	$100	$65	$65	$65
Retain earnings	$100	$65	$65	$65

Given the differential tax treatment of dividends, capital gains, and corporate earnings, and other related features of the tax code, the effective rate of taxation on corporate income varies. This system generates several well-known problems. We focus on the following two issues:

- Corporations have economic incentives and legal opportunities to shelter income from the corporate tax; and
- Corporations have incentives to retain earnings rather than pay dividends.

These problems have led to proposals for integration of the corporate and personal taxes. Under a well-designed integration scheme, all corporate income would be taxed; all corporate income would be taxed once; and all corporate income would be taxed at the same nonpreferential rate.

The nontaxation or preferred taxation of corporate income is arguably at least as big of a concern as double taxation.

As noted above, under the administration's proposal, dividends paid out of corporate earnings that were already taxed at the corporate level would not be subject to taxation under the individual income tax. In addition, corporate retained earnings that were taxed at the corporate level would generate a basis adjustment for shareholders so that — when the stock was eventually sold — capital gains taxes would not have to be paid on the increase in stock price that was due to already-taxed retained earnings.

To implement this plan, firms would have to create excludable distribution accounts based on their taxable earnings. The creation of these accounts is likely to involve a variety of complicated issues. From the shareholder perspective, however, the system could be relatively simple. For example, the 1099 that shareholders receive could list (a) total dividends paid to the shareholder (as it currently does); (b) the taxable share of these dividends; and (c) the appropriate adjustment in basis for the stock price.

III. Incentives in a Simple Model

A. Taxable Investors

To analyze the effects of the administration's proposal for firms owned by taxable investors, we consider a simple example. We assume that the marginal statutory corporate tax rate is 35 percent, the marginal individual tax rate on taxable dividends is 26 percent,[8] and the effective marginal individual tax rate on capital gains (on an accrual rather than realization basis) is 10 percent. These rates are assumed for simplicity; the qualitative findings do not differ under other similar rates. Furthermore, we assume that $1 in retained earnings results in $1 in capital gains for shareholders. We also assume the firm's motivation is to maximize after-tax income for its shareholders.[9]

Under these assumptions, consider a firm that has $100 in pre-tax earnings. We focus on two of its choices: Should it shelter the funds? Should it pay dividends or retain earnings on any after-tax profits? Table 1 works through this example under current law and the administration's proposal for a firm owned by taxable investors.

Under current law, if the corporation pays taxes on the $100 and then pays the rest out in dividends, the shareholder ends up with after-tax income of about $48 (=100*(1-0.35)*(1-0.26)). If the firm pays taxes and retains the earnings, the shareholder has a capital gain of $65, and thus keeps about $59 on an accrual-equivalent basis (=100*(1-0.35)*(1-0.10)).

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[8]This rate is based on Treasury data reported in Kiefer, *et al.*, "The Economic Growth and Tax Relief Reconciliation Act of 2001: Overview and Assessment of Effects on Taxpayers," *National Tax Journal*, March 2002.

[9]If managers were more interested in maximizing the firm's after-tax income (rather than shareholders' after-tax income), the incentives to shelter corporate income under the administration's proposal would be even stronger than depicted below.

Table 2: After-Tax Returns From $100 in Pre-Tax Corporate Income for a Nontaxable Investor

	Shelter $100 in corporate earnings/ do not pay corporate tax		Do not shelter $100 in corporate earnings/ pay corporate tax	
	After corporate tax	After individual tax	After corporate tax	After individual tax
Current law				
Pay dividend	$100	$100	$65	$65
Retain earnings	$100	$100	$65	$65
Administration's proposal				
Pay dividend	$100	$100	$65	$65
Retain earnings	$100	$100	$65	$65
Administration's proposal modified to tax at 35 percent dividends and accruing capital gains based on income not taxed at corporate level				
Pay dividend	$100	$65	$65	$65
Retain earnings	$100	$65	$65	$65

Under the administration's proposal, the shareholder receives $65 after tax (=100*(1-0.35)), regardless of pay-out policy. If the firm pays a dividend, the dividend is not taxable at the individual level. If the firm retains the earnings, the retained earnings raise the basis of the stock value for the shareholder and therefore wipe out any capital gains taxes that would have been owed at the personal level. Therefore, as long as the corporation pays taxes on the $100, the shareholder gains $65 after tax, regardless of whether the firm pays out or retains the after-tax earnings.

Now consider the incentives for sheltering the $100 from corporate taxation.[10] Under both current law and the administration's proposal, if the firm shelters the funds (and thus pays no corporate tax), the only tax paid is at the individual level (since taxable shareholders continue to be liable for taxes on dividends and capital gains resulting from nontaxed corporate earnings). Under both current law and the administration's proposal, shareholders end up with $74 (=100*(1-0.26)) if sheltered funds are paid out as dividends and $90 (=100*(1-0.10)) if sheltered funds are retained.

