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“Jumpstarting the Economy:

Increasing Investment in the Equity Markets.”

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Mr. Chairman and members of the Committee, my name is Mark Zandi, I am the Chief Economist and Co-founder of Economy.com.

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I will make three points in my remarks. First, the economy is struggling significantly, and a well designed fiscal stimulus plan that is passed quickly would be useful in jump-starting the economy and by extension the equity market. Second, while the elimination of the double taxation of corporate income is a laudable economic objective, doing so will provide only a small boost to the equity market, and do little to support the economy's near-term prospects. This is particularly true of the current proposals to simply scale back dividend income taxes for a limited period. Third, the long-term economic benefits of the proposals to scale back dividend income taxes are also small, as any gains to economic efficiency are all but offset by the economic drag resulting from larger budget deficits and higher interest rates.

Fiscal stimulus

The need for more fiscal policy stimulus is motivated by the struggling economy that is operating well below its potential. The economy is posting gains in real GDP, but those gains are barely half those necessary to support any meaningful job growth and a stable unemployment rate.

Adding to the pernicious character of the economy's current problems is that they are extraordinarily broad-based. Industries as wide-ranging as manufacturing, commercial construction, travel, retailing, investment banking, and now state governments are reducing payrolls. The economy's difficulties are also widespread from coast-to-coast. Large economies ranging from Boston and New York in the Northeast, to Atlanta and Dallas in the South, to Chicago and Detroit in the Midwest, to the Bay Area of California and Denver in the West, are engulfed in full-blown recessions.

Near-term impacts

Fiscal stimulus is needed to jump-start the economy and by extension the stock market, but such stimulus must be well-designed and it must be provided quickly. Scaling back dividend taxation, particularly as envisaged under the plans currently being debated, will provide at best only marginal support to the economy this year and early next, when it needs it most.

The link between scaling back dividend taxation and the economy's near-term performance is largely through stock prices. Stock values will rise by an amount equal to the present value of the stream of future tax savings. With approximately only one-half of individual dividend income excluded from taxation,

under the current plans, stock values will receive an estimated boost of no more than 5%. The increase in stock prices will occur quickly as investors discount the tax benefit. Indeed, at least part of this benefit may already be discounted in current stock prices, as investors have likely attached some probability to some reduction in dividend income taxes.

A key conduit through which higher stock prices affect the economy is through the positive wealth effects on consumers. The wealth effect postulates that households consider all their financial resources when deciding how much to spend and save. When household net worth rises, households are more willing and able to increase their spending out of income and thus save less. Conversely, when household net worth is falling, households are more anxious about their financial well being and are less willing and able to spend out of income and thus save more.

The wealth effect from a change in stock values is estimated to be almost 2.5 cents. That is, for every permanent dollar increase in stock values, consumer spending ultimately increases by 2.5 cents. This wealth effect is distributed over nearly three years and is very small in the first year given that households must expect that any increase in wealth is permanent before changing their spending and saving behavior in response.

Higher stock prices also support the economy through a lower cost of equity capital for businesses. Businesses are able to issue new equity at lower cost to finance their growth, supporting stronger business investment.

The economic benefit of a positive wealth effect and lower cost of equity capital occurs with long lags. The lags are likely to be even longer in the current economic environment, which is characterized by a high degree of consumer and business angst and uncertainty. Given the approximately 40% plunge in stock values during the past three years, households will be skeptical that any increase in the value of their stock portfolios represents a permanent increase in the value of their portfolios. Without that expectation, households will be slow to increase their spending in response. Businesses will also be unlikely to quickly raise more equity capital to finance increased investment in response to any rise in stock prices. The equity

market remains particularly unreceptive at this time to companies looking for capital to expand, and businesses remain exceedingly cautious in taking risks given heightened geopolitical concerns.

Mitigating the economic boost of scaling back dividend income taxation is the higher long-term interest rates that will result. Like equity investors, fixed income investors will quickly discount the implications of such a change, most importantly being the larger long-term federal budget deficits that will result from the lost tax revenues.

