S. HRG. 108–6

TAX FAIRNESS: DOES DOUBLE TAXATION UNFAIRLY TARGET OLDER AMERICANS?

HEARING

BEFORE THE

SPECIAL COMMITTEE ON AGING UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

WASHINGTON, DC

FEBRUARY 4, 2002

Serial No. 108–2

Printed for the use of the Special Committee on Aging

U.S. GOVERNMENT PRINTING OFFICE

85–624 PDF WASHINGTON : 2003

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

SPECIAL COMMITTEE ON AGING

LARRY CRAIG, Idaho, *Chairman*

CONRAD BURNS, Montana
RICHARD SHELBY, Alabama
RICK SANTORUM, Pennsylvania
SUSAN COLLINS, Maine
MIKE ENZI, Wyoming
GORDON SMITH, Oregon
JAMES M. TALENT, Missouri
PETER G. FITZGERALD, Illinois
ORRIN G. HATCH, Utah
Elizabeth Dole, North Carolina
TED STEVENS, Pennsylvania

JOHN B. BREAUX, Louisiana, *Ranking Member*
HARRY REID, Nevada
HERB KOHL, Wisconsin
JAMES M. JEFFORDS, Vermont
RUSSELL D. FEINGOLD, Wisconsin
RON WYDEN, Oregon
BLANCHE L. LINCOLN, Arkansas
EVAN BAYH, Indiana
THOMAS R. CARPER, Delaware
DEBBIE STABENOW, Michigan

LUPE WISSEL, *Ranking Member Staff Director*
MICHELLE EASTON, *Staff Director*

CONTENTS

TAX FAIRNESS: DOES DOUBLE TAXATION UNFAIRLY TARGET OLDER AMERICANS?

TUESDAY, FEBRUARY 4, 2003

U.S. SENATE,
SPECIAL COMMITTEE ON AGING,
Washington, DC.

The committee convened, pursuant to notice, at 10:05 a.m., in room SD–628, Dirksen Senate Office Building, Hon. Larry Craig (chairman of the committee) presiding.

Present: Senators Craig, Smith, Hatch, Talent, Breaux, and Carper.

OPENING STATEMENT OF SENATOR LARRY E. CRAIG, CHAIRMAN

The CHAIRMAN. If the room would come to order, let me convene this U.S. Senate Special Committee on Aging. Before we start the hearing this morning, this is a difficult day in our country and I would ask that you join me in a moment of silence.

[A moment of silence was observed.]

I thank you very much for that. It is a difficult morning in America, but those seven who lost their lives on Saturday that we honor and recognize today at the Johnson Space Center in Houston would be the first to tell us it is important to get on with life and for this country to continue to function so well and to be able to properly deal with the problems that it faces, and that is, in part, what this hearing is about today.

I have been joined with my colleague, Senator Breaux, who has chaired this committee for the last nearly 2 years and we have worked very cooperatively on a variety of issues. This is one, as I began to delve into it, that I found absolutely fascinating and appropriate for this committee to deal with. Why? Because I really do believe it speaks to the issue of double taxation, and after I have looked at this, the method by which double taxation unfairly targets older Americans.

We are pleased to have some of the nation's top economic experts testifying on what impact double taxation has on our senior citizens, with a particular eye on the President's tax relief plan. I look forward to their testimony.

When you study the tax code, it becomes apparently clear that older Americans, both working and retired, are subject to double taxation more than most other age groups. The question we hope to explore today is whether the rhetoric about tax cuts for the rich is really about tax relief and fairness for our seniors.

Older Americans are more likely to hold investments in assets that pay dividends than other age groups. Millions of seniors, many on fixed incomes, rely on dividend income to make ends meet from month to month. The pie chart to my right, your left, shows that 52 percent of seniors receive taxable income.

Ironically, my wife is en route back from Tucson this morning, where she has spent the last 4 days with her 85-year-old mother, who is now a widow living in a retirement community in Tucson. She was a nurse all of her life. Her husband, my late father-in-law, was a career military person. They were not wealthy, but they were frugal and they cautiously and quietly invested all of their lives for their retirement. I asked my wife this morning, when she had taken all of the materials with her mother over to the tax accountant these past few days, about how much of Shirley's income is going to be dividends. My wife said, "Over 50 percent."

It is interesting that that work is being done now as we get ready to visit our accountant and pay our taxes, that the pie chart and the studies really are reflective of a good many seniors across this country, and I will tell you that my mother-in-law, like many in our country, does not classify as a wealthy person. But most assuredly, she receives a large share of her income from the very issue we talk about today.

The Cato Institute recently published data from the Organization for Economic Cooperation and Development showing dividends and corporate tax rates around the world. The bar chart to my right, your left, is a summary of the Organization for Economic Cooperation and Development data. The U.S. has the second-highest combined Federal, State, and local dividend tax rate in the world. The chart begs the question, why would any company pay a dividend under these stifling tax rates? We hope to hear from our witnesses on this question.

I also find it ironic that we are second from the top and the top is Japan, and Japan for the last decade has struggled to try to get its economy going and get investment back into it.

Older Americans are also subject to double taxation by the Federal Government in the form of the death tax and the taxation of Social Security benefits. The death tax has forced the break-up of family farms and the sell-off of small businesses in order to pay the government after death. It is unfair to tax a person's savings and earnings twice while they are alive, but it is immoral to tax those life savings again, in my opinion, when a person dies.

Today's seniors already pay income taxes on their payroll taxes when they work, and now a growing number of modest and middle-income seniors must pay income taxes again on already taxed Social Security benefits. For many seniors, 85 percent of their Social Security benefits are taxed. This tax is a disincentive for seniors who want to work.

I am looking forward to the testimony from the Chairman of the President's Council on Economic Advisors who is with us, Glenn Hubbard, and also Hilary Kramer of Montgomery Asset Management, a regular business expert appearing on Fox News, as our first panel.

Our second panel will be Dick Buxton, one of my constituents, who will describe the impact of double taxation on his family in

Idaho. Also testifying are Dr. Dan Mitchell, a tax reform expert from the Heritage Foundation, and Dr. Mark Crain, a Professor of Economics at George Mason University and a Trustee for the Virginia Retirement System.

We look forward to hearing more about these issues from our panels of witnesses, and so I welcome them.

But before I turn to the panels, let me turn to my colleague John Breaux from Louisiana, who has been an outspoken and appropriate leader for the senior community for a good number of years.

STATEMENT OF SENATOR JOHN BREAUX

Senator BREAUX. Thank you, Mr. Chairman. I will try to be very brief. I think it is appropriate that we look at tax recommendations on a regular basis, particularly to determine whether the tax code targets any group of Americans unfairly or differently from others, and I think that the purpose of the hearing this morning is to look to see if there are problems in the existing code which unfairly treat seniors.

The fact is, on Social Security taxes, the benefits of most recipients are not taxed. Most seniors who are retired do not pay taxes on their Social Security income because you don't start paying it until you reach a certain threshold. The 85 percent taxation coverage only kicks in when seniors have a single income in retirement of over $34,000, or $44,000 for a couple. The average income in Louisiana for working people is about $22,000 a year. That is for working people, so for retired people, it is much less than that.

So most of the benefits of people who get Social Security are not taxed. Some are. The concept is that there should be taxation of those benefits that exceed the contribution of an individual that they have placed in over their working years. Congress has determined back, I guess, in 1993, that that was an appropriate request for seniors who reach a certain income level in requirement to help shore up the Social Security system, which, if you have seen the projections on the difficult situation that it is in, as well as the Medicare program under the HI portion of the Social Security tax. So it is appropriate that we can look at this, but we also need to keep it in proper perspective.

The second portion is the double taxation of dividends. I think as a policy measure, double taxation is not a good idea. Having said that, over half of the President's tax proposal is addressing this problem, which originally was a proposal to stimulate the economy. Almost every economist that we have talked to has indicated both publicly and privately that elimination of the double taxation on dividends is not going to be short-term stimulative to the economy. Is it correct policy in the long term? The answer is probably yes and I think we need to take a look at it in that vein.

But at the same time, I would point out that in my State, which a lot of other States fall in the same category, only 8 percent of the people in my State of Louisiana are subject to any tax on dividends at all, 8 percent, IRS figures. So we are going to spend $374 billion on a program that 92 percent of the people in Louisiana don't pay taxes on anyway. Now, is that good tax policy? Maybe. Is it worth over half of the total package? I question it. Does it stimulate the economy? The answer is no.

So these are all questions that are appropriately being discussed here today and we need to hear both sides of the issue and I thought that is why I would say what I said. Thank you.

The CHAIRMAN. John, I appreciate those comments and your frankness and the openness. That is the value of this committee and the purpose of hearings, to build an objective record on this important issue.

We have now been joined by my colleague, the senior Senator from the State of Utah, Orrin Hatch. Orrin?

STATEMENT OF SENATOR ORRIN G. HATCH

Senator HATCH. Thank you, Mr. Chairman. I want to welcome both of you here. We appreciate both of you being here. Dr. Hubbard, I have watched your career down at the White House and I think you are doing a terrific job. I think as one of the designers of the President's tax program, you have made some bold moves here that I think could make a real difference in our society.

I am appreciative, Mr. Chairman, of you scheduling this hearing today. I am new to this committee and I look forward to working with you and Senator Breaux on the issues that matter to Utah's seniors and seniors all over the country.

I am especially glad we are here today discussing the double taxation of senior citizens. Millions of older Americans pay far too much in taxes, and this year, we are going to cut those taxes. Our nation's seniors spent decades working long hours, scrimping and saving for their well-deserved retirement, only to find that no matter how old they get, the tax man still has seniors in his sights. Age springs wisdom, but not tax relief, and this year, I want to help the President change that.

President Bush wants to cut income taxes for seniors. He wants to lower their marriage penalties, and he wants to eliminate the double tax on their dividends. I think this is the right plan for America's seniors as well as everybody else.

This hearing examines the double tax on dividends. Over half of all income tax filers over 65 years of age pay tax on dividends, and over one-third of all filers between age 55 and age 64 have taxable dividends. Millions of people saving for retirement, close to retirement, or working for an early retirement are also paying these double taxes. Right now, corporations give more than a third of their profits over to the government in taxes, and then we demand that when investors get their share of these profits in the form of dividends, they have to pay income tax on it again. As President Bush keeps reminding us, taxing income once is fair, but taxing it twice is not fair.

Mr. Chairman, this is not a question of rich versus poor. Elderly Americans with modest incomes receive substantial stock dividends. In fact, more than half of all tax filers over the age of 65 earning between $30,000 and $40,000 per year receive taxable dividend income. Because our nation's senior citizens have been so thrifty during their lives, these dividend payments are sizable. Seniors who receive dividends and earn between $30,000 and $40,000 per year in total income receive an average of over $2,000 per year of that income as taxable dividends.

Further, ending the double tax on dividends will decrease the risk of bankruptcy and improve corporate accountability. Over my years of public service, I have met far too many seniors who have lost part or all of their savings because the companies that they invested in went bankrupt. Last year, we enacted tough corporate accountability reforms to help strengthen our nation's capital markets. This year, we should enact the President's corporate reform tax cut to finish the job. America's seniors will be rewarded with safer investments and a more secure retirement.

I am very interested in this issue, but unfortunately, my duties are not going to permit me to stay at all here because I have got to be over in the Capitol in just a few minutes, but let me just say one thing. I have got an analysis that says this more than $300 billion revenue loss from the dividend plan would be more than made up over the years and that if you use any kind of scoring total besides static analysis, the country would wind up actually benefiting, not only because we wouldn't be paying double taxation, but because, in essence, Treasury would get as much revenue anyway.

I remember when we were arguing for capital gains rate reductions on the Hatch-Lieberman bill in 1997. The argument against it was, using a static analysis, that we were going to lose revenues. Our argument was, the Treasury wouldn't lose revenues and we would probably gain revenue. Well, a study by DRI, not a conservative econometric modeling firm, concluded that, yes, we didn't lose revenues, that we slightly gained on the capital gains rate reduction.

I suspect removing the double taxation of dividends is going to have a similar effect over time. So I would be interested in knowing what you feel about that, both you, Ms. Kramer, and you, Dr. Hubbard, because I think sometimes people around here using static analysis are wrong. In fact, many times, they are wrong. Now, I think we could go too far in using a dynamic analysis, too, but there ought to be something in between that acknowledges that there is some dynamism in the economy that will work in favor of tax rate reductions.

I just want to compliment both of you, but especially you, Dr. Hubbard, for the work you are doing down there at the White House. It isn't easy to make these type of decisions. It isn't easy to promulgate them. It is certainly not easy to win on them, but I intend to see that you win this year and I just hope that we can.

Thanks, Mr. Chairman. If you will forgive me, I had better get over there.

The CHAIRMAN. Orrin, thank you very much, and in the course of their testimony, it is possible that Mr. Hubbard could respond to your query. But I do thank you for coming this morning.

Now let us turn to our first panel. I had mentioned in my opening comments their introduction. Dr. Glenn Hubbard is Chairman of the President's Council of Economic Advisors, and as I think Senator Hatch has said, "He has worked with the President to put forth a daring tax reform stimulus package that is now before the Congress and will clearly be before us soon."

Again, this morning, we want to focus on the impact on the senior community, a community of fixed-income Americans who vie with inflation and a variety of costs in which they and we all live, but unlike us, in many instances, their incomes are fixed.

Second on the panel is Hilary Kramer, a Senior Advisor and Strategist at Montgomery Assets Management and Business Commentator for Fox News Channel.

We welcome you both. Dr. Hubbard, please proceed.

STATEMENT OF HON. GLENN HUBBARD, CHAIRMAN, PRESIDENT'S COUNCIL OF ECONOMIC ADVISORS, WASHINGTON, DC

Dr. HUBBARD. Thank you very much, Mr. Chairman, for holding this hearing, and thank you, Senator Breaux. I think this is an extremely important topic that you have raised, Senator, and the implication for seniors.

What I want to do in my oral remarks is really just focus on a couple of things with you. One, to go over the questions you asked directly about seniors in your remarks, but also to tell a little story of why I think this is economic policy that the Aging Committee should be concerned with going long-term, as well, and to get at the issue of why, if you never receive a dividend check, this is still very much in your interest.

To start, of course, with what the President was trying to accomplish, the President in his Jobs and Growth Initiative was trying to provide near-term growth insurance for the economy while also being consistent with very good long-term tax policy. This policy toward bolstering the economy in the short-term and the long-term, we believe, helps America's seniors in important ways.

To start with, as you made, Mr. Chairman, the point in your opening remarks, ending the double tax on corporate income directly benefits seniors who receive dividend checks. About half of all the dividend income in the U.S., whether it is measured just as total dividends or dividends that would be excludable under the President's proposals, goes to America's seniors, who often, as you indicated in your example, Mr. Chairman, rely on those checks for a steady source of retirement income.

It is also important to note that even among seniors, low- and moderate-income seniors benefit. About 40 percent of seniors with incomes below $50,000 receive dividend income, and, of course, seniors generally benefit from overall relief.

But just as important as this increasing after-tax income is for seniors and reducing double taxation, it is important to tell a story of why this is so much in our economy's interest. When we double tax something, like double taxing corporate income, the burden gets borne somewhere, and surprisingly, who pays it is all of us. It is not just who gets dividends, but all of us in terms of our wages.

To see this, if we double tax corporate income, we raise the tax burden on capital, we get less investment in our economy, and ultimately lower wages for all of us. For this committee, Mr. Chairman, as you think about aging policy, there is no variable more important for the long-term integrity of the Medicare program or the Social Security program than our economy's capacity to grow. These are very important long-term issues for seniors.

There is an important long-term piece of good news to start out with, as well. The American economy has very strong fundamentals. Those don't come from the sky. They result from the flexibility of the American private sector and from public policies that try to promote flexibility in capital accumulation in the consumer.

To get to the here and now reasons the President was so bold in his growth package, I think it is important, if I might, Mr. Chairman, to say a bit about the current economic situation. We all know where we are and we all know that events of over-investment in the late 1990's, the terrible tragedy of September 11, corporate governance scandals, have placed a cloud on the nation's economic activity and recovery. A good chunk of what makes this particular episode in our economy different is the pattern of business investment.

In a typical recession and recovery, investment drops and then sharply rebounds. In the current recovery, we are seeing a lagged and delayed recovery of investment. As I travel across the country talking to business people, as I am sure you do, as well, you hear stories of very high hurdle rates, very high bars placed on new investment, and this is really a key drag to our economy. The uncertainty surrounding the recovery, uncertainty surrounding tax policy, is a key risk to the outlook, as well as consumers deciding, perhaps, to increase their saving a bit in the near term in response to declines in equity values.

In response to these downside risks, the President put forth a growth package which would shore up consumer incomes, the acceleration of the marginal rate cuts you have already enacted, increasing small business investment incentives through expensing, and importantly, eliminating the double tax on corporate income, not just on dividends, but on corporate income generally.

We believe that these proposals will help the economy a great deal in the near term. To those who say that the corporate income double taxation has no short-term effect, I beg to differ. Most of my professional career has been spent studying investment, and I believe it is fair to say that the bulk of research on this topic would suggest very large effects on the cost of capital of what the President is doing.

To be concrete, were the President's proposal to be enacted by you in its entirety, the cost of capital for investment could fall by as much as 10 to 25 percent, depending on the life of the equipment we are talking about, and that is equivalent to an investment tax credit of between 4 and 7 percent. That is very big. This is perhaps the most radically pro-investment tax policy in decades.

In addition, of course, the President remains very focused on job creation in the short run. The President's proposal would get $58 billion into the economy in 2003, and that is the down payment on a long-term tax cut with very large projected responses from consumers.

I think it is important to close, if I might, again with a couple of longer-term obligations. One, of course, ultimately, economic policy, whether it is in the short-term or the long-term, has to be about our economy's fundamentals. The best way to tax capital from a purely economic perspective is not to tax it at all, and again, the reason for this has little to do with who gets dividends, although that is important, too, and everything to do with all of our wages. The person who writes the check to the IRS is not the person bearing the burden of the tax.

The final point I would raise is there is caution, and rightly so, as we think about the nation's fiscal health going forward. The President's budget remains very committed to restoring fiscal health through pro-growth tax policies and through spending restraint. It is important to look at a fiscal anchor, and to me, as an economist, a good fiscal anchor is our country's debt-to-GDP ratio, which, again, is not rising as a consequence of the President's proposals.

Are the current deficits welcome? No, of course, they are not. Are they understandable? We know they are, and the administration's pro-growth plans have a way to get out of them.

I will just close with you, Mr. Chairman, with the observation that were the President's proposals to be enacted, we believe the level of GDP would rise by almost a percentage point in 2003, and by the end of 2005, be close to 2 percentage points higher and remain so. So going back to Senator Hatch's observations when we started, this is a permanent feedback in Federal revenue from higher economic growth.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Dr. Hubbard, thank you.

[The prepared statement of Mr. Hubbard follows:]

Testimony
of
R. Glenn Hubbard
Chairman, Council of Economic Advisers

before the
Special Committee on Aging
United States Senate

Tuesday, February 4, 2003
10:00 a.m.

Chairman Craig, Ranking Member Breaux, and members of the Committee, I thank you for the opportunity to discuss how the President's Jobs and Growth Initiative will affect America's seniors. The central role of the package is to support near-term economic growth at the same time it improves the long-run productivity of the economy. This approach to fiscal policy is appropriate in the short run, because it focuses on what the economy needs now—faster investment and higher job growth for today's workers. By raising long-run economic growth, the package will help America's seniors as well. To start with, ending the double tax on corporate income will directly benefit seniors who receive dividend checks. About half of all dividend income goes to America's seniors, who often rely on these checks for a steady source of retirement income. But just as important as increasing after-tax dividend income is the effect that the President's package will have on the overall productivity of the economy. Higher taxes on corporate capital act to reduce investment, which in turns lowers the amount of capital that workers can use at their jobs. With less capital, workers are less productive, so they are paid less. By ending the double tax on corporate income and permanently raising expensing limits for small firms, the President's package encourages investment. This starts the virtuous circle of higher investment and job growth today, with higher capital stocks, productivity, wages, and standards of living tomorrow. In the end, the more productive economy will be better able to support the large number of workers who will soon retire.

Because so many seniors depend on Social Security and Medicare, any discussion of how the proposal will affect seniors must also discuss how it affects the government's fiscal position. One of the most important lessons of the past several years is the importance of strong economic growth for the Federal government's fiscal health. Accordingly, the central role for fiscal policy is to craft a tax policy that reduces tax-based distortions that hinder growth, while at the same time limiting the growth of government outlays to a sustainable path. Given the importance of economic growth to the government's fiscal position, I will start my testimony today by reviewing the economic situation currently facing our Nation. I will then discuss the ways in which the President's proposals contribute to higher growth, specifically by targeting business spending on investment.

At the start, however, I would like to stress an important fact: While the past two years have presented many challenges to the American economy – the long decline in the stock market and the terrorist attacks and economic contraction in 2001 – our long-run economic outlook is as strong as it has been in a generation. As Chart 1 shows, the trend rate of U.S. labor productivity growth has risen from rate of 1.4 percent per year from 1973 to 1995 to 2.5 percent per year from 1995 to 2000. Because higher productivity growth is the foundation of higher incomes and living standards, the productivity acceleration is good news for all of us. What is more, over the last four quarters for which we have data, labor productivity has risen by 5.6 percent – the best four-quarter change in productivity since the early 1970s. The ongoing productivity revival speaks well for the long-term outlook. Additionally, inflation remains low and stable, which helps the economy interpret relative price signals efficiently and which gives policymakers the room to support near-term growth.

THE ECONOMIC SITUATION IN 2002

In many ways, the economy's recent performance has been different than that of past recoveries since World War II. Typically, business investment declines most sharply in recessions and expands most briskly in recoveries. By contrast, the household and government sectors do not fluctuate as much. In 2002, however, the recovery from the economic contraction of the previous year took place amid continued weakness in business investment and strength in the household sector. After rising at an annual rate of 3.4 percent during the first three quarters, GDP rose at an annual rate of 0.7 percent in the fourth quarter. Business fixed investment rose at an annual rate of 1.5 percent in the fourth quarter – the first quarterly increase since mid-2000 – but much larger rates of increase will be needed for the recovery to be fully established.