These calculations lead to several conclusions:

- Under current law, some corporate income is taxed at more than the full corporate rate (35 percent) and some corporate income is taxed at less than the full corporate rate. (After-tax returns to the shareholder that are above $65 reflect taxation at less than the full corporate rate; after-tax returns to the shareholder that are below $65 reflect taxation at more than the full corporate rate.) Funds that are sheltered pay less tax than those that are not. Earnings that are retained face less tax than earnings paid out as dividends. The implication is that taxing all corporate income once and only once at the full corporate rate requires reducing the tax burden on some forms of corporate income and raising it on others.
- Under current law, the most profitable after-tax strategy is to shelter income and retain the earnings. The same strategy is also the most profitable under the administration's proposal. Under both regimes, firms have incentives to shelter income, regardless of payout policy. These incentives are smaller in the administration's plan, but they are present in both systems.
- Under current law, tax incentives induce firms to retain earnings if they pay taxes on their earnings. Under the administration's proposal, tax incentives would not bias firms to retain earnings or to pay dividends if they pay taxes on their earnings. That is, the administration's proposal does eliminate the tax bias toward retaining earnings if and only if the corporation has paid tax on the earnings.
- In short, the administration's proposal eliminates the double taxation of corporate earnings: In all the scenarios where shareholders end up with less than $65 under the current system, they end up with $65 under the administration's proposal. But it does not eliminate incentives for corporate tax sheltering: In all the scenarios where shareholders end up with more than $65 under the current system, shareholders also end up with more than $65 under the administration's proposal. And, given sheltering, the administration's proposal does not eliminate the incentive to retain earnings.

B. Nontaxable Investors

All of the calculations and conclusions above refer to firms owned by taxable investors. The problems with the administration's proposals are even more significant to the extent that firms are owned by nontaxable investors. We define "nontaxable investors" as

[10] For simplicity, we assume that sheltering eliminates the corporate tax. In reality, sheltering may reduce rather than eliminate the tax. In addition, sheltering typically involves administrative expenses. Incorporating partial rather than full tax savings as well as administrative expenses would attenuate the incentives for tax sheltering under both current law and the administration's proposal, but would not eliminate them. The basic point remains.

shorthand for investors whose individual income tax liabilities would be unaffected by reductions in income taxes on dividends and capital gains. As noted above, half of all dividends accrue to entities that do not pay dividend taxes — including pension funds and nonprofit institutions. These entities own a substantial share of all outstanding equities (though not necessarily exactly half, since dividend payout ratios vary) and thus also receive a substantial share of all capital gains.

To the extent that firms are owned by nontaxable shareholders, the administration's proposal provides no new incentives for corporations to pay taxes or dividends.

To the extent that firms are owned by nontaxable shareholders, the administration's proposal provides no new incentives for corporations to pay taxes or dividends. Because they do not pay dividend or capital gains taxes anyway, those shareholders would prefer that corporations shelter their earnings, under current law and under the administration's plan. Table 2 shows these effects.

IV. Taxing All Corporate Income

The final two rows of Tables 1 and 2 show the incentives that would arise if the administration's proposal were modified to tax at the same rate:

- Earnings that the corporation chose not to shelter;
- Dividends paid out of nontaxable corporate earnings; and
- The change in market value of the company less retained earnings that come from the Excludable Distribution Account (more technically, the change in the market value less the part of the EDA that is not paid out in dividends).

Under this change, as under the administration's existing proposal, dividends paid out of EDAs and capital gains due to the retention of funds in EDAs would not be taxed.

These changes would tax income sheltered at the corporate level at the same rate as nonsheltered income. Under these changes, as under the administration's proposal, nonsheltered corporate earnings would be taxed at the corporate rate. Unlike the administration's proposals, however, these changes would also tax sheltered earnings — which have to be either paid out as dividends or retained — at the same rate as nonsheltered earnings. Any dividends paid out of sheltered earnings would be taxed at the full corporate rate (albeit at the individual level). Any retained earnings out of sheltered earnings would raise the firm's market value and thus would be taxed under this plan. To see this, note that the change in the firm's value is the sum of retained earnings out of EDAs and retained earnings out of sheltered income. Thus, the difference between the total change in market value and the amount of retained earnings from EDAs is the value of retained earnings out of sheltered earnings. That difference would be taxed under this change.

In Tables 1 and 2, we assume that the tax rate for all three items is 35 percent. The key result, shown in the final two rows of the table, is that taxing the three items above at the same rate eliminates incentives to shelter income at the corporate level and eliminates any tax-induced incentive to retain earnings. Modifying the administration's proposal in this manner — which would require taxing dividends and accruing capital gains for individuals at the 35 percent corporate tax rate if such capital gains or dividends did not reflect earnings already taxed at the corporate level — would be necessary to achieve the goals that the administration has apparently set, and claims, for its proposal.