As is evident historically, larger long-term deficits result in higher long-term interest rates. During the first half of the 1980s, when the federal debt was expanding at over a double-digit pace, real 10-year Treasury yields were over 8%. As debt growth slowed during the 1990s and fell during the later half of the decade, real Treasury yields were halved.

Interest rates on tax-free bonds such as municipal bonds will be under added pressure, as they compete for investable funds against the stocks of dividend paying companies.

Higher interest rates raise the cost of debt capital to businesses, at least partially offsetting the boost to investment provided by the lower cost of equity capital. Higher rates also constrains consumer spending on consumer durables and housing demand. This in turn weighs on near-term growth in house prices and housing wealth, at least partially offsetting the boost to consumer spending provided by the increase in stock wealth. The wealth effect out of housing wealth is an estimated 4.5 cents over a three year period. This is larger than the wealth effect out of stock wealth given the substantially broader ownership of housing. Well over two-thirds of households own their home, while not quite one-half of households own stocks.

Of all the tax cuts currently being considered by policymakers, scaling back dividend taxation provides the smallest near-term economic stimulus. The near-term economic bang for the buck, or one-year change in real GDP provided for a given dollar of lost tax revenue, is only 9 cents. This compares to a near-term economic bang for the buck of 59 cents for rolling forward the marginal personal tax rate cuts now legislated to occur next year and in 2006, for example, and 124 cents for providing direct aid to hard-

pressed state governments, and 173 cents for extending emergency federal unemployment insurance benefits.

Long-term impacts. The elimination or scaling back of dividend taxation does result in several important long-term economic benefits. Most importantly, it reduces the disadvantage the corporate sector now faces in the competition for capital. Under current law, some corporate income is taxed twice, but most small businesses are taxed only once at the personal level, and the imputed income on housing is not taxed at all. These differences in tax treatment lead to less investment in the corporate sector than is economically optimal.

Eliminating or scaling back dividend taxation also reduces the current tax incentive businesses have to use debt over equity to finance their operations. The resulting over-leveraging of businesses does make them more vulnerable to financial problems during recessions, forcing them to undertake more draconian cost-cutting and thus exacerbating the downturn.

There are also long-term economic benefits as businesses will devote a higher share of their corporate income to paying dividends. Businesses will thus find it more difficult to temporarily lift their stock prices through stock repurchases and other financial engineering techniques. These strategies, which were very popular during the equity market boom of the late 1990s, likely result in inefficient corporate decision-making.

These economic benefits, however, are ultimately significantly offset by the higher actual and anticipated future budget deficits that result. As previously discussed, larger persistent deficits result in higher long-term interest rates. This weighs on business investment and ultimately productivity growth and the economy's long-term potential growth. Indeed, the economic drag of higher interest rates ultimately outweighs the economic benefits of eliminating or scaling back dividend taxation.

The long-term economic bang for the buck, or ten-year increase change in real GDP provided for a given dollar of lost tax revenue, is estimated to be 20 cents. The most significant economic bang for the

buck occurs 3 to 5 years after taxes are reduced, but due to the pernicious economic effects of higher interest rates, real GDP is lower by year 8.

Conclusions. The economy is struggling and while it is expected to avoid another recession given the very successful military action in Iraq, more federal fiscal stimulus is needed. The fiscal stimulus plan policymakers are currently coalescing around is a good effort to provide that stimulus, although it must soon become law to be of significant help.

Scaling back dividend income taxation, however, will do little to jump-start the economy. There are longer-term economic benefits to scaling back dividend taxation, but they are significantly diluted under the plans being considered by the resulting higher budget deficits and long-term interest rates. The benefits of dividend tax cuts would thus be significantly enhanced if they were coupled with broader corporate tax reform that would result in a fiscally neutral change.

While such tax reform is laudable, it is a complex and thus time-consuming endeavor, and thus should not be included as part of the current fiscal stimulus plan.