Household sector. In large part, the strength of the household sector last year stemmed from the aggressive monetary easing by the Federal Reserve in 2001. Over the course of that year, the Federal Reserve cut its target federal funds rate eleven times, lowering the target from 6.5 percent to 1.75 percent. Given the well-known lags in monetary policy, these reductions continued to provide stimulus throughout 2002. Lower interest rates, for example, allowed motor vehicle companies to offer aggressive financing incentives, which have supported auto sales through much of the year.

Additionally, the substantial cuts in the target federal funds rate by the Federal Reserve have translated into lower mortgage interest rates, supporting housing starts and mortgage refinancing. In the first three quarters of 2002, mortgage refinancing alone injected more than $100 billion into home owners' pocketbooks. After they paid down second mortgages and outstanding home equity loans, they had more than $59 billion left over to spend in other ways. Survey evidence indicates that about half of this $59 billion was probably used for consumption and home improvements – two components of aggregate demand – which would have raised nominal GDP by about 0.4 percent in the first three quarters of 2002. All in all, the interest rates cuts were helpful in maintaining the recovery last year. The most recent rate reduction of 50 basis points undertaken on November 6, 2002, will provide further support for the recovery in 2003.

Fiscal policy has also been an important force behind robust consumption in 2002. In addition to enhancing long-term economic efficiency, the tax cut proposed by the President and passed by Congress in 2001 provided valuable support for disposable income, which has been far more robust than is typical at this stage of a recovery. The upshot has been solid growth in both personal consumption expenditures and residential investment that has supported the recovery so far.

Business investment. In contrast to positive impetus from the household sector, business investment has been the economy's key weak spot. As I noted earlier, during the current business cycle, the decline in business investment has been sharper, and the recovery more modest, than an average postwar business cycle. On average, the peak-to-trough decline in nonresidential investment in the typical post-war recession is 6.2 percent. Assuming that the trough in the most recent recession occurred during the fourth quarter of 2001 – a decision that ultimately resides with the National Bureau of Economic Research – the corresponding decline in the most recent recession was 8 percent. Comparing the typical pace of recovery, during the first four quarters of this recovery, business investment fell 1.9 percent further, compared to a typical increase of roughly 5.3 percent four quarters into a recovery. Chart 2 displays the current weakness investment graphically, by comparing it to the typical experience of recoveries since 1960. Simply put, the recovery in investment that one would expect at this stage of the business cycle has yet to materialize.

The current weakness in investment results is linked to adverse developments in equity markets during the past three years. Indeed, both stem in large part from the same underlying shock – a scaling back of expected profit growth. Evidence that earnings growth was adjusted downward comes from surveys of Wall Street analysts who track individual firms. According to one such survey, five-year-ahead earnings growth forecasts for the firms in the S&P 500 fell from a peak of more than 18 percent per year in mid-2000 to slightly more than 13 percent per year by September 2002. Another factor in lowering both equity values and business investment is the current risk climate. Higher levels of uncertainty in the economy and/or higher aversion to risk on the part of investors reduce the willingness of investors to hold corporate equities and lowers stock prices and investment. One reflection of the risk outlook is the spread between yields on corporate bonds and U.S. Treasury securities, because corporate bonds are subject to default risk while U.S. Treasury securities are not. The widening gap between yields for corporate and Treasury securities after 2000 coincided closely with the decline in the stock market during this period. Corporate-Treasury spreads continued to widen sharply in 2002, reaching near-record levels, indicating that risk aversion played a key role in markets in the months following September 11, 2001 as well.

Inventory investment contributed strongly to the economic slowdown in 2001, but by early in 2002, the pace of inventory decline slowed, providing a significant boost to production. In some sectors of the economy, evidence suggests that inventory restocking is underway. Over the next several quarters, as inventory and sales growth come together, inventory investment should provide upward momentum to the recovery.

Government purchases. The war on terror continued to exert upward pressure on Federal government purchases in 2002. In late March, for example, the President requested that Congress provide an additional appropriation of $27.1 billion, primarily to fund the effort in the war against terror. More than half of this amount was allocated to the activities of the Defense

Department and various intelligence agencies. Most of the rest was needed for homeland security (mainly for the new Transportation Security Administration) and for the emergency response and recovery efforts in New York City. Though most of this spending was required for one-time outlays, it nevertheless contributed to the large 7.3 percent annual rate of increase in real Federal government purchases in 2002. State and local government purchases rose by a more moderate 1.7 percent annual rate during the same period.

External sector. While the United States economy remained below potential in 2002, its growth rate still outpaced that of many other industrialized countries. Growth in Canada – America's largest trading partner – was a healthy 4.0 percent in during the four quarters ending in the third quarter of 2002, but growth in many other countries, including Mexico, France, Japan, and Italy lagged behind. Low demand for U.S. exports combined with the emerging recovery in the United States (and the consequent increase in U.S. demand for imports) caused the U.S. trade deficit to reach record levels in 2002.

The widening trade deficit placed additional downward pressure on the U.S. current account balance, which reached a deficit of almost five percent of GDP in the middle of 2002. As a matter of accounting, the current account balance is simply the difference between net domestic investment and net domestic saving. Several factors can raise the current account deficit, including higher investment within our borders on the part of foreign investors, or lower savings rates on the part of U.S. citizens. In light of the large number of trade-related and financial forces operating on the current account, it is impossible to label a current account deficit as either "good" or "bad." Indeed, one factor contributing to high U.S. investment relative to savings is the rapid increase in U.S. productivity relative to many other major countries, which makes the United States a good place to invest. Because productivity growth is ultimately responsible for rising living standards, the current account deficit reflects at least in part good news about the American economy. Even so, a current account deficit indicates that the United States is consuming and investing more than it is producing, and the U.S. current account has typically been in deficit for the past two decades. As a result, the net international investment position in the United States has moved from an accumulated surplus of slightly less than 10 percent of GDP in the late 1970s to a deficit of almost 20 percent of GDP in 2001.

Recent increases in the current account deficit have led to some concerns that continued current account deficits (and the subsequent increases in international debt that would result) could not be sustained. Because debt has to be serviced by the repatriation of capital income abroad, the ratio of a country's debt to its income must stabilize at some point. Yet the United States is currently far from the point at which servicing our international debt becomes burdensome. In fact, until 2002, more investment income was generated by U.S. investment in foreign countries than was generated by foreign investments inside the United States.

In the end, the key determinant of the sustainability of the U.S. international debt position is continued confidence in the economic policies of the United States. As long as the United States pursues its current market-oriented, pro-growth policies, then the current account deficit will not represent an impediment to continued economic growth.

Labor market. The unemployment rate hovered between 5.5 and 6.0 percent throughout 2002 after rising 1.8 percentage points in 2001. Nonfarm payroll employment in 2002 was similarly weak, with 181,000 jobs lost in 2002, compared with 1.4 million jobs lost the previous year.

As in past business cycles, declines in manufacturing employment have been especially pronounced. Factory employment fell nearly 600,000 in 2002, following a decline of 1.3 million in 2001 and about 100,000 in 2000. Another feature of previous business cycles that has recurred in the past two years is the increase in the number of workers who report a long unemployment spell. Like the overall unemployment rate, the number of workers unemployed for 27 weeks or more rose in the 2001 and 2002. Yet the pattern of long-term unemployment observed in 2001 and 2002 was similar to patterns traced out in previous postwar fluctuations. Like the overall unemployment rate, the level of long-term unemployment remains moderate relative to past business cycles.

RISKS TO THE OUTLOOK

The slowing of GDP growth and weakness in labor markets in the fourth quarter of 2002 highlight the risks the recovery currently faces. In order of importance, these risks include:

A Delayed Investment Recovery. The key to transforming the current recovery into sustained robust growth is an increase in the pace of business fixed investment. Only with robust business investment will labor markets improve. A recovery in investment is a key factor in creating more jobs—when companies build new factories, they hire new workers and boost employment in capital-goods industries.

While private forecasters expect business investment spending to recover in 2003, there are several potential sources of a delay in an investment recovery. One risk is weaker profit growth. Due to a sharp increase in the fourth quarter of 2001, corporate profits have rebounded from recessionary lows. Yet the recovery in profits has been uneven. In the first three quarters of 2002, profits as a share of income averaged 7.5 percent. While this represents a recovery from the 7.2 percent share in 2001, it is still below shares of 8.7 percent in 1999 and 7.9 percent in 2000. Moreover, on a quarterly basis, corporate profits declined in each of the first three quarters of 2002. Because current profits are an indicator of future profits, firms may interpret recent weakness in profit growth as an indication of reduced investment opportunities. The decline in profits may have an even more negative impact on investment at firms that depend on retained earnings (rather than external capital markets) to fund investment projects.

A second potential setback to the investment recovery reflects an increase in the level of uncertainty about the course of the near term events or higher levels of risk aversion on the part of investors. Higher levels of uncertainty in the economy can also make firms delay new projects until the uncertainty is resolved. This delay is translated into a higher expected rate of return in order for new projects to be undertaken, which reduces the level of investment that is undertaken in the near term. Additionally, higher levels of risk aversion on the part of investors can reduce investment by making it harder for firms to raise external funds.

A Decline in Consumer Spending. As mentioned, the recent business cycle stands apart from the typical postwar recession in that household income growth has been stable while stock price declines have eroded household wealth. In the typical recession, incomes and net worth move together, but in the most recent recession, net worth fell dramatically relative to income. Yet in contrast to the negative effect of lower equity values on business investment, consumption has remained remarkably robust, even as household net worth has suffered. The contrast in the pattern of spending mirrors a reversal of conventional income and wealth dynamics. In the current cycle personal income – especially disposable personal income, supported by the tax cuts of 2001 – has held up quite well, even as household balance sheet positions have weakened.

The deterioration in household wealth over the past three years raises the possibility that consumers will increase their active saving out of disposable income in order to restore at least some of their lost wealth. An increase in precautionary saving of this type could have a substantial effect on yearly consumption. From the first quarter of 2000 to the last quarter of

2002, households lost nearly $7 trillion in equity wealth. A rough rule of thumb suggested by aggregate data on wealth and consumption is that yearly consumption declines by 3 to 5 cents for every dollar of lost equity wealth. Based on the midpoint of this range, the $7 trillion reduction in equity wealth since early 2000 would be expected to eventually lower yearly consumption by about $280 billion per year. For comparison, a reduction of this amount would represent nearly 4 percent of consumption and almost 3 percent of GDP in 2002.

Empirical findings also suggest that the response of consumption to changes in stock market wealth is drawn out over time, which has crucial implications for the precise path of consumption over the next few years. Because the appreciation of equity prices before 2000 would be expected to increase consumption, some of the implied $280 billion drop in consumption after 2000 may simply represent a "cancellation" of an implied consumption increase that had not yet taken place. Moreover, positive influences from the other determinants of consumption (such as current income and the continuing appreciation in housing wealth) are likely to offset the stock market's negative effects on personal spending. Even so, the possibility that consumers might pull back somewhat represents a risk to the recovery in the near term.

An Increase in Oil Prices. Oil prices trended upward in 2002, with the spot price of the benchmark West Texas Intermediate rising from about $20 per barrel at the start of the year to about $32 by year's end. Much of the increase was due to the recent turmoil in Venezuela. The general strike in that country began in the first week of December; since then, the WTI price has risen from around $27 dollars per barrel to about $33 dollars per barrel today. Concerns over the failure of the Iraqi regime to disarm in a credible way may have also been partly responsible for the increase in oil prices in 2002.

The effect of further oil price increases on the economy is difficult to determine. To be sure, there are "rules of thumb" that are often used to quantify the effect of export disruption on oil prices as well as the subsequent effect of higher oil prices on GDP. For disturbances of a few million barrels per day, a reduction of oil supplies of one million barrels per day typically raises prices by about 3 to 5 dollars per barrel. Additionally, a sustained increase in oil prices of $10 per barrel would be expected to lower GDP growth by about 0.25 to 0.50 percentage points after six months to one year. While these rules of thumb are useful guideposts, the actual effect to the economy could vary greatly from episode to episode. For example, a disruption of oil production that was that was expected to last indefinitely would affect prices differently from one that was likely to be unwound quickly. Moreover, if higher oil prices accompany a serious deterioration in consumer and business confidence, the ultimate effect on GDP could be much larger than a simple rule of thumb would suggest.

THE PRESIDENT'S JOBS AND GROWTH INITIATIVE

In light of the risks to the near-term outlook, the President has advanced a proposal to enhance long-term growth while providing near-term support against downside risks to the Nation's economic outlook. It is important to note that the recovery is not in immediate jeopardy. Private forecasters expect the recovery to gather momentum over the coming year, with both higher investment and improved job growth. Yet the presence of current risks suggests that insurance against unforeseen deterioration in economic activity is especially valuable. The best proposals are those that will raise the rate of long-term growth even if the recovery takes shape as private forecasters anticipate.

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 this income is paid out to individuals as dividends or retained by the firm. Dividend income will no longer be taxable on the individual level, while a step-up in basis will be allowed in order to reflect the effect of retained earnings on share prices.
3. Increase to $75,000 the amount that small businesses may deduct from taxable income in the year that investment takes place.
4. Provide $3.6 billion of funds to the states 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."

How the Proposals Will Help the Economy in the Near Term

Supporting investment. To be effective in aiding the current recovery, any proposal must support investment. The President's proposals do this 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).

The most immediate effect of ending the double taxation of corporate income will be to lower the cost of capital faced by firms in equity markets. Under the double taxation inherent in the current law, investment projects funded with new equity capital face effective rates of federal taxation of up to 60 percent. The President's proposals address this problem by removing the layer of tax at the individual level. Corporate income will be taxed once – and only once – which 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.

In addition to the direct stimulative effects of lower costs of equity capital, ending the double taxation of corporate income will rationalize dividend payout policy among American companies. This will aid investment, even in the short run. Currently, the tax code encourages firms to retain earnings and remit income to shareholders through share repurchases. This gives firms an incentive to inflate their reported earnings, so that their stock prices will rise. A main goal of the President's policy is to reduce this incentive by making tax policy neutral with respect to retaining earnings or paying dividends. Firms wanting to transmit their profitability to outside investors need only show them the money, in the form of dividend checks. With less uncertainty about the true profitability of firms, investment funds will flow more easily to firms with good investment prospects. This will not only make financial markets more efficient, but—like the reduction in the equity cost of capital—may also raise the total level of investment.

Other parts of the proposal support investment for smaller firms. Small firms will be allowed to expense up to $75,000 in new investment, which will lower the tax-adjusted cost of capital significantly. Eligibility for this immediate deduction would begin to phase out for small businesses with investment in excess of $325,000, which is increased from $200,000. (Both the expensing limit and the phase-out range will be indexed to inflation.) Additionally, the acceleration of the marginal tax rate reductions will help firms that pass through earnings to their owners. According to the Treasury Department, more than 30 million individual returns listed small business income in 2000. Virtually all of these firms will enjoy marginal tax relief by accelerating the rate reductions which have already been approved by Congress.

Supporting consumption. Consumption accounts for about two-thirds of economic activity, and consumption spending must remain vigorous if the recovery is going to continue. The President's proposals will accelerate the tax relief that has already been enacted, which will put 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. Of this amount, about $29 billion will be due to the marginal rate reductions, while another $16 billion will result from the acceleration of the increase in the child credit. On a "cash-out-the-door" basis, the proposal as a whole will infuse around $52 billion into the economy this year, and tax savings for individual families will be substantial. A typical family of four with two earners making a combined $39,000 in income will receive a total of $1,100 in tax relief under the President's plan.

As with any attempt to increase economic activity with a tax cut, an important question is how much of the cut will actually be spent. An 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. Delivering tax relief now, rather than in 2004 and 2006, sends a message that the government will meet its commitment to the American people to allow them to keep more of what they earn. As taxpayers realize that their long-term disposable income has risen, their spending plans will rise as well. By contrast, tax policy based on temporary changes to tax rates, or one-time tax rebates, has rarely worked as advertised. A temporary tax increase did not rein in the economy in 1968, a temporary tax cut did not stimulate the economy in 1975, and a temporary tax cut is not the right policy for 2003. Former Federal Reserve governor and CEA member Alan Blinder has written that in the year after enactment, a temporary tax cut has at most only about half the effect of a permanent tax cut.

Supporting job growth. The best policies for improved job growth are those that insure the economy itself will continue to grow. Still, government policy can affect the rate at which unemployed workers find and train for the jobs that a growing economy provides. The Reemployment Accounts in the President's proposal build on the existing Workforce Development System and empower unemployed workers by giving them more flexibility and personal choice over their assistance. Unemployed workers have a wide range of needs and are best-suited to understand their particular circumstances. Some workers may want extensive retraining. Others may not require retraining, but may need help relocating or with childcare while looking for work. Economists have long recognized that except in rare circumstances, giving individuals choices over how to spend their money improves their welfare. In this case, giving unemployed workers a choice of whether to receive training or to receive other services for which they may have a greater need will not only improve the efficiency of government services (by matching unemployed workers with the services they need most), it will improve unemployed workers' welfare at the same time.

The potential to receive a reemployment bonus would provide eligible workers a greater incentive to find new employment. At various times from 1984 to 1989, four states—Illinois, New Jersey, Pennsylvania, and Washington—conducted controlled experiments to determine the effectiveness of providing reemployment bonuses to unemployed workers. In these experiments, a random sample of new UI claimants were told they would receive a cash bonus if they became reemployed quickly. The advantage of these experiments is that the effect of offering a reemployment bonus on the duration of unemployment and on earnings upon reemployment can be directly evaluated by comparing the experiences of UI claimants randomly chosen to be offered a reemployment bonus with those of UI claimants not chosen for the bonus (who received the regular state UI benefit).

An evaluation by the Department of Labor of the reemployment bonus experiments conducted in the states of Washington, New Jersey, and Pennsylvania showed that a reemployment bonus of $300 to $1,000 motivated the recipients to become reemployed, reduced the duration of UI by almost a week, and resulted in new jobs comparable in earnings to those obtained by workers who were not eligible for the bonus and remained unemployed longer. Similarly, a study of the experiment conducted in Illinois—and published in a leading American economics journal—found that a reemployment bonus of $500 reduced the duration of unemployment by more than a week and did not lead to lower earnings at the worker's next job. This evidence suggests that giving unemployed workers the option of receiving the unspent balance in their Personal Reemployment Accounts will provide an incentive to find a new job quickly, reducing the time spent unemployed, but will not result in workers taking lower paying jobs than they would get if they searched longer.

Total effect on the economy. As chart 3 shows, CEA estimates that the package would raise the level of real GDP at the end of 2003 by 0.9 percent above the level it would have been absent the proposal. At the end of 2004, the level of real GDP would be 1.7 percent higher than it would have been without the proposal, and 1.8 percent higher than otherwise at the end of 2005. Put in terms of GDP growth rates measured from the fourth-quarter of 2002 to the fourth-quarter of 2003 and so on, the package will deliver an additional 1.0 percentage points of higher growth in 2003 than would have been the case otherwise, and an additional 0.8 percentage points of higher GDP growth in 2004. This increase in GDP will immediately put more Americans back to work, delivering about 510,000 jobs in the second half of 2003 alone. The plan will create another 891,000 new jobs in 2004. The plan works so well because it is focused on what the economy needs now—it encourages an investment rebound while supporting continuing growth in consumption.

How the Proposals Will Help the Economy in the Long Run

In the near term, the President's proposal insures that the recovery proceeds by supporting investment. In the long run, the higher investment delivered by the plan leads to higher productivity – the fundamental source of higher standards of living for American workers. Economists have long known that from the workers' point of view, the best level of capital taxation is no taxation at all. The reason for this surprising result concerns the burden, or "incidence," of the capital tax. An investor with an extra dollar to spend can either use it to fund consumption today or save it to fund a larger amount of consumption later. His or her preferences for consuming now versus consuming later determine how much extra consumption he or she must enjoy in the future in order to resist consuming the dollar's worth of goods and services today. Lowering the capital tax means that investors receive larger after-tax returns on their investments. This change in returns makes it more likely that households will defer consumption and instead invest, which will raise the amount of savings available to firms that want to borrow in financial markets. As firms invest more, the amount of capital available to workers goes up, as does their productivity. In the end, higher productivity raises workers' wages and standards of living. This line of reasoning shows that even though workers may not write a check to the IRS for dividend taxes, all of us as workers still pay part of the double tax on corporate income such as dividends in the form of lower wages, because the tax reduces the amount of capital in the economy.

Workers enjoy long-run gains from the President's proposals in other ways as well. Marginal rate reductions and permanently higher expensing limits for small business will raise investment, which in turn raises productivity and wages for the same reasons outlined above. The rationalization of dividend payout policy will improve corporate governance and place corporations on equal footing with non-corporate users of capital. Both of these developments will improve the efficiency of markets. (A 1992 Treasury Department report on the double taxation of corporate equity showed that the reallocation of capital toward more efficient uses would raise economic well-being in every year in the future by the equivalent of $36 billion worth of consumption in today's dollars.) Additionally, ending the double tax in the way in which the President has suggested will increase economic efficiency by reducing the incentives for corporations to engage in tax sheltering activities, because only income on which corporate taxes have been paid can be transmitted to shareholders tax free.

The Effect of the Proposals on National Saving and Budget Balance

Some critics of tax relief have argued that now is not the time to cut taxes, but to raise them. The view is that if the government adopts deficit reduction as its number one goal, growth will somehow follow. I disagree. To begin with, surpluses tend to follow growth, not the other way around. Raising taxes may lower the deficit, but this is not equivalent to spending restraint that limits the size of government in the economy and lets the private sector create jobs. Standard models of the economy suggest that an increase in debt of $200 billion dollars would raise long-term interest rates by 3 to 5 basis points. This modest increase in interest rates must be set against the large costs that a current tax increase would entail – higher distortions on saving, risk-taking, and entrepreneurship, as well as the loss of credibility that comes when the government reneges on its promise to provide Americans with tax relief.

