Statement of
David R. Malpass before the
Senate Budget Committee
January 29, 2003

Chairman Nickles, Senator Conrad, members of the Committee, thank you for the invitation to testify on policy issues and the economic outlook.

The economy faces an unusual number of near-term problems – Iraq-related uncertainty, the war on terrorism, artificially expensive oil, sudden weakness in the U.S. dollar, a large and growing current account deficit, rapid growth in federal government spending, and a three-year decline in equity values.

Arrayed against these problems are the small-business character of the U.S. economy, record low interest rates and inventory/sales ratio, the likelihood of a pro-growth tax cut, a strong, flexible labor force of 131 million workers, and fast productivity growth.

The balance, in my view, is favorable for the longer-term U.S. outlook, but I will be more confident about the near-term when Iraq disarms, a growth-oriented tax cut passes Congress, and oil prices find a lower level based on market forces rather than a cartel.

A growth-oriented tax cut is a critical part of the recovery. In my testimony, I describe how our economic health depends on the efficiency of the capital and incentive structures rather than on cash in the consumer's pocket. I disagree with the view that consumption is the weak part of the economy or that a demand-oriented tax cut is a necessary step for economic recovery.

One key to faster economic growth is to shift from the present debt-biased capital structure to a more balanced one. That's why the President's proposal to eliminate the double taxation of dividends (which heavily biases the corporate sector toward debt) would, in my view, add to both the near- and longer-term growth outlook.

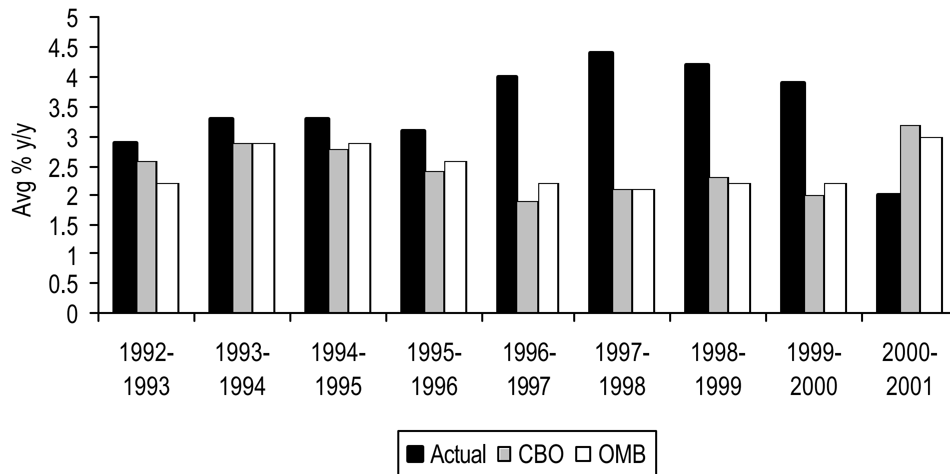
There is an additional urgency for the U.S. to make progress on a growth agenda. In most other parts of the world, economies are substantially weaker than ours, with unemployment higher, government spending and unfunded pension liabilities even greater than ours, health care systems less effective, and currencies even more volatile.

As a result, clear U.S. leadership will play a critical role in helping improve growth policies elsewhere, including promoting tax reform, currency stability, sensible environmental policies, and restraint in the size of government.

On budget issues, I would like to make several observations:

- Forecasting budget deficits is an art, not a science. This is true of most of economics. For example, in the 1990s growth was consistently above the forecast. Conversely, the recession produced growth well below forecast.

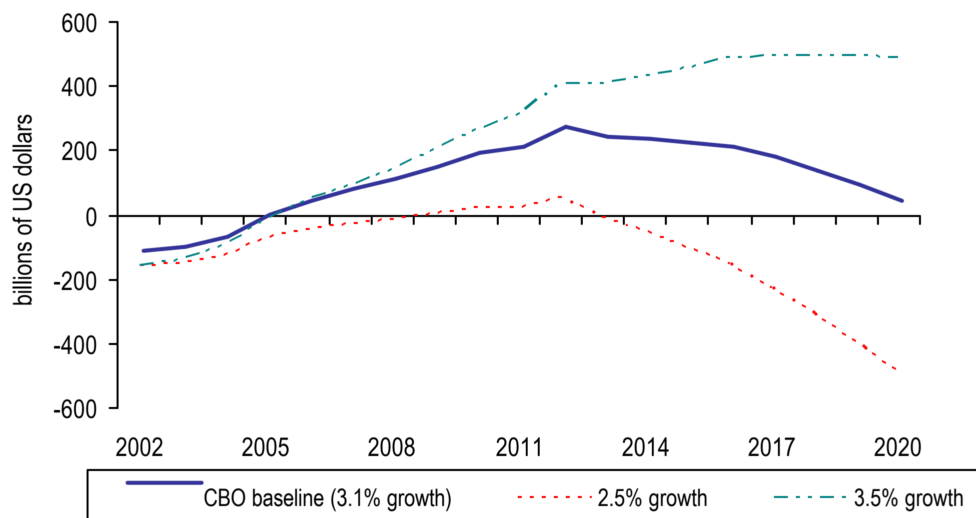
Two Year Real GDP Growth: Actual Vs. Forecast



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

- Budget deficits are very sensitive to growth rate assumptions.

