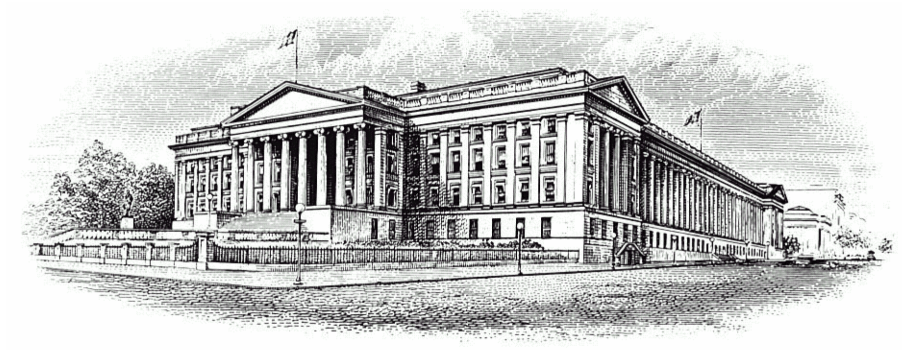

DEPARTMENT OF THE TREASURY
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Testimony of Peter R. Fisher
Under Secretary for Domestic Finance
House Financial Services Oversight and Investigations Subcommittee
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Chairwoman Kelly, Ranking Member Gutierrez, and distinguished members of the Oversight Subcommittee, thank you for your invitation to testify on the President's Jobs and Growth package. I will emphasize two critical features of the President's plan to create and secure jobs, accelerate and sustain our recovery, and increase workers' standards of living and the economic performance of our nation for many years to come.

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

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

The right prescription for today's macroeconomic circumstances

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

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

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

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

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

Keener incentives for more efficient capital allocation

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

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

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

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

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

The impact on capital efficiency may be huge. Each year American firms invest over $1 trillion in fresh capital and generate $700-800 billion in corporate profits. Think of the gains in capital utilization and job creation if we accelerate and re-target this investment process.

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

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

Impact of anticipated borrowing on fiscal sustainability

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

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

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

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