In addition, the tax relief the President suggested in his January proposal does not significantly worsen the government's fiscal position. One way to judge the effect of tax proposals on the government's fiscal position is to view them in the context of a "fiscal anchor," such as the debt-to-GDP ratio, or the share of federal outlays that go to service the government's debt. Even with the President's proposal, the debt-to-GDP ratio does not rise in the out-years of the budget window. Moreover, the effect on the proposal on debt service costs is small. According to either of these potential fiscal anchors, the tax relief offered in the President's proposals remains sound policy.

CONCLUSION

Though the long-term fundamentals for the U.S. economy are strong, we still face a number of challenges. The recovery which began in the fourth quarter of 2001 must be maintained, and fiscal policy must remain on sound foundation. By focusing on the economy's most uncertain component – business investment – the President's proposals insure that the recovery will proceed. Although the proposals focus on the economy's near-term needs, they also promote stronger growth in the long term as well. In doing so, they insure that the standard of living enjoyed by American workers will continue to improve in the coming years.

Chart 1: Labor Productivity (Nonfarm Business Sector)

Index, 1992 = 100 (ratio scale)

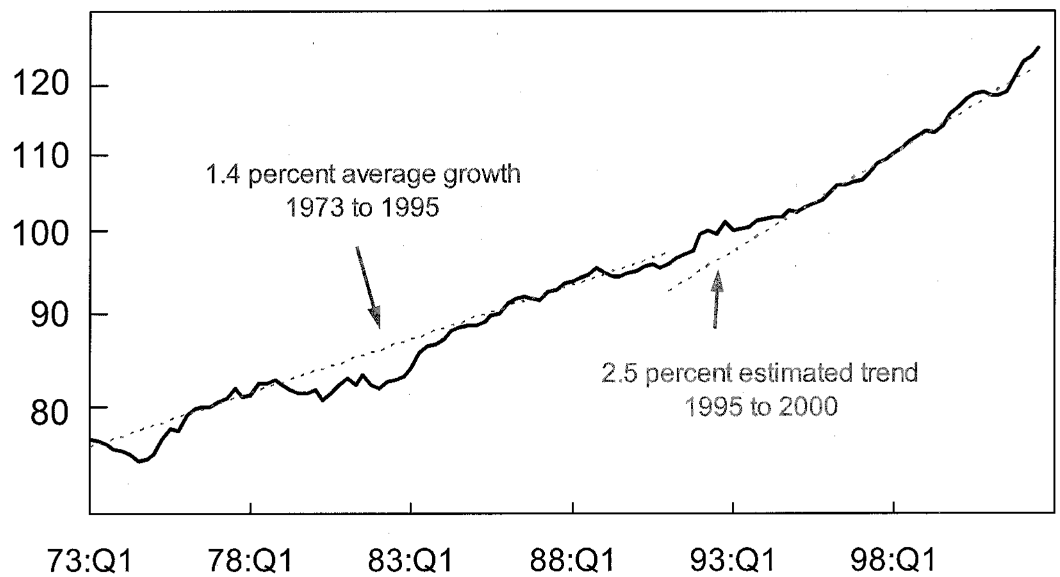


Chart 2: Real Nonresidential Fixed Investment

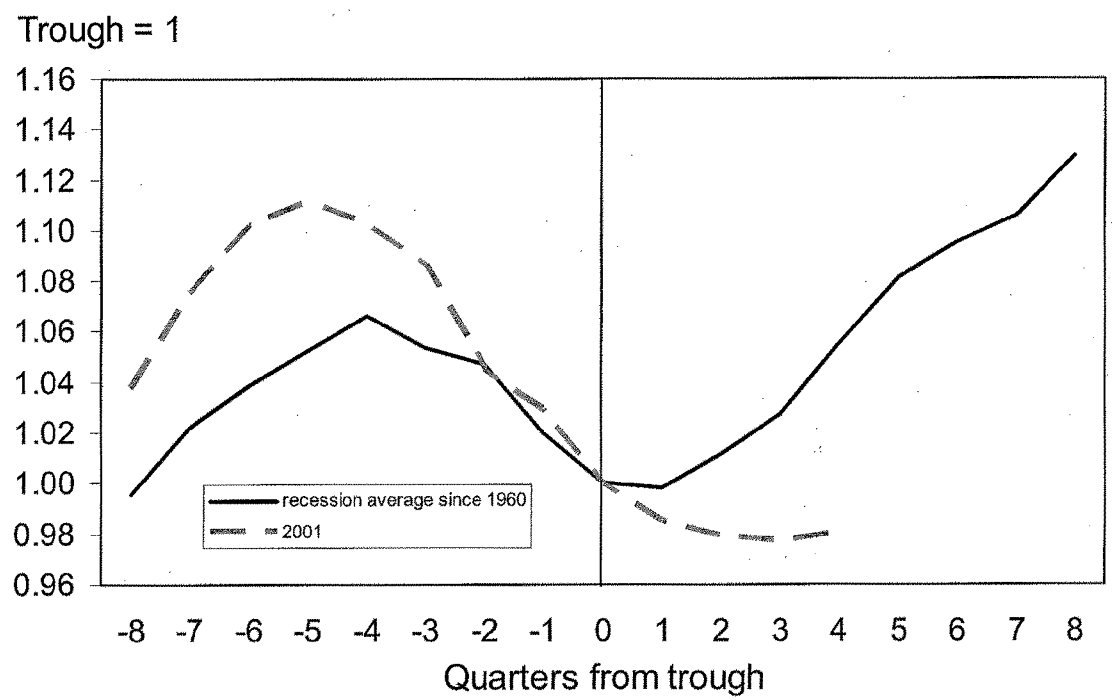
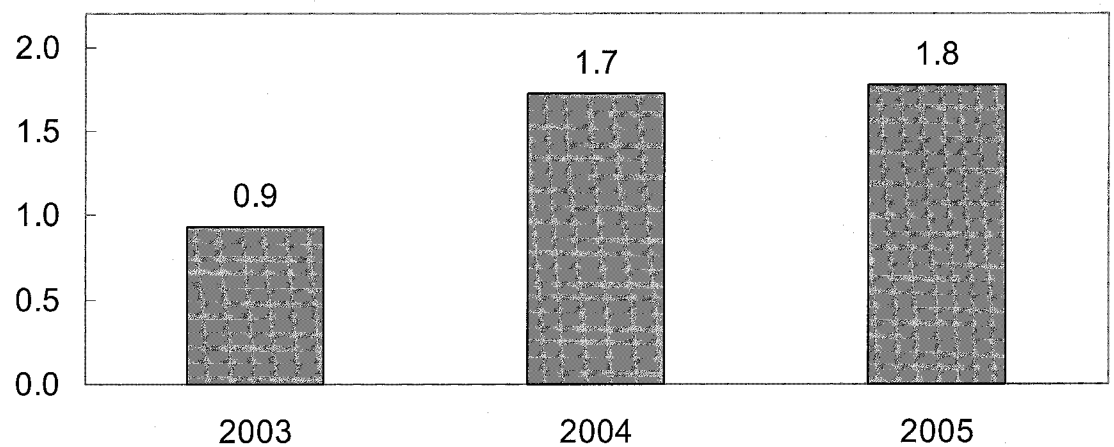


Chart 3: Growth Package Effect on Real GDP

Percentage difference of the level of real GDP at the end of the fourth quarter from the level without the President's proposal.



Fourth-quarter to fourth-quarter growth rates are higher by 1.0, 0.8 and 0.0 percentage points for 2003, 2004 and 2005, respectively.

The CHAIRMAN. Ms. Kramer, before we turn to you, let me turn to my colleague from Oregon who has just joined us for any comments he would make to make in opening statement, Senator Gordon Smith. Gordon?

STATEMENT OF SENATOR GORDON SMITH

Senator SMITH. Thank you, Mr. Chairman. I am pleased to be here and honored to be on this committee. I think the topic we are discussing today is very important because of the simple, logical conclusion you can reach, that if you tax something, you will discourage it, the activity you tax, and if you tax it twice, you will doubly discourage it. I think whether it is dividends or taxing Social Security twice, which is another double taxation in our system, we ought to, as a matter of whether you call it stimulus or just to improve tax policy, we certainly ought to pursue this.

For several Congresses now, Mr. Chairman, I have introduced a bill that ends the double taxation on Social Security benefits that was begun in the Clinton Administration in 1993. My colleagues probably know that senior citizens pay Federal taxes on a portion of their Social Security benefits if they receive additional income from savings or from work, and this is something that if we are serious about helping seniors to be able to provide for themselves, we ought to end this practice and encourage work and encourage saving. I am going to introduce that bill again in this Congress, Mr. Chairman, and certainly invite my colleagues' support and cosponsorship.

I have a more lengthy statement I would like to include in the record, Mr. Chairman. In the interest of time and hearing Ms. Kramer, I will just do that and look forward to her testimony.

The CHAIRMAN. Thank you very much, Senator.

[The prepared statement of Senator Smith follows:]

For Committee
Record
Gordon H. Smith

Double Taxation of Social Security Benefits
Aging Committee Hearing
February 4, 2002

- I thank the Chairman for holding this important hearing on the inequity of double taxation on our senior citizens.

- I believe that one of the most egregious examples of double taxation is the taxing of Social Security benefits. One of the most ridiculous taxes on Social Security benefits is the 1993 tax increase by the Clinton Administration.

- As my colleagues are aware, senior citizens pay federal taxes on a portion of their Social Security benefits if they receive additional income from savings or from work.

- Before 1993, seniors paid taxes on half their Social Security benefits if their combined income - which translates as their adjusted gross income and one-half of their Social Security benefits - exceed $25,000 for individuals or $32,000 for couples.

- The Clinton administration immediately raised this tax on these retirees as part of the 1993 tax bill. After this increase, individuals with incomes above $34,000 and couples with income above $44,000 now had a portion of their Social Security benefits taxed at 85 percent. This is outrageous.

- This one provision increased taxes for almost one-quarter of Social Security recipients.

- This tax increase was unfair and it provided a disincentive to our seniors who chose to save or chose to work.

- I have been a cosponsor of various bills in the past few Congresses to repeal this unfair tax. As a new member of the Senate Finance Committee, I am pleased to announce that this week I will introduce legislation to repeal this onerous tax on our senior citizens.

- I believe that we should not have passed this tax increase in 1993 – it was patently unfair to those seniors who already were saving or working and placing their confidence in the United States Government not decreasing their benefit package.

- Yet this is exactly what the 1993 tax increase did – it decreased the Social Security benefits on those Seniors who planned for retirement or those who were working to supplement the Social Security benefit.

- I believe that we must do everything possible to turn back this 10 year old tax increase and return some small measure of equity and fair play to those senior citizens affected by that tax.

- I thank the Chairman for holding this hearing and look forward to having my colleagues cosponsor legislation to repeal the 1993 Clinton tax on Social Security.

The CHAIRMAN. Now, let me turn to Ms. Hilary Kramer, who, if you have caught her on Fox News, is an open critic, an outspoken critic of double taxation, and so we thank you very much for being with us. Please proceed.

STATEMENT OF HILARY J. KRAMER, SENIOR STRATEGIST AND ADVISOR, MONTGOMERY ASSET MANAGEMENT, AND BUSINESS COMMENTATOR, FOX NEWS CHANNEL, NEW YORK, NY

Ms. KRAMER. Thank you. Mr. Chairman and members of the committee, I am very, very thankful that you invited me to testify on the relationship between corporate governance and the double taxation of dividends. It is extremely important at this moment in our nation's history that we take care of abolishing the double taxation on dividends because it is contributing to problems with corporate governance and we cannot once again go through another round of WorldCom, Enron, Adelphia. We cannot afford that and we need to see our stock market come back up.

But most important, we need to protect senior citizens and give them another option, and the option is—the option would be dividend-yielding stocks, and this gives them as asset that can grow and income going forward.

How does it work today? Today, we encourage companies to keep the money they have earned. Instead of issuing dividends to shareholders, what we do is we have this inefficient system in which senior management has been able to exercise creative control over the financial results they report to the public and has provided them the freedom to stray and wander away from their core competencies. Abolishing the double taxation on dividends is about keeping companies honest, competent, and resourceful and allowing shareholders to enjoy the financial returns that they deserve as owners of the companies.

With a reduction in the taxation of dividends, the interest of corporate management would become better aligned with the interest of shareholders. Right now, the way it works, a significant portion of management compensation in companies today is through stock option ownership rather than actual ownership of shares. Since an option holder doesn't receive a dividend but instead receives all his benefits, or her benefits, from the appreciation of the stock, the interest is to take extra cash in the company and try to invest it in whatever kind of enterprises could create the hype that could create a stock price to go up.

Where have we seen this? Everyone can talk about United Airlines and U.S. Airways and talk about the fact that the aviation industry is broken and the model doesn't work. As far as I am concerned, United Airlines twice has made the same mistake. They took the money they made in the boom days of the late 1990's and they spent it on fractional jet aviation ownership companies, spent it on the Internet. They did it in the 1980's by deciding to become a hotel chain company, buying Westin, buying rental car companies. We can't see this happen again. It would have been much more beneficial if the money had been careful used and given to shareholders to decide if they wanted to go and rent a car. That is the way it needs to work.

Moreover, companies also use the cash to buy back stock or simply to hoard it for future opportunities, like with Microsoft. In many cases, none of these actions is as good for shareholders as would be receiving a dividend and having the discretion to spend it as we need. But with the current punitive tax treatment of dividends, management has significantly less pressure to change this damaging and negative behavior.

Finally, with the present double taxation of dividends, most companies have a major incentive to raise a significant amount of debt and, therefore, have unhealthy balance sheets. So it is not just companies going into bankruptcy because of accounting fraud, but you have companies that weren't prepared for the downturn and that is the problem. So companies like K-Mart, for example, and what we have seen in the retail space, Montgomery Ward, Bradley's, there is a whole list of them, and we keep hitting new records of bankruptcies across the board.

The bottom line, implementing President Bush's tax reform proposal promises wide-scale impact on the stock market. It will help boost stock prices, encourage more responsible investing, strengthen corporate governance and responsibility, provide investors, especially senior citizens, with income, and with long-term ownership and the opportunity to make money because the stock itself can go up in value.

Plus, we need to never have a stock bubble like we have now because we are still going through the correction and we are still paying the price today, and I am out there talking to people all the time and senior citizens especially are hurt. They are hurt, their portfolio is down, and many are broke. Just go to retirement areas. I was just in Palm Springs at a conference. I go to Florida. You know what? I see 85-year-old people at the cash register instead of enjoying the fruits of their labor and the work that they have done.

Now, on the positive side, and I think it is important to end on the positive side, history proves to us that our country and our stock market is about dividend-paying enterprise, and when we look back—I took a look and I have done research and I have made analysis on this. If you look at companies that are around 50 years, 100 years, they pay dividends, where prosperity is integral to dividend-paying companies.

For example, Johnson and Johnson, over 100 years old, a 1.5 percent dividend yield. Bristol Myers, 4.8 percent. General Motors, 5.5 percent. J.P. Morgan Chase, 5.8 percent. Another point with this is the reason J.P. Morgan Chase is going to make it through their problems, through their clouds of uncertainty, is that shareholders know they are going to receive a check in the mail, and that is what matters at the end of the day.

So dividends don't lie and it is very important senior citizens have other options besides a 1.5 percent C.D. Thank you. Thank you.

The CHAIRMAN. Ms. Kramer, you lived up to expectations and we thank you very much for that.

[The prepared statement of Ms. Kramer follows:]

4 February 2003

Statement of Hilary J. Kramer

Before the U.S. Senate Special Committee on Aging

The Imperative Case for Abolishing the Double Taxation of Dividends

Mr. Chairman and Members of the Committee, I am very thankful that you have invited me to testify on the relationship between corporate governance and the double taxation of dividends. This is an extremely important issue at this moment in our nation's history. Improving trust in our financial markets is critical to all investors. However, for our current retirees already living on fixed incomes as well as for our country's workers planning for their retirement, the need to restore confidence in our stock market is critical.

My name is Hilary Kramer. I am the Senior Strategist and Advisor at Montgomery Asset Management and also appear as a Business Analyst and Commentator on the Fox News Channel. Again, I am pleased to have the opportunity to share my analysis, research and conclusions with the Committee today.

Allowing companies to keep the money they have earned---instead of issuing dividends to shareholders---has promoted a dangerous and inefficient system in which senior management has been able to exercise creative control over the actual financial results they report to the public and has provided them the freedom to stray and wander away from their core competencies. Abolishing the double taxation on dividends is about keeping companies honest, competent and resourceful and allowing shareholders to enjoy the financial returns they rightfully deserve as owners of the companies in which they have invested.

With a reduction in the taxation of dividends, the interest of corporate management would become better aligned with the interest of the shareholders. A significant portion of management compensation in many companies today is through stock options rather than actual ownership of shares. Since an option holder does not receive dividends, but instead receives all of his benefit from appreciation of the stock, an incentive of management is to use cash---not for dividend distribution---but to grow the business, in many cases into areas where the company lacks all expertise and synergistic potential.

Companies also use the cash to buy back stock, or simply to horde it for future opportunities. In many cases, none of these actions is as good for shareholders as would be receiving a dividend and having the discretion to spend it as the recipient wished. But, with the current punitive tax treatment of dividends, management has significantly less pressure to change this damaging and negative behavior.

Finally, with the present double taxation of dividends, most companies have a major incentive to raise a significant amount of their capital as debt rather than as equity. This resulting high leverage creates instability in the company's balance sheet and makes companies more vulnerable to any downturn in economic activity.

The bottom line: implementing President Bush's tax reform proposal promises a wide scale positive impact on the stock market. It will help boost stock prices, encourage more responsible investing, strengthen corporate governance and responsibility, provide investors with more income opportunities and prevent stock bubbles ---like the Internet Bubble of the 90's---that can ultimately lead to massive corrections---such as the one we have been experiencing since the second quarter of 2000.

How Companies Behave Now:

Current tax policy encourages corporations to hold on to shareholders' money forever. By taxing earnings initially at the corporate level, then taxing earnings again when distributing dividends to shareholders, the state and federal governments claim up to 65 percent of earned income. Since over half of that tax expense can be avoided if the corporation simply retains the earnings, shareholders have traditionally been more willing to allow management to perpetually reinvest their money-- *and management has been even more willing to comply.* This policy has enticed corporations to find increasingly creative uses for their shareholders' money, including stock repurchase plans that often benefit executives who hold stock options rather than the public shareholders of the stock.

The Internal Revenue Code has traditionally and unwisely favored reinvesting corporate profits over distributing them. The first time that income taxes were raised high enough to produce major economic effects was back when the country was still fighting World War II. At that time, the finer points of corporate finance weren't even part of the public agenda. After the war, however, when tax policy became a high-profile issue, there was widespread concern that an economic state of depression might return unless investment was vigorously encouraged. With dividends taxed at rates over 90 percent throughout the 1950s, there was the strongest incentive for businesses to plow every cent back into their companies.

Even so, the average dividend yield on public companies remained fairly high throughout the second half of the 20th century. Economists were puzzled over the persistence of high dividend yields in the face of such tax inefficiency, and many correctly predicted that dividends would eventually disappear altogether. But until about 10 years ago, stock dividend rates for large, well-established firms held up reasonably well, both as a percentage of profit ---known as *the payout rate*---and as a percentage of the value of the stock---*the yield.*

In one sense, however, dividend yields have been falling steadily since the 1950s. In fact, the last time the dividend yield on the S & P 500 was actually higher than the yield on high-quality corporate bonds was in 1958. This condition reflected the popular view at the time that investors needed higher equity yields to compensate for the additional risk they bore. Since then, the decline in yield has been both steady and dramatic. In fact, the absolute drop in the dividend yield from 1990 to 2000 declined a fairly consistent 25 basis points per year throughout the decade.

As dividends from major companies declined, the number of firms that pay no dividends whatsoever rose dramatically, from under 30 percent of all public companies in 1960 to over 65 percent today. Shareholders' appetites for dividends decreased as they became more convinced that when the time came to sell, they could expect large capital stock gains instead. Meanwhile, corporations have also become more aggressive in repurchasing their own stock, since this has been the more tax-efficient way of placing earnings into shareholders' hands. Of course, share buy-back programs are like dating while a dividend payout is really a marriage---in terms of commitment, consistency and responsibility.

The Abolishment of the Double Taxation of Dividends will Strengthen Corporate Governance and Promote Healthier Companies:

- **Dividends show the truth about a company's financial status.** Jeremy Siegel of the Wharton School implies that our tax laws helped provide the incentive for management to play with the accounting of their companies which, in turn, heralded in the stock market bubble. What did the stock market bubble give us? Full scale corporate scandals and, ultimately, bankruptcies and portfolio-poor investors. Siegel states, "Nothing could possibly excuse Enron, Arthur Andersen from their deceptive and fraudulent practices. But cries for accounting reform, transparent earnings reports, and auditor independence will not amount to anything if our tax system encourages firms to do just the opposite. Why should we rail against accountants who do not provide investors with a clear view of their clients' earnings and balance sheets when many are also getting paid as consultants to minimize their clients' taxes and exploit loopholes in our Byzantine tax laws?" Whereas current tax law rewards policies that are more likely to conceal the inefficient use of earnings, a greater emphasis on dividend payments makes it more difficult for companies to perpetrate fraudulent earnings.