Long-term Government Budget Paths Under Different Growth Assumptions



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- The connection between budget deficits and interest rates is complex. Interest rates and bond yields respond to expectations for currency levels, inflation and economic growth. Budget deficits, especially the quality of government spending and taxation, can affect these. For example, to the extent that a tax rate cut is viewed as growth-oriented, it may strengthen the currency, lower the inflation expectations, and lead to

lower interest rates. We saw this phenomenon in the 1980s. A later portion of my testimony goes into this issue in detail.

Economic Outlook

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The current peak in near-term uncertainties will probably keep growth soft in the first quarter of 2003. As the year progresses, the economy should get a strong boost from an Iraqi disarmament, the associated drop in oil prices, and passage of a pro-growth tax cut. I expect the economy to be running at a 4% growth rate by the fourth quarter of 2003.

I am confident about the medium-term economic outlook. The U.S. economy showed resilience in 2001 and 2002, not fragility. I expect similar strengths to continue in spite of terrorism concerns and economic weakness abroad.

I expect the U.S. to move past the "piece-by-piece" recovery of 2002, which was the logical aftermath of the 1997-2001 deflation. Assuming progress on Iraq's disarmament, the next economic phase should be a more normal expansion focused on earnings and business investment.

2002: Aftermath of Deflation

The U.S. economy underwent a moderate recovery in 2002. It was characterized by higher levels of employment and lower inflation than in recent recessions, but relatively weak growth in investment and inventories. Prices paid to corporations fell while average wages rose, squeezing corporate profits. New home sales hit a record of 981,000 new homes sold in 2002, a new record.

Other recent recessions were uniformly a response to *inflation*. In contrast, the 2001 recession was, in my view, a response to the deflationary pressures of the ever-strengthening dollar policy of 1997-2001.

The magnet of the strong dollar policy supported by high real interest rates contributed to over-investment in the U.S. and a massive transfer of resources from the private sector to the government through the capital gains tax. The government was able to pay down the national debt, but the private sector built record debt levels.

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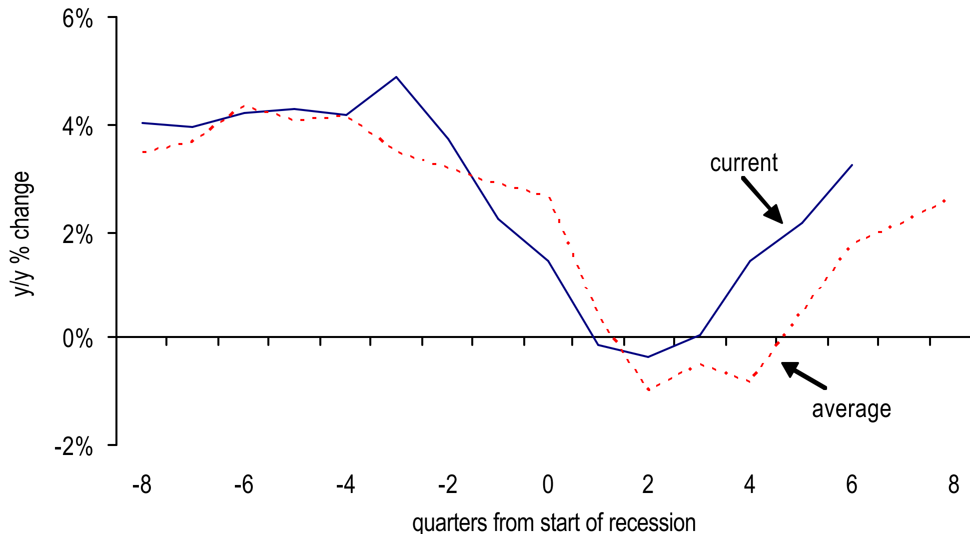
GDP Growth in Current and Past Recessions



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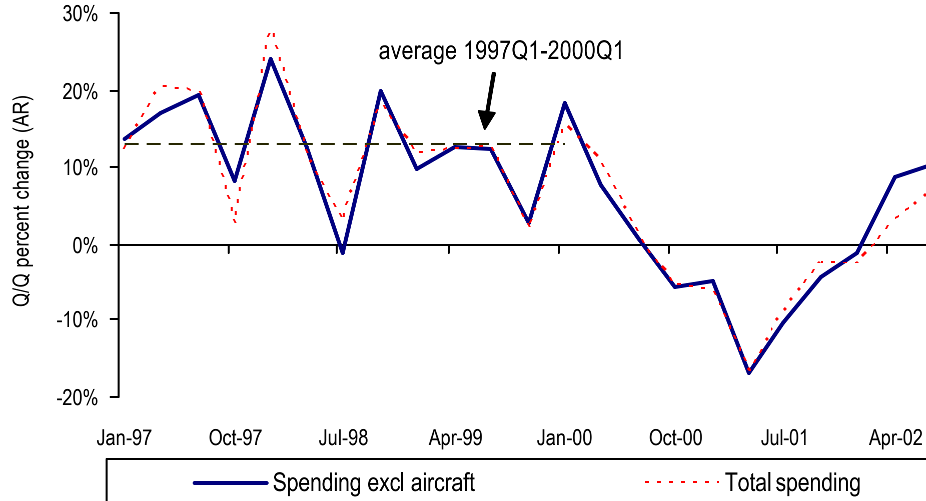
Growth in Business Investment, Employment and Personal Income