It is worth emphasizing that the requisite modification to the administration's proposal would not eliminate the legal opportunity for corporations to shelter income. It would just take away the economic incentive to do so. To see this, note the following examples for taxable shareholders (similar conclusions apply to nontaxable shareholders):

- If the corporation paid tax on its $100 of earnings, the outcome is the same as under the administration's existing proposal: the shareholder would end up with $65 in dividends or $65 in capital gains and does not have to pay individual-level taxes on either. The shareholder thus receives $65 after tax.
- If the corporation sheltered its earnings and then paid $100 in dividends, the dividends would be taxable at the individual level (just as under the administration's existing proposal). The individual income tax rate on the dividends, however, would be set at the corporate tax rate, 35 percent, rather than the existing 26 percent rate (the average rate that would also prevail under the administration's proposal). As a result, the shareholder would receive $65 after tax.
- If the corporation sheltered its earnings and retained the $100 in earnings, the market value of the firm would increase by $100 — but the firm would have no increase in its EDA. As a result, taxing (at the full corporate rate) the increase in market value less the retained earnings paid from the EDA (in this case, none) would leave the shareholder with $65 in capital gains that would not be taxed again. Again, the shareholder would receive $65 after tax.[11]

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[11]A hybrid example may also be insightful. Suppose the firm sheltered $50 and paid taxes on $50. It would pay $17.50 in taxes on the $50 of declared earnings, so that its EDA would be $32.50 (=50-17.50). Suppose it paid out $10 in dividends and kept $22.50 of the EDA as retained earnings. With the other (sheltered) $50, it paid $20 in dividends and retained $30. How would the modified version of the administration's proposal work in this case? The shareholder would have $10 in dividends paid from the EDA, and would keep

(Footnote 11 continued on next page.)

V. New Sheltering Opportunities

In addition to failing to eliminate the incentive for corporations to shelter income and retain it, the administration's proposal is likely to result in a variety of new tax shelters. As just one example, the Treasury Department has indicated that the EDA will be calculated as U.S. taxes (plus foreign tax credits used to offset U.S. tax liability), divided by 0.35 minus U.S. taxes plus foreign tax credits used to offset U.S. tax liability, plus excludable dividend income.[12]

This approach to computing the EDA opens a potentially large loophole involving corporate tax rates below 35 percent. In particular, corporate income is currently taxed at a 15 percent rate on income up to $50,000, and 25 percent on income between $50,000 and $75,000. Now consider a consultant earning $500,000 a year, who is currently in the 38.6 percent individual marginal tax bracket. Assume the consultant opens a new corporation to handle some of her specialized cases. She could channel up to $50,000 in income through such a corporation, pay $7,500 in corporate tax (= 0.15*$50,000), and pay herself a tax-free dividend of $42,500. The result is that the consultant will have succeeded in reducing the effective marginal tax rate on the $50,000 in income to 15 percent and saved almost $12,000 in taxes. Given the proposed EDA formula, this loophole is likely to be extremely difficult to monitor or offset.

VI. Conclusion

The administration's proposal to exclude dividends from individual taxation (and allow a basis adjustment for retained earnings) if the income has been taxed at the corporate level is a significant tax cut on dividends and capital gains. Although it is being marketed as an effort to reform the corporate tax, it would not eliminate the incentives for corporate tax shelters, nor would it eliminate the incentives to retain earnings based on shelters. These findings hold especially strongly to the extent that firms are owned by shareholders whose tax liability is not affected by individual income taxes on dividends and capital gains. Indeed, under the administration's proposal, as under current law, the strategy that generates the highest after-tax returns for the firm's shareholders involves sheltering the income from corporate taxation and retaining the earnings.

Modifying the administration's proposal to achieve true tax reform — which would tax corporate income once and only once at a nonpreferential rate, and eliminate the incentives for corporate tax sheltering as well as double taxation — would require taxing dividends and accruing capital gains at the full corporate tax rate to the extent such capital gains or dividends reflected income not already taxed at the corporate level. The implication is that for the administration's proposal to achieve its ostensible goals, it would have to be modified to include an increase in the effective marginal tax rate on dividends and an increase in the effective tax rate on accruing capital gains.

[Last week's column, "The President's Tax Proposal: First Impressions," (Jan. 13, 2003, p. 265) included the statement that "Davis (2002) reports that the administration believes that a $200 billion reduction in the surplus raises interest rates by 3-5 basis points. By that measure, a $900 billion package would reduce rates by between 13 and 22 basis points." The word "reduce" should have been "raise." Thanks to Bruce Bartlett for pointing out this mistake.]

that with no individual level taxes owed. The shareholder would have $20 in dividends from outside the EDA and have to pay $7 in taxes on that, keeping $13 after tax. The firm would have an increase in market value of $22.50 + $30 = $52.50. But the shareholder would owe tax on the $30 of that increase that is due to retained earnings from outside the EDA. So the shareholder pays $10.50 in taxes (=0.35*$30). The bottom line is that the shareholder gets $10 + $13 + $52.50 - $10.50 = $65 after tax.

[12] "Fact Sheet: The President's Proposal to the End of the Double Tax on Corporate Earnings," Office of Public Affairs, Department of Treasury, Jan. 14, 2003, KD-3761.

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