- **A focus on dividends would prevent stock bubbles.** Legislation eliminating dividend taxes will help avert stock bubbles by preventing companies from over-investing cash in risky ventures just to boost stock prices. The money is spread throughout the economy (via dividends to investors) instead of being used to buy back company stock or invested in potentially dangerous non-related businesses. Thirty years ago, large companies that paid sizable dividends were expected to continue doing so. But as newer companies like Microsoft started to grow large, investors' expectations changed. It became acceptable for even the biggest firms to retain earnings for future growth, seemingly in perpetuity. A majority of the huge technology companies, including Cisco, Sun Microsystems, Oracle, and Dell, have paid insignificant dividends or no dividends at all on their common shares. Instead, these companies used their earnings to fund activities tangentially related to their core businesses. The late 1990s saw a massive over-investment in websites, web hosting centers, internet infrastructure, and software solutions-- from which the economy is only now starting to recover. If earnings had been distributed to shareholders who made their own investment decisions, it's possible that the same over-funding might have occurred. But it's very likely that the Internet bubble would not have been so enormous without the initial credibility achieved from so many large companies spreading so much seed money to so many unproven ventures.

- **Companies would be prevented from hoarding cash and engaging in investment schemes where they don't belong.** Microsoft has $36 billion in cash but has never paid a dividend on its common shares. Yet it is becoming more difficult for Microsoft to deploy its earnings profitably without incurring further charges of anti-competitive behavior. In recent years, a primary avenue of investment for Microsoft has been telecommunications. The company put $5 billion into AT&T, several billion into Comcast, and lesser amounts into WebTV and other cable ventures. The profitability of its new investments remains very much in doubt. There are some who would rather Microsoft just start paying big dividends. One of the most vocal is Ralph Nader, who claims the company's no dividend policy actually runs afoul of the tax code's provision against the unreasonable accumulation of earnings. In a public letter to Microsoft, he also suggested that the interests of Bill Gates and other major insiders are at odds with the bulk of Microsoft's shareholders. Eliminating an excuse for companies to hoard cash gives them greater incentive to consider shareholder interests in their governance decisions.

- **Management would be aligned with the interests of their shareholders.** Encouraging larger dividend payments would signal to shareholders that managers are willing to let them participate in decisions regarding corporate investment. It would also give shareholders a degree of confidence in the future distribution of cash flows. As Morgan Stanley strategist Steven Galbraith noted, share buybacks are like dating, while dividends are like the commitment of marriage. Marrying corporate manager's interests to those of shareholders promotes solid corporate governance.

- **A more level playing field would be created.** Pressuring traditionally high stock growth firms (like tech companies) to pay dividends could mean a more level corporate playing field. Consistent, stable old-line firms such as Dupont Co., Eastman Kodak Co. and General Electric Co., which have long paid dividends, might be viewed more favorably relative to these firms. And the old-line companies might be expected to raise their dividends even further. Both high growth and mature companies would correctly be judged by both their current payments to investors in the form of dividends and their future returns in the form of stock value, instead of investors heavily overvaluing stock prices alone.

- **Firms would be encouraged to compensate managers with stock grants rather than options.** The current methodology of valuing stock appreciation over corporate earnings encourages companies to use stock options rather than stock grants as employee incentives. A greater emphasis on dividends may compel companies to issue stock grants to its managers instead of stock options. Managers would hold the same stock instruments as shareholders, thus ensuring that management benefits only when their actions are in the long-run interests of the corporation and its shareholders.

- **Companies would be reigned in from taking on dangerously high leverage---that is, *debt*.** For years now, experts have been calling for a repeal of the double taxation on dividends. A major rationale is that the current system has encouraged a dangerous buildup of debt at the expense of equity financing. Because interest is tax deductible to businesses, the cost of debt financing is made artificially low relative to equity financing, and firms are encouraged to adopt a leveraged capital structure. High debt levels make companies and the economy as a whole less stable. Any protracted weakness in economic activity can turn a heavy debt burden into a bankruptcy. In fact, high debt levels have been associated with many of the large bankruptcies during the recent two years. While interest rates today are at 40-year lows, risk spreads in the corporate bond market are at 40-year highs.

- **Management will focus on the company's operations and results.** Eliminating the dividend tax amplifies the importance of dividend payments, and this increases companies' incentives to issue stock. But increased use of dividend payments could also force companies to focus more on their operations instead of their stock price alone. For some time now, ratings agencies have been pushing for companies to concentrate on cash generated rather than reported earnings. This concept encourages more prudent investment in the stock market, where a company's worth is clearly spelled out by the amount of cash it earns and a company's dividend payment authenticates its profitability.

- **Companies would focus on creating healthy balance sheets.** Companies can be judged by dividend payment rather than easily manipulated balance sheets that may contain complex, fraudulent schemes. For companies, the proposal could dramatically change how they structure their finances. To raise money, issuing certain types of new stock could become more appealing than issuing debt. And pressure almost certainly would grow on all firms to increase the share of profits they pay to shareholders via dividends. John Lonski, chief economist at Moody's Investors Service. "Anything that might reduce balance sheet leveraging will be in the long-term interest of bondholders."

- **The Proposal does not penalize growth companies.** There is a provision in the dividend plan that could reduce capital-gains taxes. With potential dividend cuts coming, the Bush Administration didn't want to make businesses overly favor payouts instead of retaining earnings for investment and expansion purposes. So they dangled this carrot: If corporations decide to retain earnings instead of paying out dividends, a subsequent increase in its share price would be used to offset the investor's cost. The result: Investors won't be penalized for buying shares of a growing company that needs cash to expand. Let's say a company decides to retain its earnings and its share price rose to reflect a higher stash of profits, say from $2 to $21. If the investor bought the stock at $18 before the move and decides to sell at $21, he or she would owe $2 a share in taxes, not $3. The $1 dollar gain in the stock would be added to the investor's cost.

The Tax Reform Would Create Positive Momentum and Ignite the Besieged and Fraught Stock Market---Investors would be Lured in and Stock Prices would Rise:

- **Historically, cutting taxes has inspired a surge of money into the stock market.** Cutting taxes on long-term capital gains reinvigorated the American economy in the 1980s and pulled the stock market out of a decade long slump. In 1997, the capital gains tax rate was cut again to a more appropriate rate of 20%, which spurred even more investment into the market. For this reason, the DJIA average gained 4.8% in the first four trading days of the New Year upon anticipation of this legislation. Fundamentally, the best way to determine if an idea will bring value to the market, is to watch the effect that it has =on the market during the expectation phase alone. The stock market never lies---over the long term.

- **The stock market should significantly benefit from the tax reform:** The standard valuation model for equity securities provides that the value of a security is equal to the after tax dividends that the holder will receive over the life of the security, discounted by the risk adjusted cost of capital. If after tax dividends on a stock are increased for the life of the stock by a constant, *the value of that security should go up, theoretically by as much as the amount of the constant.* Thus, the after tax dividend received by a taxpayer in the 30% tax bracket will go up by 43%, due to the proposed change, and finance theory says the value of that security should likewise increase by as much as 43%. Furthermore, even prices for stocks that are not current dividend payers should rise as the market will assume that these companies will begin to pay dividends at some point, and at that time every shareholder will benefit.

- **There will be a significant reduction in the volatility of stock prices---it will be about long-term holding and not short term trading.** The benefit received by a holder from a dividend paying stock is less volatile than the benefit that holder enjoys from holding a stock whose return is dependent solely on future appreciation. This should further increase the value of dividend paying stocks because people will be willing to pay a higher price for less volatility. For example, drug companies can provide a much more stable long term relationship it their shareholders by paying dividends as opposed to forcing the investors to rely exclusively on sporadic announcements of research breakthroughs. For example, Bristol Meyers saw its stock price crater in the past six months with concerns over a dry pipeline and "inventory stuffing". Over the long term, Bristol Meyers is a healthy and productive----research committed company---and this should not have happened, but the investors today have more of an incentive to think about making a "quick buck" than being a long-term owner of a company.

- **There is wide-scale Wall Street support.** The stock market has been on a rally ever since speculation about the Bush proposal began in early January. The Dow Jones Industrial Average gained 4.8% in the first four trading days of the New Year following public reports about the legislation. There is every indication that Wall Street's acceptance of the proposal will sustain higher stock values.

- **Creates investor demand for dividend-paying stocks.** "All things being equal, you'd have to expect that individuals would increase their demand for equities, which would bid up the price and create more incentive for corporations to look toward the equity markets as being a preferential area of financing," said Timothy Fogarty, who chairs the accounting department at the Weatherhead School of Management at Case Western Reserve University. He called the different tax treatment for issuing debt and equity "one of the fundamental discrepancies in financing."

- **Evidence of earnings attracts investors.** After three years of falling share prices, Americans are demanding a regular payment from companies in return for risking capital in the firms. The Bush plan could all but assure that those payments would be more substantial, money managers and other experts say. Jeremy Siegel, Professor of Finance at the Wharton School says, "The dividend yield, and thus the concrete evidence of real earnings, has declined dramatically in recent years. In the 19th century and first half of the 20th century, the average dividend yield on stocks was 5.8%. It was not until 1958 that the dividend yield on stocks fell below the interest rate on long-term government bonds, and even through the 1980s the dividend yield averaged 4.3%. But during the great bull market of the 1990s, dividends fell out of favor. The dividend yield sunk to 1.2% at the market peak in March 2000 and has subsequently risen to only 1.6%." Eliminating the dividend tax encourages companies to pay out dividends again and attracts investors back to the stock market.

- **Invigorates newer investors while teaching them investment responsibility.** Current tax policy has transformed the newer generation of investors into a generation of gamblers. Many of these investors need to learn that the value of investing in stocks is derived from high returns *over time* rather than short-term gains in stock price. Eliminating the dividend tax boosts the stock prices of fundamentally sound, dividend-paying companies. Newer investors will follow other investors back into the stock market. But this time, they'll invest with a focus on companies with solid earnings rather than simply speculating on companies with potential for huge future stock price appreciation.

- **New legislation would repair the current negative Wall Street investor environment.** Eliminating the double taxation of dividends would lead to a powerful rally in stock prices and would do much to lift the penumbra of uncertainty that has bedeviled both consumers and corporate managers. Positive investor sentiment about stock values will support a healthier investment atmosphere. A change in dividends' tax status is likely to spur the brokerage industry to embark on a huge sales campaign touting dividend-paying stocks. "It's fantastic for stock brokers," said Lehman's Willens. "Now they have something to sell." Anand Iyer, global head of convertible research at Morgan Stanley, said companies with household names could potentially tap individual investor demand with traditional convertible preferred securities. Going forward, this presents an opportunity for issuers to access the convertible market to raise capital with the traditional preferred stock structure, particularly for companies with consumer brand name familiarity," he said. From 1926 to 1993, blue-chip stocks produced an average return of about 10% a year for investors, according to data tracker Ibbotson Associates. Of that total, 5.4% a year was from capital appreciation and 4.9% was from dividends.

An Abolishment of the Double Taxation of Dividends Provides More Money to the Entire Investor Population which, in turn, Provides them with More Money to buy Goods and Services---which ultimately serves to Improve Corporate Profitability:

- **The Multiplier Effect of more money in consumer's hands magnifies the benefit to the economy:** A significant benefit from this proposed legislation is what I call the *multiplier*. Up until now, many companies with ample cash have been reluctant to pay dividends because the tax treatment to the recipient is punitive. With this proposed legislation, such would no longer be the case, and corporate management---encouraged by their boards---should now be inclined to increase their present dividend, if they are currently paying one, or if not, to institute one. This will put more money in people's hands either to spend on consumption or to reinvest in other securities in the market. The reason I call it the multiplier is that, unlike any other proposal in this package, the benefits to the economy exceed the amount of the tax cut. For example, if the average dividend recipient is in a 30% tax bracket, for every $100 of dividends that this recipient receives, he will now have $100 to spend rather than $70, due to the elimination of the tax. In addition, if companies increase their dividends by 20% because of this tax law change, now the holder will receive $120, all of which is after tax. Thus, his after tax cash to spend and invest has risen by $50, on a $30 tax cut. The size of the multiplier is the amount of the stimulus provided to the economy, divided by the amount of the tax cut (in this case $50 divided by $30, or 1.67x). In other words, Uncle Sam and we taxpayers receive more stimulus bang for our tax cut buck from this change than from any other proposed tax law change that I know.

- **Senior citizens depend on dividend income.** The Congressional Budget Office says that senior citizens are more likely to invest in stocks that pay out their income in dividends. It is also important to note that aside from social security, dividend income makes up the greatest percentage of senior citizens' income over capital gains, wages, and other income-- especially for the lowest income senior citizens. Accordingly, eliminating the double taxation of dividends will significantly help seniors who depend on dividends for income during their retirement. Under Bush's plan, seniors who currently weight their savings in effectively lower tax investments could turn instead to dividend yielding stocks as an alternative and complement to bonds and certificates of deposit.

- **Higher dividend payout ratios would exist.** Companies would be happy to pay dividends again, once taxes on dividends are eliminated. For instance, last year a Cisco Systems Inc. (CSCO) shareholder proposed that the San Jose, California network equipment maker begin paying a dividend, explaining that it would be an effective way to utilize part of the company's $21 billion in cash and marketable securities. But at their annual meeting in November, shareholders overwhelmingly defeated the measure. Cisco executives cited the double taxation principle as the reason for the defeat. John Chambers, President and CEO of Cisco, has even made it clear that Cisco would reconsider its "no dividend" policy if the tax law were changed.

Investors Deserve Alternative Investments Options that are all on a Level-Playing Field:

- **Increases attractiveness of stocks over other financial instruments.** Eliminating dividend taxes could boost the appeal of stocks compared to bonds. Ten-year Treasury notes, for example, currently pay an annualized yield of 4.01%, and the interest is subject to normal tax rates. Du Pont (DD) common stock pays an annual dividend of $1.40 a share. Based on the firm's recent stock price of $44.58, the dividend results in a 3.1% annual yield. But for an investor in the top 38.6% federal tax bracket, a tax-free 3.1% yield is equivalent to a taxable yield of 5.05%. Furthermore, while bond interest payments remain fixed for the bond's entire life, dividends are expected to increase as a business grows and its earnings rise. The combination of these factors makes stocks an even more attractive option for investors if dividend taxes are eliminated.

- **More equity alternatives for investors.** In a world free of a double taxation on dividends, fixed-income investors that shift into equities can expect preferred stock instruments to provide attractive equity alternatives. With debt instruments, investors pay income taxes on the interest payments they receive. So, if an investor in the 35% tax bracket holds a bond that pays 9% interest, that investor will yield an after-tax return of just 6%. Preferred shares, on the other hand, combine characteristics of bonds with those of common stocks. So eliminating dividend taxes for preferred stock creates a financial instrument with essentially tax-free interest. This is an instrument that many Wall Street professionals believe companies may begin offering with increasing frequency if dividend taxes are eliminated. Preferred stock is less risky than common shares because of several features: its face value is repaid at maturity, it offers a fixed dividend, and it typically ranks higher in the capital structure and is therefore better protected in the case of bankruptcy.

- **The tax reform actually would help corporate bonds.** "Anything that's done to improve a corporate balance sheet and its credit structure benefits corporate bonds," said Mitchell Stapley, chief fixed income officer at Fifth Third Investment Advisors of Grand Rapids, Michigan. "A lot of the problems we had this past year were with companies like Tyco. And others basically centered on their inability to access the debt markets or [to] rollover debt," said Stapley. "So if the capital structure of companies improves in quality, as a bondholder, I sleep easier at night. And believe me after last year, that's a good thing," said Stapley. In a bid to avert a year-end cash crunch, Tyco International Ltd. (TCY) recently sold $3.75 billion of convertible bonds, to help pay down maturing debt. The firm has to repay as much as $11.3 billion of debt this year, including nearly $6 billion in February. "It really comes back to the fact that if you miss a coupon payment on a bond, the bondholders could drive the company into bankruptcy," Stapley said. "If you miss a dividend payment in equity, in most cases you don't drag the firm into bankruptcy-- you can avoid that." Portfolio managers agree that if equity issuance becomes a more attractive financing option than debt (as it likely would if taxes are eliminated on dividends), the potential drop in the supply of corporate debt would go far toward narrowing spreads in the secondary market as demand grows for secondary corporate debt. "Already, we're going into a year where there are expectations for corporate issuance [of debt] to fall off by 15 percent or so from last year's levels. From a technical standpoint, that sets up corporate debt to do better," said Christopher Mahony, portfolio manager at J&W Seligman & Co. "If, in fact, the elimination of the double taxation of stock dividends leads to less corporate issuance, that makes things even more appealing for corporates."

- **More investment choices and fewer tax shelters.** Eliminating the double taxation on dividends would effectively allow investors to have more freedom in selecting the ways in which they save for retirement. Wider choices make for better markets.

- **Stocks that already pay high dividend yields**: Utility funds, Real Estate Investment Trusts (REIT's,) and the "Dogs of the Dow." Utility funds invest in companies providing power and phone service that traditionally pay relatively high dividends. As a group, they currently pay dividends averaging about 3%. REIT funds invest in real estate properties and as a fund sector, have been paying dividends averaging 7%. The Dogs of the Dow are the ten stocks of the Dow Jones Industrial Average that pay the highest dividend percentage. Currently, the list includes several household names and pay an average dividend of about 4%. As a case in point, the dividend paying Dogs of the Dow, during the tech bubble of the late 90s, was up 28.6% in 1996, up 22.2% in 1997, up 10.7% in 1998, and up 4.0% in 1999. During the difficult bear market years of 2000 - 2002, the Dogs of the Dow was up 6.4% in 2000, down 4.9% in 2001, and down 8.9% in 2002, and that was enough to significantly outperform the Dow, S&P 500, and NASDAQ.

- **More companies that pay dividends:** ChevronTexaco 4.1%, Bank of America 3.6%, SBC Communications 3.6%, Emerson Electric 3.0%, General Electric, 2.9%, ExxonMobil 2.6%, Abbott Laboratories 2.4%, Wells Fargo 2.3%, 3M 2.0%, Procter & Gamble 1.9%, Pfizer 1.9%, Anheuser Busch 1.6%, Johnson & Johnson 1.5%, Sysco 1.4%. For a point of reference, Coca-Cola currently pays its shareholders $.60 a share annually. So if the stock is priced at $64 a share, the 60 cents represents about a 1% dividend. Although 60 cents may not sound like much, if you own 10,000 shares you earn $6,000 a year on your investment.

The Elimination of the Double Taxation of Dividends Creates a More Reasonable Tax Code:

- Most industrialized nations do not have a double taxation of dividends. The punitive taxation of dividends is not a policy pursued by most industrial economies. In a recent study by the American Council for Capital Formation, 62.5% of all countries provided complete or partial offsets to the double taxation of dividends on the corporate level. An additional 25% of those countries gave shareholders a break on dividend taxation. Even the U.S. once gave exemptions for dividend income. In 1954, there was a $100 exemption per couple, which doubled to $200 in 1964 and doubled again to $400 in 1980 (almost $1,000 in today's prices). The 1986 Tax Reform Act repealed this exemption, and it hasn't been restored. The U.S. is one of the few countries in the world where dividends are taxed at both the corporate and the individual level. Treating debt and equity in an equivalent fashion will eliminate a major distortion in the tax code.

A New Life Would be Created for the Beleaguered Technology Companies---Investors would Return and the Approach would be Long-Term in Focus and not the *Quick Trade* of the 1990's:

- Indeed, cash-rich technology leaders such as networking firm Cisco Systems Inc. and software giant Oracle Corp., which have never paid any of their profits to shareholders through dividends, would reconsider those policies under the Bush plan. Oracle has $5.5 billion in cash and investments, while Dell has about $4 billion. Jeff Henley, Oracle's chief financial officer, told investors at a recent conference that the end of dividend taxes "would have a significant impact on our thought process" about cash payments to investors. Some big tech companies already pay dividends, including Intel Corp. (INTC), Hewlett-Packard Co. (HPQ) and International Business Machines Corp. (IBM). Certainly, these technology companies may be encouraged to increase their dividend pay-outs.

Again, Mr. Chairman, thank you for the opportunity to share my thoughts on the President's proposal to end the double taxation of dividends.

###

Hilary *Kramer is the Senior Strategist and Advisor at Montgomery Asset Management and the Fox News Channel Business Analyst and Commentator. She can be contacted at hilary@hilarykramer.com.*

The CHAIRMAN. Let us go through a round of questions with the panel and get your responses to a variety of our concerns.

Dr. Hubbard, the President talked about how the proposal of ending the double taxation of dividends was especially good for seniors, and while I am not an investor in any major way, I do know that in studying it a bit, you hear investment advisors talk about active and aggressive investments during your earning years and as you become more senior, you shift your assets in your portfolio and you move to much more stable, secure investments and dividend-earning capacity. When you leave the job market, that is where the largest portion of your investment ought to be.

My questions are, is that a true pattern with most seniors as they move toward retirement and as they shift their investment, and do you agree that these figures that I have offered that Cato has come up with are accurate as it relates to seniors and as it relates to investment dividend to their income? Last—that would be two questions. The other one would be, can you tell us the average dividend income and the average potential dividend tax savings per senior?

Dr. HUBBARD. Sure. Just to take up your questions in turn, Mr. Chairman, it is, of course, true that seniors, on average, have higher levels of assets because they have been saving for their retirement, and as you pointed out, often more conservative portfolios as they become elderly, which makes them particularly benefiting from the President's proposals.

If you look at Treasury estimates of who is paying the dividend tax now, about $37 billion in dividends that are currently received by seniors would become tax-free. There are more than that received by seniors, but that much would be excludable. As you noted in your opening, more than half of the seniors are getting excludable dividends.

It might interest you to know that if you look at the seniors making under $50,000, and then I will get to your more general question, roughly five million tax returns in that area, would still get about $1,500 in dividend income and save a few hundred dollars a year, and this is just the seniors making less than $50,000. Obviously, higher-income seniors would benefit more.

If you look at the totality of what the President is proposing, the typical senior would get an average tax cut of about $1,400. So this is actually quite substantial.

Your question about the OECD numbers, it is quite correct that for equity-financed investments, the U.S. has a punishing tax system. There is really no other country in the G–7 that fails to provide some sort of relief for double taxation, so this is a real problem. It shows up, as Ms. Kramer was saying, in biasing toward other kinds of investments that expose the economy to financial fragility. It makes our companies less competitive abroad as well as at home. So these are all very important issues the OECD study raises.

The CHAIRMAN. I thank you.