Contrary to the common perception that businesses didn't invest in 2002, the data shows almost across-the-board growth in equipment spending except for aircraft. Aircraft production and commercial construction stalled in the aftermath of September 11. Apart from these two areas, business spending was up almost universally in the first three quarters of 2002, rising at a 5.9% annual rate in the first three quarters of 2002 and increased 11% in the third quarter (quarter-over-quarter seasonally adjusted annual rate.) When aircraft are excluded from total business spending on equipment, spending growth is approaching the average pace of the 1997-2000 boom.

Business spending including aircraft grew from a $954 billion annual rate in the first quarter of 2002 to a $977 billion annual rate in the third quarter. This dwarfs the rate of investment in any other part of the world. The eurozone's annual rate of investment in the second quarter of 2002 was only $452 billion.

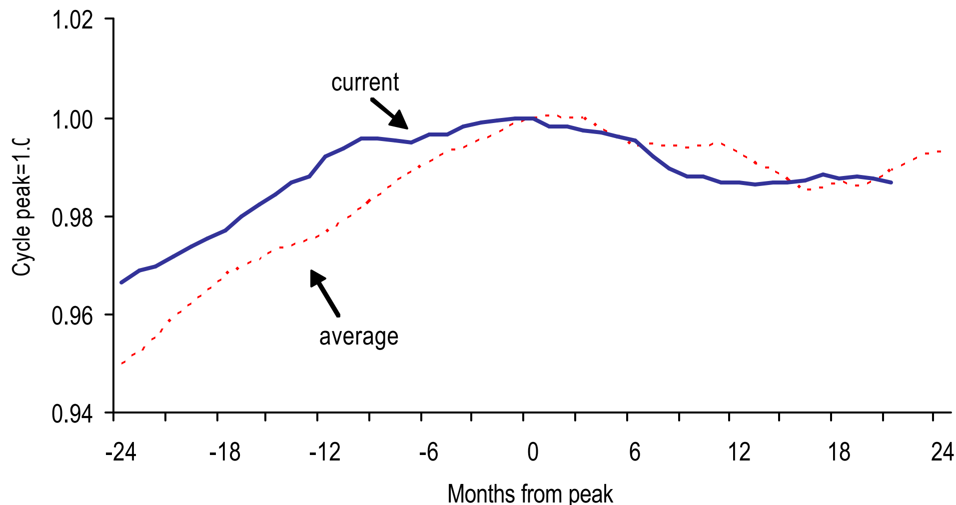
Business Spending on Equipment (1996 Dollars)



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

As the economy has become increasingly flexible and responsive to business conditions, so has the labor market. In past recessions, there was a lag between the peak of the business cycle and the peak of employment, but this lag has disappeared. There hasn't been much re-hiring in this cycle, in part because there wasn't as big a drop in employment during the recession. The result is that, relative to previous recessions, employment is at about the average spot for 21 months after the start of the recession.

Employment Level: Current Vs. Average Recession



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The peak-to-trough loss in employment in the 2001 recession was 1.7 million jobs or 1.3% of employment. This is relatively small shrinkage in the labor force (see the table), in part due to the unusual timeliness of the fiscal and monetary stimulus applied in 2001.

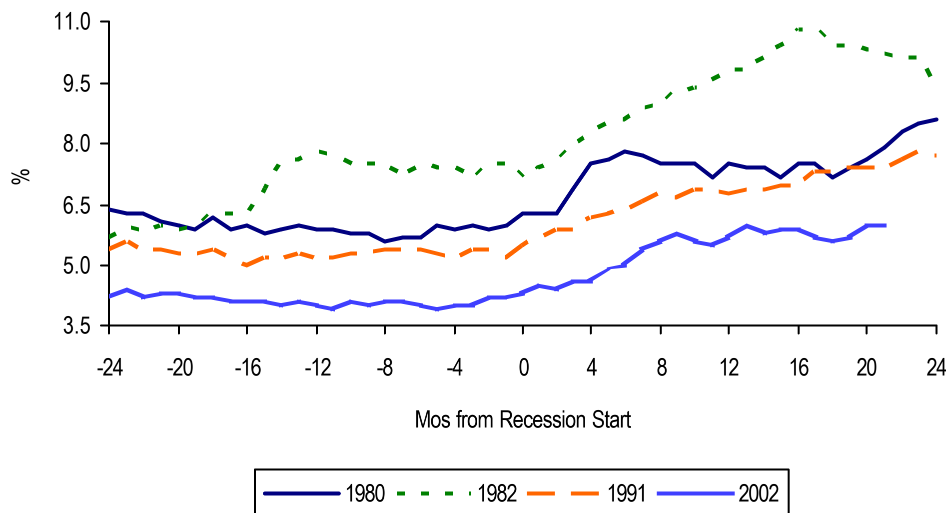
Changes in Employment; Peak to Trough (Millions of Employees)

Date	Peak	Trough	Chg, Mns	Chg, %
1970	71.4	70.3	-1.1	-1.5%
1974-75	78.6	76.3	-2.3	-2.9%
1980	91.0	89.7	-1.3	-1.4%
1981-82	91.4	88.7	-2.8	-3.0%
1990-1991	109.9	108.1	-1.8	-1.6%
2001-2002	132.4	130.7	-1.7	-1.3%

Sources: Bloomberg; Bear, Stearns &Co. Inc.