Ms. Kramer, while I am going to work mightily to keep this focused on the impact on seniors, because that is the guide and the direction of this committee, we also understand the impact of the economy on seniors and the reality of declined incomes for them.

You have mentioned, and, therefore, having to shift lifestyles, and we are not talking about wealthy people, but people who have saved all of their lives to build a nest egg to gain those rewards, and then to have the difficulty of seeing them disappear and/or substantially be reduced.

In your testimony, you have listed several critically important corporate governance advantages from the President's dividend proposal. Can you think of any disadvantages for corporate governance if Congress ends the double taxation of dividends?

Ms. KRAMER. No. There would be no disadvantage to ending it. The concern we keep hearing is concern about what would be lost in terms of tax revenue, but that would be more than made up for in terms of a stock market that would rise quickly, and we have lost $8 trillion dollars of wealth in the stock market, right? We have gone from $18 trillion to $10 trillion. We would make up that $300 billion and whatever possibly could be lost immediately.

In terms of disadvantages, there are none on the corporate governance level because we would get everybody on the same page, the shareholder, senior management, and the boards of directors.

The CHAIRMAN. You would still have in the economy, obviously, startups and venture capitalists and all of those kinds of things, and once that company began to grow and build its base and do all of that, and this is obviously showing my ignorance, I am assuming the transition occurs at a point of profitability and a strive to gain profitability.

I am looking at Microsoft, sitting there with the hugest bucket of cash of almost any corporation in America, never having paid dividends. I found it fascinating that after the President's proposal, they are now talking about dividends. Is that a reaction to, or have they simply come to a point in time where to secure investment, they feel they have got to start rewarding the investor beyond stock value?

Ms. KRAMER. There is an absolute correlation, Senator, because Microsoft understands with their brilliant management team that with a tax cut, with the abolishing of the double taxation of dividends, investors will want to buy Microsoft shares to get that dividend. There is $43 billion that needs to be paid out.

Also, Microsoft has lost money by, again, not sticking with core competencies. For example, they went and invested in a cable company in Brazil. Now, I would have much rather have a dividend than to know that Microsoft went, made this investment in a saturated market in an area where they couldn't make money, they have lost all their money, and me, as a shareholder in Microsoft, would prefer that dividend. Microsoft understands that, and Bill Gates, yes, he is to gain $100 million in taxes he won't have to pay, but so is the shareholder who owns one share, or the person who owns it through whatever pension fund they might have.

The CHAIRMAN. Thank you. Let me turn to my colleague from Louisiana, Senator Breaux.

Senator BREAUX. Thank you, Mr. Chairman. I thank the panel for their presentation.

Dr. Hubbard, you had indicated and were trying to make the case that the President's dividend tax elimination proposal would be good short-term stimulus to the economy. Alan Greenspan disagrees with you, and vocally and, I think, very strongly. While elimination of the double taxation on dividends is good tax policy in the long-term, which I agree, in the short-term, it is not stimulative at all. He points out that over 62 percent of dividends that are declared are not taxable now because of the fact they are going into pension funds, retirement funds, and tax-exempt funds.

But on the question of short-term stimulus, I can't think of anyone that is probably more respected by Democrats and Republicans than Mr. Greenspan and he doesn't agree with your statement on it being a stimulus in the short-term. What would you tell him?

Dr. HUBBARD. Certainly, Senator, I think first to your point about the dividends that are received currently by exempt entities, what matters for the cost of capital asset prices is in econ-speak the marginal investor, and almost all the evidence we have in finance is that that is a taxable entity. So even if the bulk of dividends went to tax-exempts, that would have little to do with the pro-investment aspects of the argument.

I suspect that a lot of this is over what the word "stimulus" means. It is certainly the case the President does not view government's job as fine-tuning the economy, and when people say the word "stimulus," that often is what comes to mind. But go back to the diagnosis I mentioned that the President believed that was the problem, which was this delayed investment recovery. That is very much centered on hurdle rates and costs of capital, and there, eliminating the double tax has a very large effect on the cost of capital. I can't comment on remarks I didn't hear——

Senator BREAUX. OK. Well, let us assume that is what he said, for the sake of argument. Does the White House say that Alan Greenspan is wrong in his belief that dividend tax elimination is not short-term stimulus?

Dr. HUBBARD. Again, the way I would put it, Senator, is we believe that the dividend tax proposal lowers the cost of capital now and in the future.

Senator BREAUX. Is it short-term stimulus?

Dr. HUBBARD. I don't like the word "stimulus." More importantly, the President doesn't because it has this fine-tuning feel to it. I think what we believe is that——

Senator BREAUX. When you all first proposed the program, it was a stimulus package. It was going to be short-term, it was going to be stimulus, and over half of it was going to the elimination of the double taxation on dividends. Greenspan says that is not short-term stimulus. Does the White House disagree with Mr. Greenspan?

Dr. HUBBARD. We believe that the dividend tax part of what the President is doing is good for the economy generally. It is good in the short-term, it is good for the long-term. In economic policy, you can't so nicely put things into short-term and long-term boxes. It is a policy that, over time, gets even better. So in that sense, it is a long-term policy. But it very much would be pro-investment in the short-term, as well.

Senator BREAUX. So you disagree with him, then, in that regard? If he says it is not short-term stimulative to the economy, the White House disagrees with him, then.

Dr. HUBBARD. Yes. I can't comment on words I didn't hear and terms that I wouldn't use, but I think what I can say to you is a very straight answer. We think this lowers the cost of capital in the same way that a quite significant investment tax credit would, and it is hard for me to believe that is not pro-investment today and in the future, and this, again, is coming from somebody who has studied this for many, many years.

Senator BREAUX. You sort of dodged the question. [Laughter.]

You have done your best. I agree that the estimates that I have seen is that a large portion of the tax package does affect seniors, and I think that is a fact. It seems that nearly 15 percent of the total tax cut benefits, in what they are now calling a growth package as opposed to a stimulus package, go to filers who are over the age of 65. But while that, I think, is positive, it also has to be fair in who it goes to, and thus the concern that I have.

I look at Louisiana, my State, and only 8 percent of the working people end up paying taxes on dividends. When you get to retired people over 65, the number drops exponentially lower than even 8 percent that are affected by any dividend tax elimination at all.

The information I have seen is that about 14 percent of the total tax package benefits go to people who are over 65 with incomes over $1 million. I don't know if there is a single person in Louisiana that would fit that category. Maybe, but you could probably count them on one hand.

Over 60 percent of the benefits in the total package go to elderly with incomes over $100,000. Now, my State has an average income of working people of about $22,000. We are talking about basically retired people, where over 60 percent of the benefits go to those who are retired making over $100,000 a year. From my standpoint, spending that much money, it has to hit the largest number of people possible.

On the dividend income, nearly 43 percent of the benefits of the dividend exemption that go to elderly individuals go to those with incomes over $200,000, on the dividend exemption. Again, I don't know how many in Louisiana I have in that category, but I will tell you, you can count them on one hand or two hands, probably. It is not a lot.

So I am just concerned that while we are spending a lot of money and it is affecting a lot of people—you point out that—you said that the average cut, I think, was almost $1,400, the average tax cut for seniors. The average cut for seniors, 13 million elderly would receive a tax cut of about $1,384, but almost 80 percent of them will get less than that amount. We can play numbers and statistics and averages. If you take the average, that is probably true. But almost 80 percent would get less than the average, with about 40 percent getting something like $100 or less from the proposal.

Now, I have laid out a lot of facts on the other side of what you have said and I would ask you to comment on them.

Dr. HUBBARD. Certainly, Senator. I think there are really two key responses to your question. One, just to play the traditional game of distribution tables, and I won't go through all the numbers. I think your question raises important points——

Senator BREAUX. Do you disagree with any of the factual numbers I used?

Dr. HUBBARD. Some of the numbers are——

Senator BREAUX. Which ones?

Dr. HUBBARD. Well, I can work with you on that because I have some Treasury data, but the patterns you are mentioning are accurate, but I would say two things. One, if you look at the distribution table as it is currently done in Washington, before and after the President's plan, it looks almost the same in terms of share of tax burden, because the President's plan has a great deal in it for low- and moderate-income families. But that is not the point.

As I tried to say in my remarks, what is really surprising as the economic result here is when you spoke well of working people, you were exactly on the point. Who ultimately bears this tax is working people, even if they never get a dividend. This isn't about who gets dividends today. It is about the wages of everybody in the future, whether they are seniors or all of us as we are getting lower. That is the surprising result of economics. That is what the President is focused on. Yes, it affects seniors today, but the real issue here is our country's productivity and long-term growth. That, to me, is the biggest fairness question.

Senator BREAUX. That will be the argument. I mean, a worker that is making $22,000 in Louisiana is not going to feel that comfortable and feel that he is getting a lot of benefits from a retired person who has an income of over $200,000 getting 43 percent of the dividend tax exemption value. That is not going to make that person with a family of four feel very good as he struggles, that I am going to really benefit because someone over 65 is getting 43 percent of the value of the dividend exemption and he is making over $200,000 in retirement income.

Dr. HUBBARD. But, Senator, you are not benefiting as a working person because the older, more affluent senior is getting dividend checks. You are benefiting because that is leading to greater capital accumulation in our economy and higher wages. I understand that that does not fit——

Senator BREAUX. I am going to bring you with me to sell that point in Louisiana and see what kind of reaction you get. [Laughter.]

Thank you very much.

The CHAIRMAN. Let me turn to my colleague, Gordon Smith from Oregon, but before I do, is that $22,000 a year working man or woman in Louisiana with a family of four paying any taxes under the current——

Senator BREAUX. Hopefully not. Some of the points of the President's package are good.

The CHAIRMAN. Yes.

Senator BREAUX. I mean, the child exemption credit is good. The marriage penalty is good.

The CHAIRMAN. Actually, that family gains more under the President's package than the seniors we are talking about here, the $1,400, if they are getting the child tax credits.

Senator BREAUX. I don't know the number on that. We could take a look at it. It is——

The CHAIRMAN. Very close to it.

Senator BREAUX. The question, though, and the whole point, obviously, is fairness.

The CHAIRMAN. Yes.

Senator BREAUX. If we are going to spend that much money on a dividend tax exemption, in my State of Louisiana, only 8 percent pay any tax on dividends.

The CHAIRMAN. OK. Let me turn to my colleague from Oregon, and then we will turn to Senator Carper if he wishes to make an opening comment. Gordon?

Senator SMITH. Thank you, Mr. Chairman, and I want to thank our witnesses for excellent testimony.

To Senator Breaux's point about who pays taxes, it is a fact that many of these dividends, as they are currently going out, are already sheltered because they are in pension funds. They are sheltered until they are pulled out. So you could argue it is not stimulative in that sense right now.

That raises for me a question I have had ever since this was proposed. I understand why, politically speaking, it makes a lot of sense to end the taxation at the individual level, but I wonder if you can comment as to the efficiency of markets, whether it makes more sense to end it at the corporate level and then perhaps give some of what we had before the 1986 Tax Act, some allowance for deductibility, though not full deductibility, to individuals. Is there a way to, in fact, increase the efficiency of this proposal? Ms. Kramer?

Ms. KRAMER. Senator, because the stock market, because the economy is all emotion, it is pure psychology, it makes sense that it really has to be on the individual level, because an individual investor has to feel the benefit of having more money in their pocket and that is the bottom line with that. Now——

Senator SMITH. Your point, I would assume, is even though the corporation still pays the tax——

Ms. KRAMER. The corporation——

Senator SMITH [continuing]. The board room will feel the heat because the shareholders will be demanding the dividends.

Ms. KRAMER. The shareholder will demand the dividend. The stock market needs to go back up. We need—we have very serious systemic problems right now, and if we don't fix them and we don't jump-start our economy, we are going to keep losing money out of our stock market.

Yes, I agree that to a certain extent, corporations, if they were to have the exemption on terms of the tax, yes, they would start capital spending immediately. But no, if their stock price goes up, companies will be in a position to start engaging in capital spending. Two-thirds of the economy is the consumer, but the consumer is almost spent out. Interest rates are as low as they are going to go right now. How many more mortgage refinancings can we have? Everyone has whatever money they are going to have in their pocket and we need companies to spend.

So your argument is well taken, but at the same time, we need people to get excited and we need that foreign money, also, back into our stock market, because it keeps going out and companies can't spend and we need them to invest in high-tech and get out there and upgrade all their systems.

Senator SMITH. Mr. Hubbard, did you all consider the corporate proposal as opposed to the individual proposal?

Dr. HUBBARD. Yes, Senator. I don't think it is politics so much as the principles in economics. If you think about it, if everybody paid the same rate of tax, say the corporate rate were the same as individual rates, nobody was tax-exempt anywhere, it really wouldn't matter in the simplest world whether you took the double tax away at the corporate level or the individual level.

But, of course, there are a lot of tax-exempt and foreign shareholders and I think what the President said in his rhetoric is no double taxation. That means tax it once, not tax it not at all. To do that in the current environment would require individual relief. It also has the very important benefit that Ms. Kramer mentioned, which is in corporate governance. It really is a discipline to management to have to go to the capital markets to be monitored whenever new money is needed, to try to pay money out of corporate solutions.

So I think the reasons to do it are entirely principled, although there are certainly good arguments for doing it at the corporate level, as well.

Senator SMITH. How about a combination of both? Was that ever considered?

Dr. HUBBARD. I don't think, again, you would want to do both in the sense that the goal here is to tax once and only once.

Senator SMITH. Hilary, you mentioned that we are competing against foreign nations, as well, and we have capital flight now, apparently. What is the policy in Europe, generally? What is the policy in Asia, generally, in terms of the taxation of dividends?

Ms. KRAMER. Well, we have the second-highest, the United States, taxation on dividends, only next to Japan. So Europe, the rest of the world, got savvy to this long ago, long ago.

By the way, foreign companies that trade on our stock exchange, Senator, in the form of ADR, American Depository Receipts, they have gotten savvy to this. They are sort of looking from a distance and have realized the importance and significance that abolishing the double taxation dividend will have on raising their stock price, so they have jumped ahead in increasing their dividend. I have seen companies. Elbit Systems, Royal Dutch Petroleum, Unilever, British Petroleum, take a look at their dividend yields compared, let us say, "To Exxon or Mobil and you will see that they know what is going on because they have experienced it themselves outside of the United States."

Senator SMITH. I see this chart now. I think, Mr. Hubbard, you all have started a very important debate. I hope you will continue with it. Whether it is part of a stimulus package or not, I don't know at this point what is possible to get through the U.S. Senate, but eventually, this needs to happen for the sake of our markets and our system in the United States, in order to be competitive and, frankly, in order to pursue what will be much more productive tax policy. So if not in this Congress, I hope as soon as possible, and a lot of us are anxious to help you win this fight. Thank you.

The CHAIRMAN. Thank you very much, Senator.

Now let me turn to Senator Tom Carper of Delaware. Tom, welcome.

Senator CARPER. Mr. Chairman, good morning.

The CHAIRMAN. Opening comment and/or questions, your pleasure.

STATEMENT OF SENATOR THOMAS R. CARPER

Senator CARPER. First of all, let me say welcome to both of you. We are delighted that you are here and we thank you for your testimony and for your response to our questions.

Before I was a Senator, I was a Governor, and I was privileged to be Governor of Delaware for 8 years. I inherited an economy that was in recession and we came out of that and had eight very, very good years. I was Governor when it was easy to be Governor. I used to say, "With an economy this strong, even I look like I know what I am doing most days," and people would nod their heads and say, "Yes, he does look like he knows what he is doing most days."

But we cut taxes, I think, 7 out of the 8 years I was Governor. We always had a litmus test for our tax cuts. One, they had to be stimulative to the economy, really, I think arguably, each time, create more jobs. We wanted to simplify the economy, so we didn't want to make it more complex; so that was another piece of our litmus test. I always wanted to make sure that the tax cuts were reasonably fair and broad-based. The last element of our litmus test was to say that we wanted to be able to sustain a balanced budget, so we didn't want what we were doing to unbalance our budget.

I was elected State Treasurer back in 1976 at the tender age of 29. Pete DuPont was elected Governor that year. About a month or two later, we ended up getting the worst credit rating in the country. Pete DuPont's first State of the State message said Delaware is bankrupt, and he was trying to get the legislators to focus on the spending side. They really didn't focus that much, but the folks up on Wall Street focused a lot and they lowered our credit rating the next week to the lowest in the country, and we were crowded out of the credit markets.

We had the worst credit rating in the country, tied for dead last with Puerto Rico. They were embarrassed to be in our company. When I stepped down as Governor, we had gotten a AAA credit rating, so I am somebody who thinks a little bit about these issues and have worked a little bit in these vineyards.

I want to ask a couple of questions, and just be thinking about these. First of all, when we issued the debt in my State, we could issue it as a credit rating B–AA–1, which is what we were in 1977, to today having a AAA. As you might imagine, it makes a difference, what your credit rating is. One of the questions I want to ask, but not just yet, is what effect will the President's proposals have on issues of tax-exempt bonds, State, local governments, counties, cities, so forth, school districts?

Second, I want to just kind of go back and look at the last couple of years. I say this not as an economist, because that is really your specialty, but I have studied a little bit in that area and I am fascinated by getting the economy moving and cycles, economic ups and downs.

Mike Castle, who was our Governor, succeeded me as Congressman—I took his job in 1992 as Governor as we kind of swapped places. He now serves as our Congressman. We were invited back by the Delaware Business Roundtable last month to speak to them like we used to do when we were Governors. One of the questions I asked of all the CEOs there from Delaware businesses, including some pretty big businesses, I said, "What do we need to be doing, Congressman Castle and myself, to help in our jobs in Washington to get the economy moving?" The President had just laid out his proposal and I was looking at them to comment on the proposal.

They didn't really have much comment on the President's proposal, which had just literally been put on the table, I think, the day before. They talked a lot about uncertainty, though. They talked about the fact that while the elections were over, that uncertainty was behind us, the uncertainty with respect to Iraq, the uncertainty with respect to North Korea are still with us. We talked about the uncertainty that still flowed out of potential terrorist attacks or reprisals, whether we went to war with Iraq or did not.

Several of them raised concerns about uncertainty with respect to the stock market and what were we going to do with the SEC, who is going to be the head of the SEC, will they be tough and will they restore investor confidence? A couple of them talked about Afghanistan.

A number of them talked about health care costs and how their health care costs for their employees and health care costs for their pensioners were really hurting them on their bottom line and those were the issues they talked about. I couldn't get them to talk a lot about tax cuts, but they talked about those other issues and they really focused on uncertainty.

We have cut taxes in 2001 by a fair amount. We cut them again by not as much in 2002, and the administration has come forward with another proposal to cut taxes in 2003. What I am hearing from some of our business folks is the idea of trying to do away with the double taxation of dividends, which I think is laudable could be done in a better way. Some folks say, "You ought to let businesses expense their dividend payments just as they do their interest payments." So I am not sure what is the best way to do it, but I think in the context of overall tax reform, it actually makes pretty good sense.

Some folks on my side, Mr. Chairman, complain about the tax cut proposal and say, "Well, there they go again, unfair, class warfare, helps the rich, doesn't help the middle-income folks." As it turns out, wealthy people actually do pay a lot of taxes. If we are going to get some tax cuts, they are going to get some of the benefit, and I think it is hard to argue with that.

That was kind of my opening statement, Mr. Chairman. [Laughter.]

What I would now like to do is just ask a couple of questions, and I will go back to the first one and I will telegraph the others.

The CHAIRMAN. The Chairman will be tolerant and lenient, especially in light of the last portion of your overall comments. [Laughter.]

Senator CARPER. Thank you, Mr. Chairman.

The CHAIRMAN. Please proceed.

Senator CARPER. Thanks a lot. I want to ask you to take up with me the effect of the issue of tax-exempt bonds. States are struggling. My State is not in as bad of shape as some others, but some of the States are just getting killed right now and they are looking to us to help them on their health care costs, they are looking for us to help them fund No Child Left Behind, they are looking for us to help them on funding first responders and all that stuff. But talk first about the effect of this proposal, eliminating the double taxation of dividends, how will that affect issuers of tax-exempt bonds? When they come to us and say, "God, help us, don't do that, that doesn't really help us," what do we say? What do you say?

Dr. HUBBARD. Let me start, if I might, with a story I told the Bond Market Association on the same question. Suppose we were all sitting in 1975 and I told you that I had perfect foresight, I could tell the future, what is going to happen to marginal tax rates over time, what is going to happen to financial innovation. If I told you that future and you were in the muni bond business, you would have grabbed your chest and run for the door because there would have been big see-saws and tax rates and——

Senator CARPER. What year?

Dr. HUBBARD. Nineteen-seventy-five, but you can pick another year if you like one better.

Senator CARPER. That is a good one.

Dr. HUBBARD. But just the notion there that there are major changes in tax rates that have not had overly adverse effects on the muni bond market.

To your question, if you are a State, there are really three things at issue here. One are the yields on muni bonds. The second is the effect on your tax base if the Congress went along with the President's proposal and exempted dividends. and the third would be the effects on economic growth and State revenues. Let me start with the last and work back.

We have estimated at the Council that State revenues would be higher by about $6 billion a year. Most States are a little more than one-for-one responsive to State income. We have done this State-by-State. I don't have Delaware on the top of my head, but I would be happy to get it for you.

Muni bond yields, we feel, would go up by minimal amounts. The largest effects we have been able to get would be 10 to 15 basis points, and that is from both the acceleration of the marginal rate cuts and eliminating the double tax, which is just to say our capital markets are very liquid, indeed. So I know this concern is raised and it is important to raise the concern, but it is also important to net that against growth effects that we believe are much, much larger.

Senator CARPER. All right, good.

Ms. Kramer, any comment at all on this one? You can take a pass if you want.

Ms. KRAMER. Have you been to Knott's Berry Farm? It is an amusement park.

Senator CARPER. You know, I have not.

Ms. KRAMER. OK. The company is Cedar Fair——

Senator CARPER. California, right?

Ms. KRAMER [continuing]. Ticker FUN, F-U-N. Actually, they are based in Sandusky, OH, a 7.5 percent dividend yield, and a company that is 140 years old that has served six, seven, eight generations of families. When people go to Cedar Fair Park or Knott's

Berry Farm, they are still going to drive on the roads and they are going to pay the tolls and they are still going to use whatever city services, State services. I mean, the pie is only going to get bigger. People are still going to buy municipal bonds. I am still going to have municipal bonds in my portfolio and I am still going to recommend it as an important part of everyone's portfolio core holding.

Now, any issues with municipal bonds and any potential problems in the future, Senator, may not have anything to do with abolishing the double taxation on dividend. It is going to have to do with the fact that people are paying less State taxes because there are more people that are unemployed and there are companies that are not doing well and they are not selling their products as fast and as profitably as they had in the past. Thank you.

Senator CARPER. Thank you. The other question that I tried to telegraph, and let me just come back to it, and someone may have raised it before me, and if they have, I apologize, but there are a couple of different ways to skin this cat. Some have said, "No, the way the President wants to do it is probably not the best way." The best way to do it is to allow corporations who have a dividend to expense those dividend payments like they expense their interest payments from their debt.

Could you just comment for me, I am sure you considered that as an option, and just maybe the relative merits of either approach and why you chose the approach you have chosen?

Dr. HUBBARD. Sure. It did come up, but I would like to go over it again with you, with Senator Craig's indulgence. Basically, the Business Roundtable for the country, and I can't speak for the business people you spoke with, but the Business Roundtable has endorsed the way the President did his plan for removing the double tax, and I think from the President's perspective, this reflected a principled concern that you only want to tax income once. It turns out if that is your principle, you are really driven to do this at the individual level, because if you do corporate-level relief, you won't tax much of the income at all because it will simply flow to tax-exempt or foreign shareholders. So the President was very serious in sticking to that principle.

It also provides very important corporate governance benefits, because facing the judgment of the capital market, paying out funds and having to go back to the capital market if you have a good project, is discipline that I think many corporate finance specialists would believe is heartily needed in corporate America.

Obviously, removing the double tax is, we believe, very important. There are many ways to do it, but those were the principled reasons the President picked his way.

Senator CARPER. Maybe one last comment, Mr. Chairman——

The CHAIRMAN. Please.

Senator CARPER [continuing]. I will be done. My mom is 80 years old and she doesn't have much in the way of investments, but she has a few. She has Alzheimer's disease these days and she is not really cognizant of really what she has, but she has two grandsons. I will never be able to have this conversation with her because of her condition, but it would be interesting to ask her, Mom, how would you feel about not having to pay taxes on dividend income, or how do you feel about your grandsons paying more taxes further down the road because we have not done a very good job managing our budget deficits?

I worry a whole lot about budget deficits. I know some people say they don't amount to much and it is not something we ought to be concerned about, but when we went as a country from, gosh, was it 1969 to, I want to say, "1998 or 1999 and never had a balanced budget and finally got into a way of having balanced budgets again, which I thought was good—and I am not one who worships at the altar of balanced budgets."

Senator Craig and I, a long time ago in an earlier role, he and I worked very hard on a balanced budget amendment to the Constitution, almost got it approved in the House, not one that mandated a balanced budget every year, but one that said if you are going to unbalance the budget, you need a three-fifths vote in the House, three-fifths vote in the Senate. You need a three-fifths vote in order to raise the debt ceiling. By the way, the President had to propose a balanced budget, which I think is maybe the most important element of all. We got it close, but we didn't get it done.

But I don't worship at the altar of balanced budget, though I think it is important. I am concerned as the CBO gives us the new budget estimates and deficit estimates for the rest of this decade that pretty much all we see is red ink and I find that troubling.

The last thing I will say, "I had a chat with Dan Crippen, outgoing CBO Director the other day, and we talked a bit about the impact of this proposal on the economy, or other tax proposals on the economy, and he put it in this context, which I thought was very interesting." He said, "If you look at the economy for the next 10 years, it might be $10, $12, $14 trillion—excuse me, $120, $140 trillion over the next 10 years." He said, "What you are looking at here is a tax cut of about $650 billion over the next 10 years." He said, "Just to put it in context, and take $140 trillion versus $650 billion, it is about a 65-cent change on $140, a 65-cent impact, not percent impact but cent impact, on $140."

He said, "Sometimes we delude ourselves into thinking that the tax cuts that we make here are going to have some huge effect, but sometimes they really don't." They make us feel better. Maybe it is the psychology that Ms. Kramer talked about. Maybe psychology is a helpful thing for the economy. But in terms of actually stimulating the economy, a far better stimulus is probably resolving these uncertainties that we talked about, getting the price of oil down and having some certainty on the price and availability of energy.

With that, I will say thank you. It was great to see you both and we welcome your presence here. It is just a real pleasure. I read a lot about you, Mr. Hubbard, and it is just a real pleasure to have a chance to actually meet you.

Dr. HUBBARD. Could I actually try to answer your question, if it is——

Senator CARPER. I didn't ask a question there, but—— [Laughter.]

Dr. HUBBARD. You had an interrogatory——

Senator CARPER. But——

Dr. HUBBARD. With your indulgence, because you posed what I think is the best analogy when you raise the issue of your mother and grandchildren. The administration obviously shares the concerns about deficits, but the human element of this is very important because this isn't about dividend recipients. It is about the economy's future and economic growth, so that is precisely the right point. We believe that the wages and the incomes of her grandsons are going to be much higher as a result of what the President is proposing, and that is exactly what we are about.

Dan Crippen is right. Economies are large. You don't steer battleships easily. But what you can do is set the right environment for growth, and that is what the President is trying to do.

Senator CARPER. My thanks to both of you. Mr. Chairman, thank you for your indulgence.

The CHAIRMAN. Well, thank you, Senator. Tom is right. Both he and I partnered up in the House to aggressively advocate in the decade of the 1980's a balanced budget, and I must tell you, I was very pleased in the post-1994, 1995, 1996 period when we got there with the help of some fiscal responsibility here and some great growth in the economy. I must tell you, I would be the first to agree with you that a $307 billion deficit budget as proposed yesterday is very perplexing to this conservative Republican. We will work our way through it.

Panelists, thank you so much for being with us today. Dr. Hubbard, we thank you, not only for your openness, but your insight into a broader aspect of double taxation as it relates to dividends that I think many people miss in the overall gaming of the issue. While this is a committee that deals with the concerns of aging Americans, we clearly know that a strong economy is the best that can ever happen to a senior citizen because it stabilizes all aspects of the world around them, including their income, and that is of real concern and importance to us, so we thank you.

Ms. Kramer, thank you for your openness, your outspokenness, your advocacy, and keep up the issue of championing this cause. I think it is the right cause, and in this instance, for elderly Americans, it certainly is a very important cause. Thank you.

The CHAIRMAN. Let us move now to our second panel. Please take a seat, gentlemen, and we will proceed.

We will first start with Dick Buxton, a constituent of mine from Idaho who will describe the impact of double taxation on his family in Idaho.

Then we will turn to Dr. Dan Mitchell, a tax reform expert from the Heritage Foundation.

Last, but certainly not least in all of this discussion, Dr. Mark Crain, Professor of Economics at George Mason University and a trustee for the Virginia Retirement System.

Gentlemen, thank you very much. Dick, please proceed.

STATEMENT OF DICK BUXTON, BOISE, ID

Mr. BUXTON. Good morning. My name is Dick Buxton and I am from Boise, ID. I am a graduate of the United States Naval Academy, Class of 1959, and have retired as manager from U.S. West, now Quest, and as a Captain in the Naval Reserve. Since retirement, I have worked several different businesses, to include teaching in the public schools. I wish to thank Chairman Craig and the other members of the committee for inviting me to testify about the issue of double taxation of seniors. Double taxation is basically immoral.

We face double taxation on Social Security benefits. It used to be simple. Social Security was not taxed. But now, seniors pay a tax of 50 percent or 85 percent of income over a certain amount. This is not fair.

Seniors also face double taxation on dividend income. Companies pay income tax and folks who receive dividends pay individual income tax on those same earnings, as well.

I don't have a lot of dividend income, maybe a few hundred dollars a year. I also purchased IRAs and have some mutual funds. It is my understanding that IRA dividends will not benefit from the removal of the double taxation on dividends.

But my 89-year-old father, who is a retired railroad switchman living in Caldwell, ID, depends on his dividends. He purchased stocks such as Idaho Power, energy stocks and utility stocks, and has income stocks to supplement his railroad retirement income. The removal of the double taxation on dividends will be of great benefit.

My 91-year-old mother-in-law, a retired school teacher, also depends a great deal on her dividends. She has invested in utility and other dividend-paying stocks that provide a large portion of her retirement income. The removal of the double taxation on dividends will be of great benefit.

Finally, when someone dies, the government taxes what might be left over. Making the tax-free limit of up to $600,000—I believe this is increasing, and Senator Symms was kind of involved in that when he was in the Senate, especially for people who own family farms and small businesses. Increasing the tax-free limit will help hold these farms and businesses together after the founder dies.

There are reasons I support the President's proposal to give tax relief to all Americans. His plan should open the eyes of investors in stocks that the objective of business is to make a profit. In my view, a major cause of the stock market decline and the corporate breach of trust can be attributed to high degrees of speculation in tech stocks that were losing money. Companies that pay dividends usually have to make a profit, and most of these companies do make a profit.

In the last few years, stocks were hard to follow. Illinois Power became Dynergy and went from a high-dividend stock to a stock with a big increase in stock value and later decimated. With the debacle of Enron, many stocks in energy trading and telecommunications were decimated. These stocks, for the most part, were highly speculative. With the elimination of the double taxation of dividends, analysts should be more honest in their stock evaluation endeavors and people purchasing stock should be more aware of the stocks they are purchasing.

I am not an accountant, but I have made a point of doing my own taxes to more fully understand and be directly knowledgeable of the contents of my tax return. I also do my parents' return.

Thank you, Senator Craig and the committee, for allowing me to testify.

The CHAIRMAN. Dick, thank you for traveling from Boise to be here to testify. I think it is important to recognize when we talk about the impact on seniors, and there will be some who will speculate that this kind of double taxation issue will only affect the rich, I doubt that your retired railworker father, is it?

Mr. BUXTON. That is correct.

The CHAIRMAN [continuing]. Views himself as a wealthy man.

Mr. BUXTON. No. Senator Carper indicated that the effect on the States, he pays no State tax. He will benefit really from the other, though.

The CHAIRMAN. Thank you. We will move to questions later, but it struck me and I thought that was the valuable part of your testimony, is there a broad range of folks out there who have the potential of benefiting.

[The prepared statement of Mr. Buxton follows:]

Me graphics 32 to 33 here

U.S. Senate Special Committee on Aging

Dick Buxton

Tax Fairness: Does Double Taxation Unfairly Target Older Americans?

February 4, 2003
628 Dirksen Senate Office Building
Washington, D.C.

Good Morning. My name is Dick Buxton from Boise, Idaho. I am a graduate of the U.S. Naval Academy, class of 1959 and have retired as a manager with U. S. West (now Quest) and as a Captain in the Naval Reserve. Since retirement I have worked several different businesses to include teaching in the public schools. I wish to thank Chairman Craig and other members of the Committee for inviting me to testify about the issue of double taxation on seniors.

We face double taxation of Social Security benefits. It used to be simple. Social Security was not taxed. But now, seniors pay tax on 50 percent or 85 percent of income over a certain amount. This isn't fair.

Seniors also face double taxation on dividend income. Companies pay income tax and folks who receive dividends pay individual income taxes on those earnings as well.

I don't have a lot of dividend income. Maybe a few hundred dollars a year. I have also purchased IRA's and have some Mutual Funds. It is my understanding that IRA dividends will not benefit from the removal of the double taxation on dividends. But my 89-year old father, a retired railroad switchman, depends on his dividends. He purchased stocks such as Idaho Power, energy stocks and utility stocks as income stocks to supplement his railroad retirement. The removal of the double taxation on dividends will be of great benefit.

My 91-year old mother-in-law, a retired schoolteacher, also depends a great deal on her dividends. She is invested in utility and other dividend paying stocks that provide a large part of her retirement income. The removal of the double taxation on dividends will be of great benefit.

Finally, when someone dies, the government taxes what might be left over. Moving the tax-free limit up from $600,000 is a good idea, especially for people who own family farms or small businesses. Increasing the tax-free limit will help hold these farms and businesses together after the founder dies.

These are the reasons I support the President's proposal to give tax relief to all Americans. His plan should open the eyes of investors in stocks that the objective of a business is to make a profit. In my view a major cause of our Stock Market decline and corporate breach of trust can be attributed to the high degree of speculation in tech stocks that were losing money. Companies that pay dividends usually have to be a for profit company and most of the companies do make a profit. In the last few years stocks were hard to follow, as Illinois Power became Dynergy and went from a high dividend stock to a stock with a big increase in stock value. With the debacle of Enron many stocks in Energy trading and Telecommunications were decimated. These stocks for the most part were highly speculative. With the elimination of the double taxation of dividends analyst should be more honest in there stock evaluation endeavors and people purchasing stock should be more aware of the stocks they are purchasing..

I am not an accountant, but I have made it a point of doing my own taxes to more fully understand and be directly knowledgeable of the contents on my tax return. I also do my Parents return.

Thank you, Senator Craig and the Committee for your time.

The CHAIRMAN. Now, let us turn to Dr. Dan Mitchell, tax reform expert with the Heritage Foundation. Thanks for being with us.

STATEMENT OF DAN MITCHELL, McKENNA SENIOR FELLOW IN POLITICAL ECONOMY, THE HERITAGE FOUNDATION, WASHINGTON, DC

Mr. MITCHELL. Thank you very much, Senator, members of the committee. This is a very important topic. I am glad you are taking the time to look at it. With your indulgence, perhaps my full testimony could be submitted for the record and I can highlight some of the things that haven't already been covered, I think.

The CHAIRMAN. Without objection, all of your texts will be a part of the record. Thank you.

Mr. MITCHELL. Both Glenn Hubbard and Ms. Kramer, I thought, did an excellent job.

We do have a very serious problem with double taxation in this country. I don't know that it was designed to deliberately target the elderly, but they certainly are the ones that are bearing the brunt of the policies.

I passed on to your staff a chart that I just did yesterday, so it wasn't part of the official testimony, showing that if a taxpayer spends his after-tax income, there is no additional Federal taxation on that decision. But if a taxpayer saves and invests, that same dollar of income can be taxed as many as four different times when you factor in the capital gains tax, the corporate income tax, the personal income tax, and the death tax, and that clearly is something that is bad for the economy.

Every economic theory, even Marxism, they all agree with the notion that capital formation is the key to long-run growth and higher living standards. It is the common sense notion of setting aside some seed corn so you can have greater production and greater living standards in the future, and that is what I think the President is trying to do with his tax plan, not only eliminating the double tax on dividends, but also the policy to try to provide relief from the double taxation for savings with the lifetime savings accounts, and, of course, 2 years ago, the elimination, at least hoped-for elimination, of the death tax.

Let me talk a little bit about how these policies affect senior citizens. The death tax, as we all know, is imposed upon a taxpayer's assets upon death if they have assets above a certain level. That is clearly double taxation, maybe even triple or quadruple taxation, because those assets were purchased with after-tax dollars.

The tax on Social Security is another example of double taxation. Under current law, 50 percent of Social Security payroll taxes are deductible, the corporate side. Anything above and beyond taxing 50 percent of benefits clearly would be an example of double taxation. Some people even make the argument that any tax at all would be an example of double taxation. But certainly, what happened in 1993 shifts from neutral treatment, at best, to double taxation.

Then, of course, we have the example of the double tax on dividends. Again, I think the chart from the data put together by the Cato Institute from OECD data highlights not only that this is double taxation, but it is very, very damaging in terms of America's competitive position in the global economy, and on the issue of what is short-term stimulus, long-term growth, I agree that those things shouldn't be separated. Good long-term policy is good short-term policy.

But I will note that in terms of eliminating the double taxation on dividends, we live in a very competitive global economy now. If we make the right decisions in our economy, our ability to attract capital to the U.S. economy is much bigger than it was perhaps 20 years ago. In other words, with the economy the way it is today around the world, the rewards of good policy are magnified more than they were in the past and the punishment for bad policy is magnified more than it was in the past. There is a reason why France is suffering the economic stagnation they are suffering, why Germany, why Japan, why countries like that are suffering, whereas other countries that are reforming their tax codes, reducing the burden of government, why they are doing so well.

Let me talk a little bit about increasing economic growth. In my full testimony, I cite a number of different papers by academics looking at the economic growth impact. I look for the Heritage Foundation. Allow me just to cite what our number-crunchers in the Center for Data Analysis came up with, that the President's proposal would increase the employment level by an average of more than 300,000 jobs a year, increase GDP by an average of $40 billion, increase business equipment new purchases by $32 billion a year.

Also, very importantly, because you are getting additional economic growth from fixing the double taxation of dividends, you will get revenue feedback. Our Heritage number-crunchers estimate that the dynamic cost of the tax cut is only about one-third of the static cost of the tax cut.

Let me go ahead and touch on the death tax real quickly. Again, we see numbers, not only from all the academics, but again from our people at Heritage, showing higher GDP, more jobs in our economy, increases in disposable income for workers.

On the issue of Social Security benefits, unfortunately, there isn't a lot of data out there. We made a search of the literature. It is not something that has been pored over. But as an economist, I am perfectly happy to stick with theory, and one important thing about the double tax on Social Security benefits, you only pay that tax if you have non-Social Security income that pushes you up into that $25,000 range, and then, of course, the $34,000 and up for the 85 percent tax. So, in other words, it is only if a taxpayer, an elderly taxpayer, is providing labor and capital to the economy that that taxpayer is going to get hit by this double tax of Social Security benefits, and that, of course, means that there must be some adverse economic impact, although, again, I am sorry to say that we don't have a whole lot of research out there that allows us to put our finger on that.

With that, I see that the red light is on. Why don't I go ahead and turn it back over to you, Mr. Chairman.

The CHAIRMAN. Thank you very much.

[The prepared statement of Mr. Mitchell follows:]

The Heritage Foundation

Testimony before

Special Committee on Aging

By

Dan Mitchell, The Heritage Foundation
McKenna Senior Fellow in Political
Economy

PROTECTING SENIORS FROM DOUBLE-TAXATION

Daniel Mitchell

Mr. Chairman and members of the Committee, thank you for this opportunity to testify. My name is Dan Mitchell and I am a Senior Fellow in Political Economy at the Heritage Foundation. The views expressed here are my own.

President Bush has proposed to eliminate the double-taxation of dividends. Under his plan, businesses will pay tax on corporate income, but individual stockholders no longer would have to pay a second layer of tax on that income when it is distributed in the form of dividends. This proposal is good for America, and it is good for seniors.

The President is addressing a very serious problem. The internal revenue code routinely imposes extra layers of taxation on productive behavior such as saving and investment, and the double-taxation of dividends is just the tip of the iceberg. Capital gains taxes are a form of double-taxation, as is the death tax. Interest payments also are double-taxed, and the 1993 tax bill even instituted an extra layer of tax on Social Security benefits.

Removing or reducing double-taxation will lead to more jobs and higher living standards. These policies will make America more competitive. Eliminating extra layers of tax will simplify the tax code. Perhaps most important, ending double-taxation is the right thing to do. People who contribute to our nation's prosperity by saving and investing – and this certainly includes many of the elderly – should not be punished by the tax code.

DOUBLE-TAXATION IS BAD FOR AMERICA

Tax policies that punish savings and investment are counterproductive. Every economic theory (including Marxism) teaches that capital formation is necessary to raise wages and stimulate long-term economic growth. Policymakers who want to boost savings should eliminate the anti-savings provisions in the federal tax code, preferably by replacing the code with a simple and fair flat tax that would end multiple taxation of capital. To the extent that such fundamental reform is not immediately possible, there are a number of incremental steps Congress should take to alleviate the bias against savings and move toward a flat and fair tax system in the future:

- Individual retirement accounts (IRAs) should become universal, so that all taxpayers could save as much as they want without being taxed twice;
- The double taxation on non-retirement savings should be eliminated;
- The 1993 tax increase on Social Security benefits should be repealed;
- Tax penalties on dividends, estates, capital gains, and other forms of capital should be eliminated.

This hearing is designed to address two issues. First, what is the impact on the elderly of the death tax, the Social Security benefit tax, and the second layer of tax on dividend income? Second, what are the potential economic benefits of the President's economic plan?

DOUBLE TAXATION AND THE ELDERLY

While certain taxes – such as the death tax and double-tax on dividends – are not explicitly designed to hit seniors, the elderly bear a disproportionate share of the burden. Seniors have higher levels of saving and investment. In part, this is simply because they have had the opportunity to accumulate capital during their working years. But there also are specific reasons why the elderly save, including the desire for economic security and the desire to provide a nest egg for their families.

Unfortunately, these goals are sabotaged by the tax code. Here are the specific forms of double-taxation that the committee is examining today, along with an explanation of why they are improper.

Death tax – The death tax is imposed when a taxpayer dies and his or her assets are above a certain value. Yet since assets generally are purchased with after-tax income, the death tax clearly qualifies as double taxation. Indeed, many financial assets in a taxpayer's estate may already have been subject to extra layers of tax, so the death tax often is a form of triple- or even quadruple taxation.

Tax on Social Security benefits – There is one form of double-taxation that specifically targets the elderly. Thanks to the 1993 tax increase, single retirees with income above $34,000 and couples with income over $44,000 now must pay tax on 85 percent of their Social Security benefits. Yet since Social Security taxes are only 50 percent deductible (the so-called employer share of the tax is paid in pre-tax dollars), it is double taxation to tax more than 50 percent of benefits.

Dividend tax – Returns to corporate equity are subject to double-taxation. First, the income is subject to the corporate income tax – and the U.S. has the fourth highest rate in the industrialized world. Then the same income is taxed a second time at the individual level thanks to the personal income tax.