Today's 6% unemployment rate is well below the recent post-recession peaks in 1992 (7.9%), 1982 (10.8%), and 1980 (7.8%). Of course, I would like to see the unemployment rate substantially lower. Given the strong productivity growth taking place, I think the U.S. economy will be able to enjoy sub-5% unemployment in the future without it being inflationary.

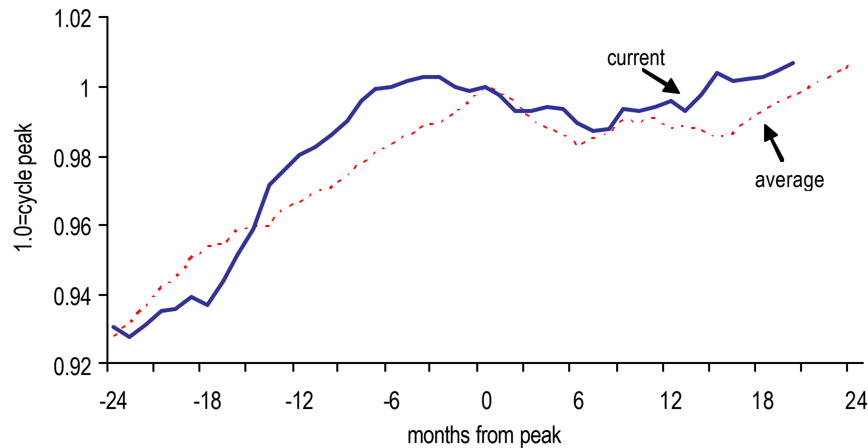
U.S. Unemployment Rates in Recession



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

With employment levels much higher than in previous recessions, personal income growth during the 2001 recession was stronger than the average. Tax cuts and extended unemployment benefits also helped support personal income in the current cycle.

Personal Income: Current Cycle vs. Average



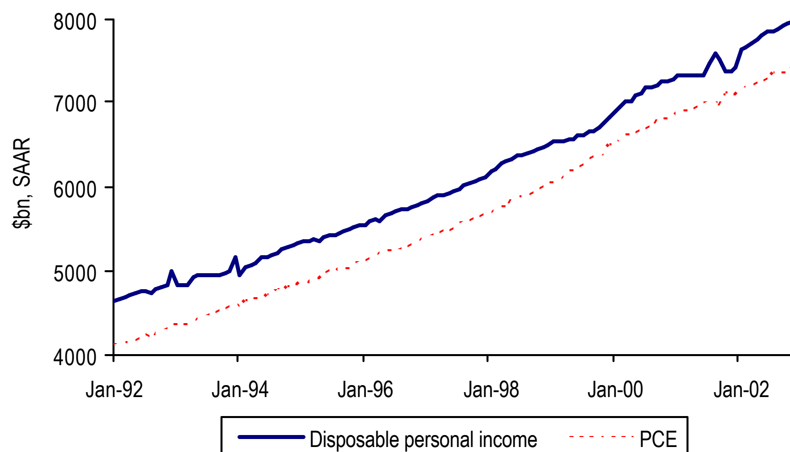
Source: Bloomberg, Bear, Stearns & Co. Inc.

Consumers haven't been as spendthrift as official figures show

Some argue that the sluggishness of the 2002 recovery is a shortage of cash in the hands of the consumer. This influences their economic outlook, the tax debate, and the debate over private savings accounts within social security. A common perception is that consumers wasted their money in the 1990s, justifying government efforts to give tax rebates and control retirement programs. Before getting into tax policy issues, it's important to evaluate consumer savings and balance sheets.

I think consumers tend to consume based on their life-time earnings expectations. There were two important changes in that outlook in the 1990s. First, the unemployment rate fell to much lower levels, establishing what I think will be a new lower non-inflationary rate of unemployment. Second, personal income grew through the 2001 recession. Combined, these two factors justified steady growth in consumption in 2002 and suggest that consumption will grow in 2003 and beyond.

Personal Income and Personal Consumption



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

A frequent argument is that the private savings rate went negative in the late 1990s, creating a shortage of consumption and arguing for Keynesian-style short-term stimulus in 2003. I disagree.