TAX RELIEF FOR THE ELDERLY

Fixing these flaws in the tax code is good for economic growth, good for American competitiveness, and good for the elderly. The White House has announced that "[a]lmost half of all savings from the dividend exclusion under the President's plan would go to taxpayers 65 and older. The average tax savings for the 9.8 million seniors receiving dividends would be $936."

One of my Heritage Foundation colleagues has combed through the data and also found that the elderly are big beneficiaries of dividend tax reform. Among post-retirement age taxpayers who receive dividends, the median taxpayers' (single, married, and combined) dividend income is $2,406, with an after-tax income of $35,544. The median single taxpayer in this group has a lower after-tax income of $21,844 and a higher dividend income of $3,184. The median married taxpayer in this group has an after-tax income of $44,921 and a dividend income of just under $2,000.

The death tax is scheduled to disappear in 2010. That is the good news. The bad news is that it reappears in 2011. This tax reform must be made permanent to boost economic growth and to rescue older Americans from this pernicious form of double-taxation. Last but not least, the double-tax on Social Security benefits currently is part of the tax code and it does not appear that this black mark will be erased anytime soon.

GOOD TAX POLICY WILL BOOST ECONOMY AND INCREASE WAGES

Dividend Double-Tax

Many economists have long argued that the double taxation of dividends reduces the after-tax return on capital in the nation's economy and thus discourages corporate investment.[1] This reduced corporate investment, such as purchases of new business equipment and machinery, weakens economic growth. Consequently, these economists would argue that eliminating this double taxation would spur corporate investment and improve the economy's long-term growth.

Empirical evidence indicates that eliminating the double taxation of dividends would lower the cost of capital and, in turn, increase investment and economic growth. Since the United States is one of only three developed countries without some form of protection from the double taxation of dividends, much of the empirical evidence examines the experiences of other countries.

In 1987, New Zealand and Australia both implemented a dividend "imputation credit" mechanism to eliminate the double tax on dividends.[2] This method, which has the effect of adding back the corporate layer of tax to the dividend received by the shareholder, was found to increase capital investment in both New Zealand and Australia.[3] Furthermore, the imputation credit employed in Australia was found to offset the investment dampening effects of a capital gains tax increase.[4]

In a 1984 paper, James Poterba and Lawrence Summers tested several competing hypotheses regarding the economic effects of dividend taxation using data from Great Britain.[5] Unlike the United States, Great Britain has experienced several dividend tax reforms since the 1950's, a condition which makes empirical testing more straightforward. The authors found that the double taxation of dividends in Great Britain did lower corporate investment and worsen distortions in the capital markets.

One of the only recent U.S. tax reforms that lends itself to this type of empirical study is the Tax Reform Act of 1986 (TRA86). A 1991 paper by Nadeau and Strauss notes that TRA86 significantly reduced the tax advantage of retained earnings over

[1] For more on the economic effects of federal double taxation of dividends, see James M. Poterba, "Tax Policy and Corporate Saving," *Brookings Papers on Economic Activity*~~,~~ No. 2, 1987, pp. 455–515; Peter Birch Sorensen, "Changing Views of the Corporate Income Tax," *National Tax Journal*, Vol.~~ume~~ 48, Issue 2~~,~~ (June 1995), pp. 279–294; and James M. Poterba and Lawrence H. Summers, "New Evidence that Taxes Affect the Valuation of Dividends," *The Journal of Finance*, Vol.~~ume~~ 39, Issue 5~~,~~ (December 1984), pp. 1397–1415.
[2] For a complete discussion of the imputation credit, as well as other methods for eliminating the double taxation of dividends, see Deborah Thomas and Keith Sellers, "Eliminate the Double Tax on Dividends," *Journal of Accountancy*, November 1994.
[3] See Ervin Black, Joseph Legoria and Keith Sellers, "Capital Investment Effects of Dividend Imputation," *Journal of the American Taxation Association*, Vol. 22, No. 2, Fall 2000, pp. 40-59.
[4] See Black, Legoria and Sellers, 2000.
[5] See James Poterba and Lawrence Summers, "The Economic Effects of Dividend Taxation," *NBER Working Paper*, No. 1353, May 1984.

dividends.[6] The authors' model estimated this tax reform reduced the cost of equity capital by about 30%. Later, Cummins and Hassett (1992) studied TRA86 and found that it lowered the cost of capital and increased investment.[7] Recently, Heritage Foundation economists simulated the President's dividend tax reform bill and found that ending the double tax on dividends would lead to higher investment and economic growth. It would:

1. Increase the employment level by an average of 311,000 taxpaying jobs per year;
2. Increase Gross Domestic Product (GDP) by an average of $40 billion;
3. Increase purchases of business equipment by an average of $32 billion.

Interestingly, this added economic growth will generate revenue for the government. The revenue feedback – or supply-side effect – almost surely won't be enough to offset the static revenue loss, but my colleagues estimate that the President's proposal will reduce revenues to the Treasury by only 30 percent of the so-called static cost. Instead of a static cost of $367 billion, the ending of the double taxation of dividends so stimulates the economy that Treasury revenues only fall by $102 billion over 10 years.

Death Tax

The death tax is imposed at death, but the actual tax burden falls on saving and investment. It is quite likely that no tax does more damage to the economy in comparison to the relatively small amount of tax revenue that is generated. This is because of the tax simultaneously discourages the accumulation of new capital and encourages the misallocation of existing capital. Repealing the tax therefore would have enormously positive consequences.

Congress' Joint Economic Committee, for instance, estimates that the death tax has slashed available capital stock by $497 billion, or 3.2 percent. Economists for the Institute for Policy Innovation project that annual gross domestic product would be $117.3 billion, or 0.9 percent, above the baseline and that the economy would create almost 236,000 more jobs than in the baseline.

My Heritage Foundation colleagues estimate permanent repeal of the death tax this year would have the following beneficial effects by 2012:

- Add $14.7 billion (adjusted for inflation) to the GDP;
- Add 118,000 jobs to the U.S. economy;
- Raise U.S. personal disposable income by an inflation-adjusted $11 billion;

[6] See Serge Nadeau and Robert Strauss, "Tax Policies and The Real And Financial Decisions of the Firm: The Effects of The Tax Reform Act of 1986," *Public Finance Quarterly*, Vol. 19, No. 3, July 1991, pp. 251-292.
[7] See Jason Cummins and Kevin Hassett, "The Effects of Taxation on Investment: New Evidence From Firm Level Panel Data," *National Tax Journal*, Vol. 45, No. 3, 1992, pp. 243-251.

Double-Tax on Social Security Benefits

Unfortunately, we don't have much economic evidence regarding the damage caused by the double-tax on Social Security benefits. But we can safely state that repeal will yield benefits. And while those benefits will be modest compared to death tax repeal and eliminating the double-tax on dividends, they should not be ignored.

The double-tax on benefits is anti-growth because it actually falls on a senior citizen's non-Social Security income. In other words, the tax only takes effect if a Social Security recipient has a certain level of income from either providing labor or providing capital to the market. The tax on that behavior is high. The senior citizen is subject to regular tax rates plus the added tax burden that results from throwing more Social Security benefits into taxable income. And since the tax on Social Security benefits results in a high marginal tax rate for people with incomes above the threshold, this means a very high marginal tax rate on productive behavior.

MAKE AMERICA MORE COMPETITIVE

There are a few other features of the Bush tax plan that are worth discussing, particularly the positive consequences of eliminating the double-tax on dividends. The Bush plan, for instance, would boost U.S. competitiveness abroad. According to a Cato Institute survey, only three of the world's 30 developed nations — America, Switzerland and Ireland — double-tax corporate income. And since Switzerland and Ireland have much lower corporate tax rates, this means America may have the most punitive and anti-growth dividend tax in the industrialized world.

This is an embarrassment — and it clearly puts America in a disadvantageous position. About one-fourth of our competitors don't impose any double-taxation on dividends, while almost all the rest have policies that provide at least partial protection from double-taxation. Only Japan – which is hardly a role model – has a top dividend tax rate above America.

HELP AMERICANS BUILD WEALTH AND SAVE FOR RETIREMENT

Another benefit of eliminating the double-tax on dividends is an increase in wealth. The value of a financial asset is determined by how much after-tax income an investment will generate over time. Removing the second tax on dividends will increase that future income flow and therefore help the stock market. Financial experts say the stock market could expand by about 10 percent under the Bush plan, boosting national wealth by nearly $1 trillion — welcome news for workers who have watched their IRAs and 401(k) accounts shrink.

IMPROVE CORPORATE GOVERNANCE

The Bush plan promises several other benefits. Under current tax law, for instance, companies are encouraged to use debt, not equity, to finance investments. Why? Because dividends are taxed twice and interest on corporate bonds is taxed only once. If Mr. Bush's plan is approved, this bias disappears and companies will have a strong incentive to strengthen their balance sheets. This would mean fewer bankruptcies.

The tax code also creates a perverse incentive for companies to hoard earnings. Why? Because the double-tax on the earnings they keep (capital gains) is lower than the double-tax on the earnings they distribute (dividends). The president's plan would end this anti-dividend bias, giving companies an incentive to attract investors by offering dividends instead of promising capital gains. This would improve corporate governance since firms no longer would feel as much pressure to boost share prices by making unwarranted claims about future revenue. Instead, investors would judge a company by the amount of cold, hard cash it pays its shareholders.

CONCLUSION

The Internal Revenue Code imposes two layers of tax on corporate income. Companies must pay a 35 percent tax on profits. If the remaining after-tax income is then distributed to shareholders, it is subject to another layer of tax since individuals must include dividends in their taxable income. Depending on an individual's tax rate, the effective tax rate on corporate income can exceed 60 percent – even higher once state and local taxes are added to the mix.

The Administration proposes to end the double taxation of dividends by allowing individuals to "exclude" dividends from their tax return, while preserving the current 35 percent corporate tax that is imposed on this income. The President's plan recognizes that dividends are after-tax payments and puts an end to the discriminatory and unfair practice of making individuals pay a second layer of tax on this income.

Eliminating the double tax on dividend income will increase growth by dramatically lowering the effective tax rate on business equity investment. President Bush understands that economic growth is the first priority. His plan to eliminate the double-tax on dividends is a bold and visionary step, and it is part of an overall economic plan will make our nation stronger and improve the living standards of all Americans.

****

The Heritage Foundation is a public policy, research, and educational organization operating under Section 501(C)(3). It is privately supported, and receives no funds from any government at any level, nor does it perform any government or other contract work.

The Heritage Foundation is the most broadly supported think tank in the United States. During 2002, it had more than 200,000 individual, foundation, and corporate supporters representing every state in the U.S. Its 2002 contributions came from the following sources:

Individuals	61.21%
Foundations	27.49%
Corporations	6.76%
Investment Income	1.08%
Publication Sales and Other	3.47%

The top five corporate givers provided The Heritage Foundation with less than 3.5% of its 2002 income. The Heritage Foundation's books are audited annually by the national accounting firm of Deloitte & Touche. A list of major donors is available from The Heritage Foundation upon request.

Members of The Heritage Foundation staff testify as individuals discussing their own independent research. The views expressed are their own, and do not reflect an institutional position for The Heritage Foundation or its board of trustees.

The CHAIRMAN. Now, let us turn to Dr. Mark Crain, a Professor of Economics at George Mason University. Doctor, welcome.

STATEMENT OF W. MARK CRAIN, DIRECTOR, CENTER FOR STUDY OF PUBLIC CHOICE, AND PROFESSOR OF ECONOMICS, GEORGE MASON UNIVERSITY, FAIRFAX, VA

Mr. CRAIN. Thank you, Mr. Chairman and Senator Carper. Thank you for inviting me.

I really want to highlight three effects of the double taxation of dividends. The first is to highlight the economic distortions; second, to highlight the potential for improving corporate governance if dividends are excluded from taxation; and third, I would like to discuss some recently provided data from the Federal Reserve on the Survey of Consumer Finances that, I think, really illustrates this idea that older workers and seniors are likely to benefit disproportionately from the President's proposal to exclude dividends from taxation.

I do want to maybe restate this, because I do think it is so important in this debate and it seems to have been missed, it has been emphasized but maybe hammering it home again is worth the effort here, and that is that the most important, I think, perspective here is the effect on the economy and that economy growth research now almost universally recognizes the fundamental role of well-functioning financial markets, and the reason is straightforward.

Financial markets provide the mechanism whereby national savings are channeled into new investments in plants and equipment. The rate of investment determines the available capital stock per worker and whether that is going to increase, decrease, or remain the same, and the amount of capital per worker is the critical determinant of how much the Nation produces, and how much the Nation produces ultimately determines our standard of living.

The current system that taxes shareholders twice, once at the corporate level and once at the shareholder level, is a bad policy, and this policy of double taxation affects capital markets and thereby limits living standards in two ways. First, it is going to reduce the rate of permanent investments that would be lower than they would be without double taxation, and second, even for a given amount of savings, double taxation distorts incentives in financial markets to channel these funds into investment activities that would produce the highest return, that is, those investment activities that would be most productive and generate the highest returns.

Now, on the first point, the elasticity of savings investment with respect to the taxation rate, the empirical evidence is a little mixed on that. I think if you have a cautious reading, we might say there might not be a major response in terms of the total amount of investment. But on the second point, the impact of double taxation on the efficiency of capital markets, the evidence and the theoretical analysis is compelling.

First, double taxation creates an incentive to invest in non-corporate rather than corporate businesses. Second, it creates an incentive to finance the corporate investments with debt rather than new equity. Third, corporations have distorted incentives to retain earnings and thereby avoid the double tax.

There are some quite important empirical analyses of these effects and I think the results, again, are quite convincing, that the effect of the reduction of dividend taxations would increase dividend payouts, would increase corporate spending on investments, and reduce the firms' cost of capital. In other words, reducing or eliminating dividend taxation facilitates the incentive of corporations to raise equity capital as opposed to debt finance capital and this gets channeled into the purchase of new plants and equipment.

The effect has been stressed here before that increasing, or reducing the tax would also increase dividend payouts, and this adds liquidity to the capital market in the sense that earnings that were otherwise retained within the firm are now going to be unlocked and put back into the hands of shareholders to invest that capital in other higher-return opportunities.

The effects on corporate governance have been stressed. Paying dividends is an easy way to monitor corporate performance. It really reduces the cost of monitoring corporate governance and we would expect there to be, with the lower cost, to be more of that monitoring of corporate governance, and I think we would see broad effects and improvements in corporate governance in the several ways that have been mentioned.

Finally, Mr. Chairman, and I won't have time to go through all these, maybe we can come to them in the questions, but I have provided three tables from the January data on the Survey of Consumer Finances which show a breakdown of the holdings of corporate equity, of stock by age group, and essentially, these data reflect this life cycle behavior of asset accumulation that Dr. Hubbard talked about, over one's lifetime, how you begin to accumulate assets and that by the time you hit retirement age, above 65, you have accumulated a substantial amount of equity holdings.

In fact, in 2001, the latest data reveal that the median holding of equities was $150,000 for individuals 65 and older, which was almost double the size of the next cohort group. So seniors are heavily invested in the stock market, the latest data reveal, and I think that these proposals to cut the dividend tax and to improve capital markets will have a major impact on seniors who hold a lot of this stock market wealth.

Thank you, Mr. Chairman.

The CHAIRMAN. Doctor, thank you.

[The prepared statement of Mr. Crain follows:]

Statement of W. Mark Crain, Ph.D.

Professor of Economics and Director, Center for Study of Public Choice
George Mason University

Statement Before the U.S. Senate Special Committee on Aging

Tax Fairness: Does Double Taxation Unfairly Target Older Americans?

February 4, 2003

Introduction

Mr. Chairman, and Members of the Committee, thank you for asking me to testify on the issue of double taxation and the potential economic effects of the President's tax proposal.

My name is Mark Crain. I am a professor of economics and Director of the Center for Study of Public Choice at George Mason University in Fairfax Virginia. I teach and conduct research on public finance, fiscal policy, government regulation, and political economy. I also currently serve as a Trustee of the Virginia Retirement System (VRS) and chair two VRS committees, the Optional Retirement Plan Committee, and the Corporate Governance Committee. My goal today is not to advocate for particular policies, but rather to analyze issues from an economic perspective.

I would like to highlight three analytical issues related to the President's proposal to exclude dividends from the federal income tax. First, I would like to highlight the economic distortions caused by double taxation of corporate dividends. Second, I would like to highlight the potential for improving corporate governance if dividends are excluded from taxation. Third, I would like to provide an analysis of the latest data showing that older workers and seniors are likely to benefit disproportionately from the President's proposal to exclude dividends from taxation. The first discussion that follows provides an assessment of the best evidence on the economic efficiencies that can be achieved by excluding dividends from federal income taxes.

The Impact of the Dividend Exclusion on Productivity and Living Standards

The President's proposal has two major features. The first is that dividends are excluded from federal income taxation. The second feature is that corporations have the option to create internal accounts that raise the tax basis for individual taxpayers and have the effect of reducing the taxable capital gain for shareholders.

To analyze the impact of these proposed policy changes, it is important to note that research on economic growth universally recognizes the fundamental role of well-functioning financial markets. The reason is straightforward: financial markets provide the mechanism whereby national savings are channeled into new investments in plants and equipment. The rate of investment, in turn, determines whether the available stock of capital per worker increases, decreases, or remains the same. The amount of capital per worker is a critical determinant of how much the nation produces, and how much the nation produces ultimately determines its standard of living.

The current system taxes corporate profits distributed to shareholders twice — once at the shareholder level and once at the corporate level. This policy of double taxation affects capital markets, and thereby limits living standards, in two ways. First, it lowers the incentive to save and invest simple because the return on investments are lower than they would be without double taxation. Second, for a given amount of savings, double taxation of dividends distorts incentives (in financial markets) to channel these funds into investment activities that would produce the highest return — that is, into those investment activities that would be the most productive and generate the highest living standards.

On the first point — the impact of double taxation on the amount of national savings and investment — the economic literature provides a mixture of theoretical predictions and results.[1] A cautious reading is that the elasticity of saving with respect to dividend taxation is small; that is, the impact on total savings and investment might not be substantial. However, on the second point — the impact of double taxation on the efficiency of capital markets — the theoretical analysis and empirical evidence is compelling. First, double taxation creates an incentive to invest in noncorporate rather than corporate businesses. Second, it creates an incentive to finance corporate investments with debt rather than new equity. And third, corporations have a distorted incentive to retain earnings or to structure distributions of corporate profits in a manner that avoids the double tax.

James Poterba and Lawrence Summers provide the most relevant empirical evidence on these issues in a series of studies.[2] Their analyses provide three important findings regarding the effects of a reduction in dividend taxation rates: an increase in dividend payouts, an increase in corporate spending on investments, and a reduction in firms' cost of capital. In other words, reducing or eliminating dividend taxation

[1] The landmark study is Arnold C. Harberger, "The Incidence of the Corporate Income Tax," *Journal of Political Economy*, Vol. 70, June 1962. For a review of further developments, see Jane G. Gravelle, "The Corporate Income Tax: Economic and Policy Issues," *National Tax Journal*, Vol. 48, June 1995. Also see CRS Report for Congress The Taxation of Dividend Income: An Overview and Economic Analysis of the Issues October 7, 2002, Gregg A. Esenwein and Jane G. Gravelle.

[2] James Poterba and Lawrence Summers, "Dividend Taxes, Corporate Investment, and Q," Journal of Public Economics 22 (1983), 135-167. James Poterba and Lawrence Summers, "New Evidence that Taxes Affect the Valuation of Dividends," Journal of Finance, 39 (1984), 1397-1415; and James Poterba and Lawrence Summers, "The Economic Effects of Dividend Taxation," in Altman and Subrahmanyam, eds. Recent Advances in Corporate Finance, Irwin, 1986.

facilitates the incentive of corporations to raise equity capital, as opposed to debt-financed capital, and this gets channeled into the purchase of new plants and equipment.

Furthermore, increased dividend payouts of income also increases the liquidity of capital so it can seek higher productivity sectors. That is, eliminating the dividend tax will change the incentive for firms to retain earnings and increase payouts to shareholders, and shareholders can invest this capital in other, higher return opportunities.[3]

Finally, critics argue that excluding dividends would only affect a small subset of equity holders because most assets are held in tax-deferred plans (IRAs, 401(k)s, annuities, and other pension plans). That is, the benefit of tax-free dividends does not benefit all investors. This understanding is incorrect. The elimination of double taxation will improve the efficiency with which capital markets channel funds into the most productive investment opportunities, thereby increasing potential returns for all shareholders. This improved efficiency and increases in shareholder returns comes in part from changes in what might broadly be labeled corporate governance practices.

Potential Consequences for Corporate Governance

As noted above, the evidence indicates that the exclusion of dividends from federal taxation will increase dividend payouts. Dividends now represent 30% of corporate earnings, down from 60% 40 years ago. Aside from the obvious gain to shareholders in the form of income, dividend payments provide an added advantage: a relatively low cost way for shareholders to monitoring the performance of corporate management. When dividend taxes are eliminated and dividend payments become the norm, shareholders will find it cheaper to monitor management, and do more of it.

Under the current double taxation system, managers have added incentive to retain corporate profits for acquisitions and stock buybacks to raise stock prices and benefit option holders. This represents capital that is locked-in and unavailable to shareholders to invest in other, higher return options. In effect, as noted above, the tax induced incentive to retain earnings drives a wedge between managerial interests and the ability of shareholders to seek higher investment returns in the broad capital market.

Finally, because the President's plan for dividend tax relief goes only to shareholders of corporations that paid taxes, firms will need to provide an accounting of the percentage of profits not taxable as dividends (or as "deemed dividends"). This accounting information will provide valuable information with which investors can assess a company's true profitability. That is, the President's plan will generate information and increase transparency about corporate performance.

---

[3] Poterba and Summer (1986) state this effect succinctly. Under double taxation, "manager's ask will this investment project raise share values by as much as it reduces the after-tax dividend income of shareholders? And they undertake some investment projects that do not raise the firm's value by the project's full cost."

Older Workers and Seniors Benefit Disproportionately from Dividend Tax Exclusion

The high levels of capital accumulation after a lifetime of work are the untold story by the mainstream press and critics of any proposal to reduce tax burdens on capital. Median and mean net worth generally peaks in the 55-64 age group. This pattern largely reflects life-cycle income, savings, and asset accumulation behavior. For example, younger families invest in their education and build a household while gaining work experience in lower income entry-level and early mid-level employment opportunities. This lowers their propensity to save and accumulate financial assets. However, as they move out of their early work years, they can expect to increase their net worth as a result of increased income and savings.

Ninety-three percent of American families held financial assets in 2001, according to the recently released Federal Reserve Survey of Consumer Finance.[4] Financial holdings include funds in checking accounts, certificates of deposit, savings bonds, corporate and government bonds, stocks, mutual funds, retirement accounts, life insurance, and other assets.

Table I shows that a disaggregated analysis further indicates that fifty-two percent of all families have stock holdings directly, in mutual funds, retirement accounts, and other managed assets.

[4] This testimony presents an analysis of data on the real and financial wealth of U.S. families in 1992, 1995, 1998, and 2001. The data are from the tri-annual Survey of Consumer Finance (SCF) collected by the Federal Reserve Bank. The SCF provides data on the income, assets, and demographic characteristics of large representative samples of the non-institutionalized population of the United States. These are the most recent data on family wealth released by the Federal Reserve Bank.

TABLE I
FAMILIES HAVING STOCK HOLDINGS, DIRECT OR INDIRECT: 1992, 1995, 1998, 2001

Age of Head	1992	1995	1998	2001
<35	28.4%	36.6%	40.8%	48.9%
35–44	42.4%	46.4%	56.7%	59.5%
45–54	46.4%	48.9%	58.6%	59.2%
55–64	45.3%	40.0%	55.9%	57.1%
65–74	30.2%	34.4%	42.7%	39.2%
>75	25.7%	27.9%	29.4%	34.2%
All Families	36.7%	40.4%	48.9%	51.9%

Source: Ana M. Aizcorbe, Arthur B. Kennickell, and Kevin B. Moore. Federal Reserve Bulletin, January 2003. "*Recent Changes in U.S. Family Finances: Evidence from the 1998 and 2001 Survey of Consumer Finances*"

Family stock ownership rates are higher among families headed by persons age 35 and older. Families with heads age 35–64 have stock ownership rates of almost 60 percent; compared to just under 50 percent for families with a head of household under age 35. This is consistent with expectations of life-cycle income and wealth accumulation behavior.

Families headed by persons age 65 and older have significantly increased their stock ownership rates over the past 10 years. This group has increased their stock holdings by 30 percent over the past decade. As might be expected in a life-cycle analysis, seniors tend to shift their stock holdings to less dynamic investment instruments.

Though families headed by a person age 65 and older have somewhat lower stock ownership rates than the overall rate, Table II shows the median value of their holdings is significantly higher than younger Americans. For families with stocks, the average median value of stock holdings headed by persons age 65-74 is $150,000; over age 74 is $120,000. Younger families again have a lower median value of stock holdings, ranging from $7,000 for under age 35 to $81,000 for ages 55-64. Again, this squares with the pattern anticipated by a life cycle income and asset accumulation model.

TABLE II
MEDIAN VALUE AMONG FAMILIES HAVING STOCK HOLDINGS, DIRECT OR INDIRECT: 1992, 1995, 1998, 2001

Age of Head	1992	1995	1998	2001
<35	$4,300	$5,900	$7,600	7,000
35–44	$9,300	$11,600	$21,800	$27,500
45–54	$18,600	$30,000	$41,400	$50,000
55–64	$30,900	$35,800	$51,200	$81,200
65–74	$19,800	$39,300	$61,000	$150,000
>75	$30,900	$23,100	$65,300	$120,000
All Families	$13,000	$16,900	$27,200	$34,300

Source: Ana M. Aizcorbe, Arthur B. Kennickell, and Kevin B. Moore. Federal Reserve Bulletin, January 2003. "*Recent Changes in U.S. Family Finances: Evidence from the 1998 and 2001 Survey of Consumer Finances*"

Another way to analyze the data is to look at the extraordinary improvement by cohort as they have moved into new age classifications. Every age group had extraordinary increases in their median value of stock holdings over the past ten years ranging from 337 percent to 438 percent increases. Table III shows an analysis of stock holdings by age over a decade. It shows that the share of those with stock holdings declined by about 14 percent for persons entering what is commonly considered retirement at age 65. At the same time, the share of families with stock holdings headed by persons age 35-64 increased significantly. The share of families holding stock headed by persons born between the years 1957-1966 increased 40 percent. During the same time period, the share of families holding stock headed by persons born between the years 1947-1956 increased 23 percent. Again, these data are consistent with the income and asset accumulation life-cycle perspective. It is worth emphasizing that in 2001, nearly forty percent of senior citizens had stock holdings, and that the median value of these stock holdings was $150,000.

TABLE III
COHORT ANALYSIS OF STOCK HOLDINGS AND MEDIAN VALUE: 1992-2001

Year of Birth	Percent of Families Having Stock Holdings, Direct or Indirect			Median Value Among Families with Holdings		
	1992	2001	Percent Change	1992	2001	Percent Change
1947-1956	42.4%	59.2%	*+40%*	$9,300	$50,000	*+438%*
1937-1946	46.4%	57.1%	*+23%*	$18,600	$81,200	*+337%*
1927-1936	45.3%	39.2%	*-14%*	$30,900	$150,000	*+385%*

Source: Ana M. Aizcorbe, Arthur B. Kennickell, and Kevin B. Moore. Federal Reserve Bulletin, January 2003. "*Recent Changes in U.S. Family Finances: Evidence from the 1998 and 2001 Survey of Consumer Finances*"

Conclusion

The President's proposal to exclude dividends from the federal income tax will eliminate a number of distortions that limit the ability of capital markets to operate efficiently. The benefits from this plan derive from market-based incentives to channel savings into investments that yield the highest returns, and through the ease with which shareholders may monitor corporate performance. The gains in the form of increased returns on equity investments will benefit older workers and seniors disproportionately simply because it is this age group that tends to hold a large share of equity wealth. Of course, this benefit will redound to future generations as they age. Finally, improvements in capital markets will expand productivity and increase living standards, a benefit that will be shared broadly across all age groups.

Views expressed in this testimony are solely those of the author. George Mason University and the Center for Study of Public Choice do not take positions on public policy issues.

The CHAIRMAN. Thank you all very much. Dr. Mitchell, Dr. Crain, I am going to ask some questions of both of you that I would appreciate your responding to.

In Dr. Hubbard's testimony, he said that the double taxation elimination could, in the end—and I thought this was very fascinating, an aspect of it I did not understand—could reduce the cost of capital anywhere from 10 to 25 percent. Do you agree with that statement?

Mr. CRAIN. I agree in the sense that I believe he was talking about the corporations, and I think that——

The CHAIRMAN. He was——

Mr. CRAIN [continuing]. That is the——

The CHAIRMAN. But he was also, therefore, as I understood it, and you can follow me up on this, therefore talking about investment, therefore talking about corporate stability, therefore talking about stock market stability, therefore talking about growth in the economy.

Mr. CRAIN. Absolutely, and I think part of that is this distortion caused by the tax, which causes funds to go into either debt-financed capital or investments in other types of activities, real estate, other types of investments rather than corporate investments, and the idea here would be that those investments would be more productive and, by reducing the tax, would attract capital to the numbers he gave back into corporate investments.

The CHAIRMAN. Do you agree with that?

Mr. MITCHELL. I agree with Dr. Hubbard's testimony. When individuals are looking whether to invest, they are making that decision based on what the after-tax income they expect to receive is, compared to the amount of consumption that they are currently willing to forego by setting that money aside and investing it. People invest in hopes of making a profit.

I forget, I think it was Senator Hatch who said, or Senator Smith, "That if you tax something once, you are going to get less of it." If you double tax it, you are going to get doubly less of it. When we are looking at whether corporations are able to attract capital at reasonable cost, investors obviously are less willing to provide capital when you have these two layers of tax imposed upon that income, not to mention then you have to factor in that a lot of these people are also going to be hit by the death tax and other forms of taxation, as well.

The CHAIRMAN. While this question was not asked, and I am not sure that in her testimony Ms. Kramer mentioned it, although we were visiting about it earlier, the impact of the elimination of double taxation on that senior, let us say, using your chart, Dr. Crain, who has got an investment at age 65 of about $150,000 worth of assets or stock, and he or she or they are being taxed on it today, not only would the tax elimination there obviously benefit them directly by less taxes paid, but Ms. Kramer makes the argument that corporate America more than likely, with the enhancement of the environment in which dividends are paid, would end up paying more dividends or it would become more attractive for corporations to do that and, therefore, would cause investors to seek out companies that paid higher dividends.

Is there a scenario there in your mind where not only does the senior benefit from not paying a tax in this doubly taxed environment, but could actually gain more dividend receipt?

Mr. CRAIN. Absolutely, in that it is—the analogy to static analysis was mentioned, in the sense it is hard to say exactly right now how senior citizens would behave if dividends were not taxed, surely they would invest more in dividend-paying companies if the law were changed. So you can't really look at the data today to get a handle on that because investment behavior would change if you eliminated the double taxation. More seniors would invest in these non-taxable dividends, as everyone would.

The CHAIRMAN. Part of my question, though, was would there be a higher rate of dividend return on the current investment? Would it change the corporate environment in that way?

Mr. CRAIN. By eliminating the tax, yes, you are going to encourage more dividend payments and it would raise the return.

The CHAIRMAN. Do you agree with that, Doctor?

Mr. MITCHELL. Yes, I do, and we also have some international evidence to this effect. Many of the countries that are in the lower range of the chart over there, that have much lower combined tax rates on dividends, used to make the same mistake we made about double taxing dividends, or at least of having less relief, and in my full testimony, you will see that New Zealand and Australia are two of the countries that eliminated double tax on dividends and there is already some evidence, even though we are only talking 10, 15 years of data, there is already some evidence that it has had a positive effect on both aggregate levels of investment in the economy and on dividend payment rates.

We also see that—as a matter of fact, President Clinton's Treasury Secretary, Larry Summers, did a paper with another economist looking at what has happened when the United Kingdom made reforms to their dividend taxation, and again, we saw positive responses.

Now, of course, it is always difficult to estimate ahead of time the level of these responses, and I think Mr. Hubbard was being very responsible in giving a range, as opposed to trying to pick an exact number, but there is no question that his direction is the right direction in terms of the numbers he is talking about.

The CHAIRMAN. Thank you.

Senator Carper, questions?

Senator CARPER. Thanks, Mr. Chairman.

Not so much a question, but to Mr. Buxton, I noted with interest that you are an old Navy guy.

Mr. BUXTON. Yes, sir.

Senator CARPER. I was a Navy Midshipman at Ohio State, graduated in 1968. When you were on active duty, what were your assignments?

Mr. BUXTON. I had a variety of assignments, but primarily, I am a qualified surface warfare officer.

Senator CARPER. What kind of ships did you serve on?

Mr. BUXTON. Destroyers, LPHs, the Valley Forge, Cone DD866.

Senator CARPER. I am a retired Captain, as well, so I feel a certain kinship with you. Your Governor out there is Dirk Kempthorne, who used to serve here in the Senate. I was Chairman of the National Governors Association when he first became Governor in 1998 and attended New Governors School in Wilmington, DE. I hope he is doing well. If you ever see him, tell him that an old Governor from Delaware sends his very best.

Mr. BUXTON. He is struggling with the tax issue, too.

Senator CARPER. I am sure he is. So are most of the Governors. A lot of the States, as you know——

The CHAIRMAN. In fact, Tom, it is fascinating you make that comment. I think our Governor right now would find that it would be easier being a U.S. Senator than a Governor, where you found it very easy being a Governor during those great years of growth. Excuse me.

Senator CARPER. Absolutely, and most Governors would certainly agree with that, and that is not to say our load here is not heavy at times.

You are from Boise, right?

Mr. BUXTON. Yes.

Senator CARPER. Your mayor, I think, Mayor Coles, used to, I believe, be the head of the Mayors Conference——

Mr. BUXTON. Last year.

Senator CARPER [continuing]. He was a very good partner of a number of us who were interested in passenger rail service. He was a great champion of that. So we think well of you and your State and it is a pleasure to serve with your Senators now.

I guess the question I have—is this the last panel, Mr. Chairman?

The CHAIRMAN. It is.

Senator CARPER. The first panel was the panel that included Dr. Hubbard and Ms. Kramer, is that correct?

The CHAIRMAN. Yes.

Senator CARPER. I was just wondering, the five witnesses that we had before us today seemed to be pretty much in tune with one another and their message is consistent in supporting what the administration has proposed. I am just wondering, did we invite anybody with a contrary opinion?

The CHAIRMAN. You had that opportunity, surely.

Senator CARPER. But we didn't take it up? We will have to do that, just to make things interesting.

The CHAIRMAN. All of these hearings are balanced off with minority and majority staff in the selecting of witnesses and those kinds of things.

Senator CARPER. Next time, we will have to be sure that we suggest that. That is not to take anything away from the testimony of each of these witnesses. They are stimulating and provocative and interesting.

I just want to conclude by saying thank you. I have no questions, but I want to thank each of you for coming and for sharing your thoughts with us, and a special welcome to my Navy buddy over there, Captain Buxton. Thank you for joining us.

The CHAIRMAN. Tom, rest assured, I would be very happy to allow the record to show that the support of the President's proposal for eliminating double taxation on dividends is not unanimously supported, either in the Congress or the country, but I think it has us all scratching our heads at this moment and I think what our intent of this hearing was, not only the double taxation of seniors, but the increased double taxation of seniors in a variety of income levels that they have, and, of course, because they are fixed-income people, that there is substantial impact.

What attracted me to this was when the President was proposing his package. He called it relief for seniors, and at the time, it had not really focused—I had not focused on the fact that we now have the figures that over 52 percent of the tax benefit would go to seniors, and we see that there is a broad cross-section out there that now hold investments—you can't call them wealthy if their whole life savings is tied up in a retirement program and $150,000 worth of assets in stocks. That is their life savings, if you will, and the impact that it is having on that.

Dick, would your investment, or do you think your parents' investment would be different if they had recognized early on that dividends would not be double taxed?

Mr. BUXTON. No. I think that they invested, and their investment is primarily in energy stocks, utilities, was for a return on investment with dividends.

The CHAIRMAN. But they were looking at it for purpose of dividend return, not speculation on stock values as much?

Mr. BUXTON. No. That is correct. No. Idaho Power pays a dividend of almost 6 or 7 percent, as you are probably well aware.

The CHAIRMAN. Yes.

Mr. BUXTON. They are highly invested in Idaho Power and they did it for that reason.

The CHAIRMAN. So for your family, owning stock that returned dividends was critical to their investment plan or strategy?

Mr. BUXTON. Even my own, I tried to invest in that. Of course, a lot of my stock is now in my IRA——

The CHAIRMAN. Sure.

Mr. BUXTON.—which I still do that because I think that they are more responsible if they are paying a dividend.

The CHAIRMAN. Thank you.

Dr. Crain, your testimony discusses the potential for increasing returns for all investors if we end the double taxation of dividends, including those who have stock holdings in tax-deferred accounts. Could you elaborate on how these increased returns might occur?

Mr. CRAIN. Yes, Senator. Broadly, through this improved efficiency of capital markets, for example, this change in the reliance on equity financing as opposed to debt financing that has been mentioned a couple of times today. Through the dividends, again, make it easier to monitor corporate performance and corporate governance, which I think is a major factor here that is going to increase and improve the returns, even in stocks that are held outside of—in a tax-deferred account.

The CHAIRMAN. Does that mean this proposal will be a positive force for returns of defined benefit pension plans with company stock, including State pension plans and union pension plans?

Mr. CRAIN. Absolutely, Senator. I chair the Corporate Governance Committee——

The CHAIRMAN. That is where I was headed. Does this change the character of the thinking of that organization?

Mr. CRAIN.—for the Virginia Retirement System, and sometimes, it is overlooked of how hard it is to really get information about what is going on inside a company. Even a large organization like the Virginia Retirement System, a $29 billion plan, it is almost prohibitively expensive for us. We must hold stocks in 3,000 companies. How do you monitor all those? It is extremely costly to do that. This would reduce that cost, not only for us, but for all other plans in that we would see benefits, benefits in terms of improved performance of companies.

Senator Carper was asking, I thought, a very good question about what is the tradeoff with the effect on States and their borrowing costs and so. But I do think, and this wasn't mentioned by Dr. Hubbard, is that States have an enormous liability to their pension plans. The States are going to have to pay that if the returns don't come in to fund those plans. The taxpayers will ultimately be liable to pay those benefits, and here is a way to help fund, fully fund the plans and, I think, reduce the liability on future taxpayers in the States.

The CHAIRMAN. Thank you very much.

Let me turn to our colleague who has just joined us from the State of Missouri, Senator Talent. Welcome.

STATEMENT OF SENATOR JAMES M. TALENT

Senator TALENT. Thank you, Mr. Chairman. My apologies for being late. I did want to attend this hearing and I want to congratulate you and Senator Breaux on the direction you are taking the committee. I really sought, as you know, to be on this committee, because I think a lot of the issues that we are going to be exploring are just second to none in terms of importance to America as a whole, as well as the nation's seniors.

The thing I am concerned about is what is going to happen to people who are now at or entering middle age and have, to this point, planned their lives on certain assumptions about the position seniors have been in in the past, assumptions which I think are generally not going to be true at the time that they are retiring, and we had a hearing which I think Senator Breaux originally scheduled on Social Security.

One of the answers, and I think we are going to have to package a lot of answers to that, but one part of the answer is to really publicize to people the need to prepare themselves more for retirement than they had thought they might have to and then empower them to do it. I see the subject of this hearing as an avenue of accomplishing that.

Now, let me just ask you, and I don't know, if this has come up, I apologize and maybe just deal with it and dispose of it briefly, but the taxation of Social Security benefits, which I hear about all the time back home. Seniors really don't like it. Have any of you commented on a feature of it that I think is particularly unfair, because payroll taxes are supposed to go to Social Security and Medicare, and except for the surplus that we spend on other things, they do. But when you tax the Social Security benefits, isn't that just a way, really, of converting the payroll tax into a general tax?

I mean, you collect the payroll tax, you pay the Social Security benefits, you tax the Social Security benefits, and then that money comes into the general revenue. Seniors back home have figured this out. Am I wrong in saying that? Isn't that the effect of taxing Social Security benefits?

The CHAIRMAN. Gentlemen?

Mr. MITCHELL. Under current law, Social Security payroll taxes are 50 percent deductible, the so-called employer half of it. If you want a neutral tax system, in other words, if you want to treat Social Security the way you would treat savings under a neutral tax code, then the benefits should be 50 percent taxable.

So it is very clear that the tax increase on benefits that was enacted in 1993 does represent double taxation of those benefits, and as was discussed a little bit earlier, that will have some adverse consequences on the economy because people only pay that double tax if they have non-Social Security income by either providing labor or capital to the marketplace. So it is double taxation and it is double taxation that, like other forms of double taxation, undermines the economy's performance.

Senator TALENT. And pulls the money, Mr. Chairman, out of, if you will, the use for which it was originally intended. I mean, it is not like the money that we collect through that tax we then turn around and use for other kinds of senior programs necessarily. It goes in the general fund with everything else. So the effect of it is to take the payroll tax and use it for other kinds of measures.

I thank the Chairman for hosting this. Again, I am sorry for being late. I intend to look through your statements. This is an important subject, and I know we are planning to do hearings on a number of other subjects, Mr. Chairman, to examine where we need to be 15 or 20 years from now in order to have a viable and high-quality system that cares and meets the needs of the seniors of the next generation, and I thank you, Mr. Chairman.

The CHAIRMAN. I thank you very much. I think the hearing that Senator Breaux chaired a couple of weeks ago as we looked at the overall view of Social Security and we had General Accounting up, I mean, it was obvious to us then, and I think we all agreed, that the "do nothing" strategy just does not work, and at some point in the very near future, hopefully, we wrestle through the tough choices there.

Senator TALENT. Mr. Chairman, will you yield on that point?

The CHAIRMAN. I would be happy to.

Senator TALENT. I mean, one other area, for example, I am very interested in, and you and I have talked about this privately, is what the spectrum of services and care of a long-term nature needs to be for seniors 10, 15, 20 years from now, you know, everything from assisted living to independent living centers to long-term care, and how do we get people from here to there. Part of that is going to be empowering people and urging them to save on their own for those kinds of alternatives.

So I see all this as a seamless web, as we lawyers say periodically, and each one of these hearings has part of the kind of decisions we are going to have to confront soon if we are going to be effective in helping the nation's seniors.

Thank you. You have been very patient, Mr. Chairman.

The CHAIRMAN. I thank you and I think your point is very real, even though when we talk of Social Security and today talking about double taxation of dividends, what is obvious is that there is a very real impact on today's wage earners. Even though they may not be the subject of the tax or the person who is the immediate recipient of the program, it does impact, and you have all said that, wages, job opportunity, the general economy itself, and that is all an important part of it.

Of course, the thing that I have grown increasingly concerned about—it is part of the reason I am on this committee—the beautiful thing that is going on out there right now, I just penned a note this morning to a neighbor of mine who celebrated his 90th birthday at the Weiser, Idaho, Senior Citizen Center on Sunday. He walked in under his own power. He drove his own car with his wife. He is having a great time in life. His problem is, and it is a beautiful problem, he had eight children, and if he has got those kinds of genes, he has probably produced eight children that are going to live to be 90-plus and they are going to drain Social Security. [Laughter.]

Unless we reform it to respond to the demographics, Senator Talent, that you have spoken to and the very reality of the community that we are dealing with here.

Thank you all very much to our panelists. Thank you very much for being here. Dick, thank you for coming from Boise.

The committee will stand adjourned.

[Whereupon, at 11:59 a.m., the committee was adjourned.]

○