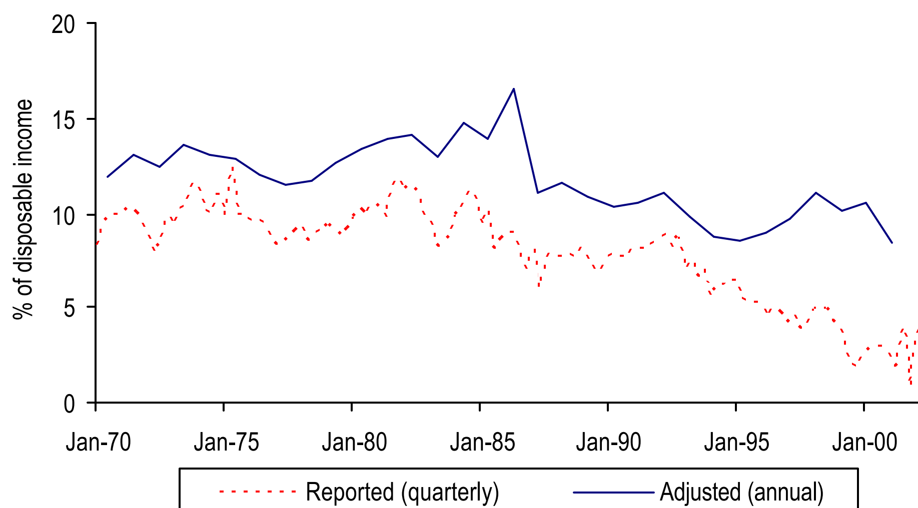
The official savings rate (released by the Commerce Department with the monthly report on personal consumption and income) is a misleading measure of savings and the consumer's financial health. The savings rate is calculated by subtracting consumption from a measure of disposable income. One of the major deficiencies in the personal savings data is that they ignore realized capital gains in calculating disposable income and therefore severely understate personal savings when equities rise.

Consider this example:

- A consumer realizes a $1,000 capital gain, pays $200 in taxes, and increases his savings account by $800. The government data on personal savings would, believe it or not, show a decline in savings. The capital gain is not included in the calculation of income, but the tax on the gain is deducted from disposable income. In this example, the government's measure of disposable income fell by $200, so personal saving is presented as having fallen by $200 (even though it actually rose by $800).

To get a better picture of savings in the 1990s, we adjusted the personal savings rate for just one of the missing items -- by including realized capital gains in disposable income. The graph shows a dramatic, positive effect on the savings rate in the 1990s, when capital gains realizations were strong. This is consistent with the recession experience of 2001 and 2002, in which consumer balance sheets were strong enough to support consumption growth despite cries that the consumer must be "tapped out."

Savings Rate Adjusted for Capital Gains Income



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

The reported savings rate has been rising in recent months. We think this reflects the crash in capital gains realizations more than a change in consumer savings behavior. As adjusted, the savings rate was relatively stable in the 1990s and, we think, remained in normal ranges in 2002.

The Fed has just released its survey of consumer finances for 2001 (Federal Reserve Bulletin, January 2003). It helps explain the strength of consumption in 2001 and 2002. The Fed survey found that the consumer's balance sheet improved dramatically from 1998 to 2001.

The Fed samples family net worth on a three-year cycle that includes 1992, 1995, 1998, and 2001. The real net worth of the median family rose 10.4% from 1998 to 2001, reaching $86,100. This is slower than the 17.4% increase between 1995 and 1998 but above the 8.3% increase between 1992 and 1995.

- The survey also showed that the real income of the median family jumped 9.6% from 1998 to 2001, nearly four times the 2.5% increase in the preceding three-year period.

- The level of debt carried by families rose from 1998 to 2001. However, despite the 2001 bear market, the value of equity holdings and principal residences rose more. This lowered the debt-to-asset ratio and allowed family net worth to increase substantially.

- The Fed survey showed that debt-servicing burdens also fell. The percentage of disposable income devoted to debt servicing fell to 12.5% in 2001 from 14.4% in 1998. This measure of debt burden declined for almost every demographic group examined by the survey. It reflects in part the growth in personal income, the decline in interest rates in 2001, and the 2001 tax cut.

We continue to disagree with the view that the consumer is close to a double dip or is near a financial crisis. Instead, we think consumption growth depends heavily on current and future employment, real wage growth, and expectations about taxes. We expect consumption to grow moderately in 2003, especially in the event of a retroactive income tax cut.

Improving the Capital Structure

Much of my testimony has lauded various structural aspects of the U.S. economy. It stands out around the world in terms of productivity and flexibility, auguring well for long-term growth.

However, one area where the U.S. is sorely deficient is the tax code. We suffer from very high marginal income tax rates, a heavy payroll tax on both the employer and employee, and huge tax incentives encouraging all types of debt – high-yield corporate debt, state and local debt, mortgage debt, etc.

As a result, one of the key variables in the economic outlook is whether the federal government can find a process to rebalance the playing field in terms of the capital structure.

The President's proposal to eliminate the double taxation of dividends and reduce the double taxation of corporate earnings would, if enacted, have a far-reaching, positive impact on the economy and equity markets, both near and longer term.

When you tax something less, you get more of it, in this case more capital and labor. That would mean more productivity, jobs and economic growth.

- The Bush proposal would lower the taxation of labor and small business entrepreneurism (by lowering marginal rates).
- It would also lower the taxation of capital (by eliminating double taxation and allowing an increase in basis for deemed dividends.)
- On the same principle, the proposal would encourage taxable income (in order to provide tax-free dividends) and more corporate earnings. It would discourage U.S. companies from moving their headquarters off-shore to avoid U.S. tax.
- At present, there's a wedge, an expensive toll gate, between corporate earnings and shareholders. Reducing the toll would increase the value of equities, including companies with current earnings and those with the prospect of becoming profitable.
- With 52% of all U.S. house-holds owning equities in some form, steps to encourage dividends and equity appreciation should provide a broad stimulus to the economy.

One of the criticisms of the tax proposal is that it might disadvantage municipal bonds. I disagree on two grounds. First, in economic theory and practice, municipal bond yields are related to the after-tax return on U.S. Treasury securities. The proposal to eliminate double taxation of dividends wouldn't affect that calculation. Second, municipal bonds are substantially different from dividend-paying equities in terms of creditworthiness and volatility. The two instruments aren't very good substitutes for one another.

We also disagree with the criticism that the stimulus from the tax cut depends on consumption or cash rebates. Consumption wasn't a weakness in the economy in the 2001 recession, so the key impact will come from improving the U.S. growth outlook.

Double Taxation Abroad

Policy makers in most other industrial countries have recognized that high rates of taxation on the earnings of capital distorts saving and investment and as a result, restrains economic growth. Of the thirty developed countries tracked by the OECD (Organization for Economic Coordination and Development), only three—the U.S., Switzerland, and Ireland—do not offer any relief from the double taxation of dividends.

Relief from double taxation takes on several forms:

- The most popular form is to tax dividends received by individuals at lower rates than other income. At least fourteen nations have chosen this type of relief.

- A close second in popularity is to provide individuals a tax credit based on the taxes paid by the firm.

- Three nations (Germany, Greece, and Luxembourg) offer partial or complete exclusion of dividends from individual taxation.

- And two nations have chosen to allow firms to deduct part of the dividends they pay to individuals, a parallel treatment to the one given to interest expense.

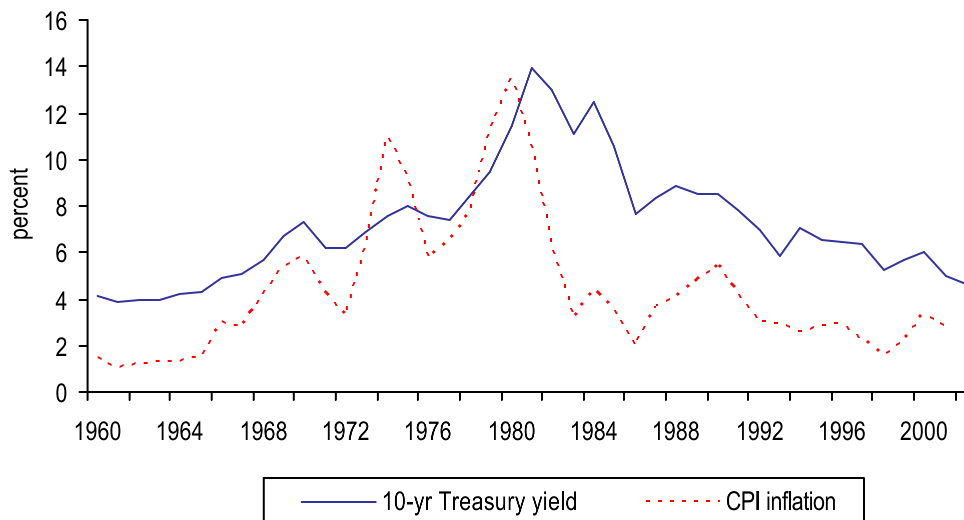
Of the countries studied by the OECD, the U.S. has the second highest combined top tax rate on dividends—exceeded only by Japan. Capital flows easily all around the world, so we should expect the higher U.S. tax rates on capital to gradually reduce investment in the U.S. from what it might otherwise be.

Deficits and Interest Rates

President Bush's tax cut proposal has rekindled the long-running debate over the relationship between the government's budget position and long-term interest rates. The relationship is complex. Interest rates and bond yields respond to expectations for currency levels, inflation and economic growth. Budget deficits, especially the quality of government spending and taxation, can affect these. For example, to the extent that a tax rate cut is viewed as growth-oriented, it may strengthen the currency, lower the inflation expectations, and lead to lower interest rates. We saw this phenomenon in the 1980s.

When inflation, or expectations of future inflation, rise, so will interest rates regardless of the size of government borrowing. I expect long-term U.S. interest rates to rise during 2003, but not because of increased government borrowing. Rather, the private demand for credit should rise as the expansion gains traction, putting upward pressure on interest rates. In this case, higher interest rates would be a good sign for the economy, since it would be the result of robust growth. It would not be a constraint on growth as many contend.

Treasury Note Yields and CPI Inflation



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

It is important to note that the empirical data do not show a relationship between interest rates and the budget deficit. This makes sense. The U.S. is part of a global capital market. Government debt is only a part of the demand on the global capital base. For example, at the end of the third quarter of 2002, the total stock of outstanding debt in the U.S. (public and private) totaled about $20.4 trillion, of which $16.7 trillion had been issued by private-sector borrowers and $3.7 trillion by the government. When you consider government debt, the world's seven largest governments alone have issued roughly $12 trillion of debt, of which less than a third has been issued by the U.S. government.

The Administration's tax cut proposal is projected to add about $67 billion per year to the federal government's deficit over the next ten years. This amount of additional borrowing will add only 0.3% to the stock of outstanding global public and private sector debt (ignoring private foreign borrowing and other capital market demands like equity issuance). It is hard to see how such a small increase in the debt outstanding can push interest rates up enough to hurt the expansion.

Consider the recent experience of the U.S.:

- The yield on 10-year bonds fell throughout the 1980s, even as the fiscal deficit moved above 4% of GDP over a number of years.
- The August 1993 tax hike was followed by an increase in 10-year bond yields to nearly 8% by November 1994 from 5.5% when the tax hikes were passed.
- Note yields rose to 6.7% by early 2000 from a low of 4.5% in late 1998, even as the budget was producing surpluses.
- Note yields have fallen despite the return of the deficit over the past two years.

Longer-Term Stimulus Ideas

The Administration's tax proposal will, in my view, provide substantial near-term and long-term stimulus for the economy. Reducing the distortion in the U.S. capital structure will boost the U.S. growth rate.

Other important reforms, in my view, should cover the tort system, the tax code, social security, and Congress's scoring system (which causes a strong bias toward bigger government).

On the international side, we should recognize the importance of currency stability, growth-oriented IMF reforms to end its bias toward austerity and impoverishment, labor flexibility in Europe, and a non-deflationary monetary policy for Japan. In combination, these policies would create more prosperity abroad, encouraging U.S. exports and reducing some of our national security burdens.

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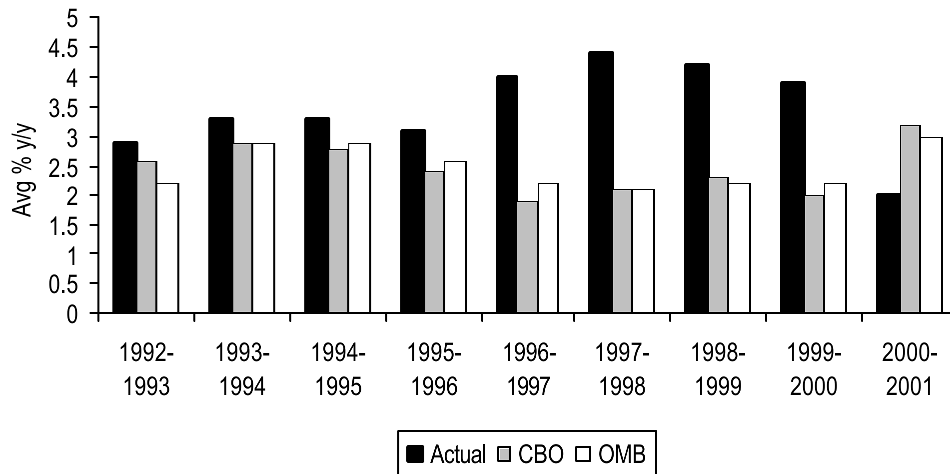

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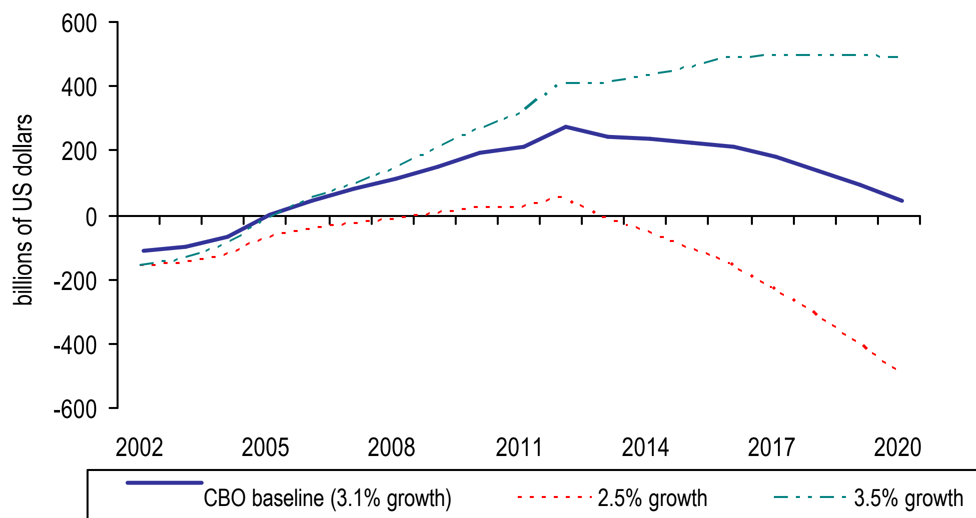

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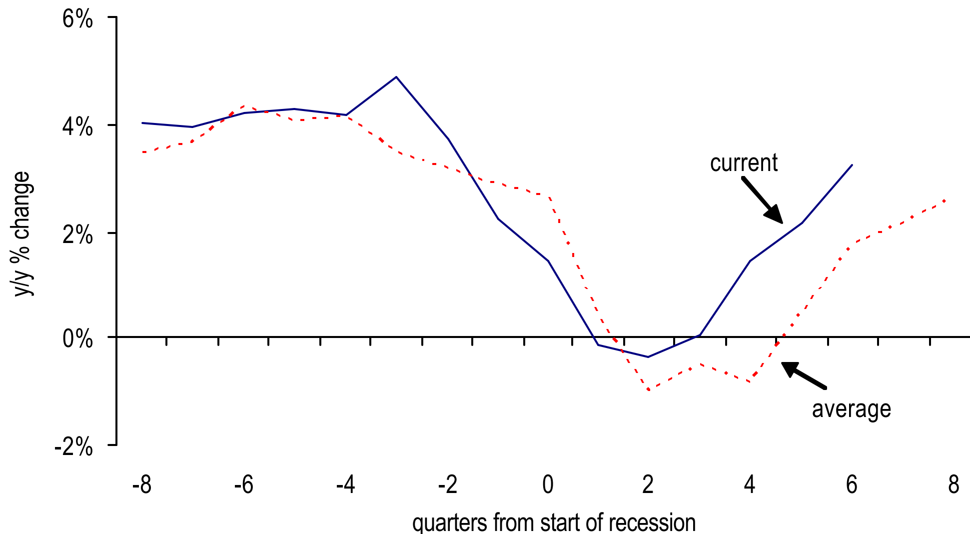

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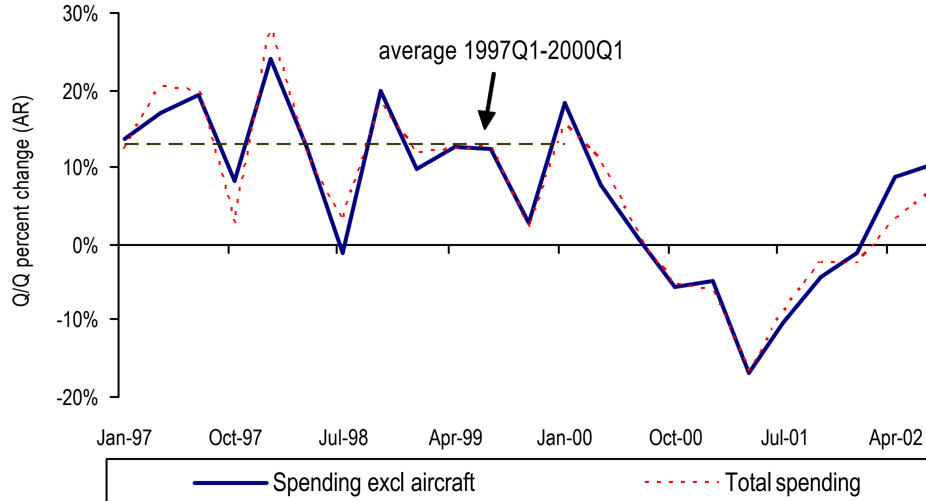

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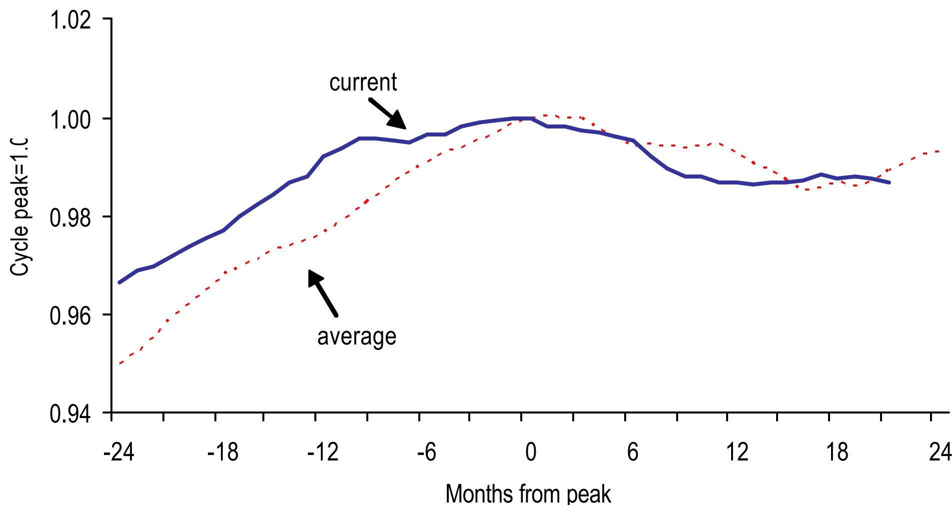


Source: Bloomberg; Bear, Stearns & Co. Inc.

The peak-to-trough loss in employment in the 2001 recession was 1.7 million jobs or 1.3% of employment. This is relatively small shrinkage in the labor force (see the table), in part due to the unusual timeliness of the fiscal and monetary stimulus applied in 2001.

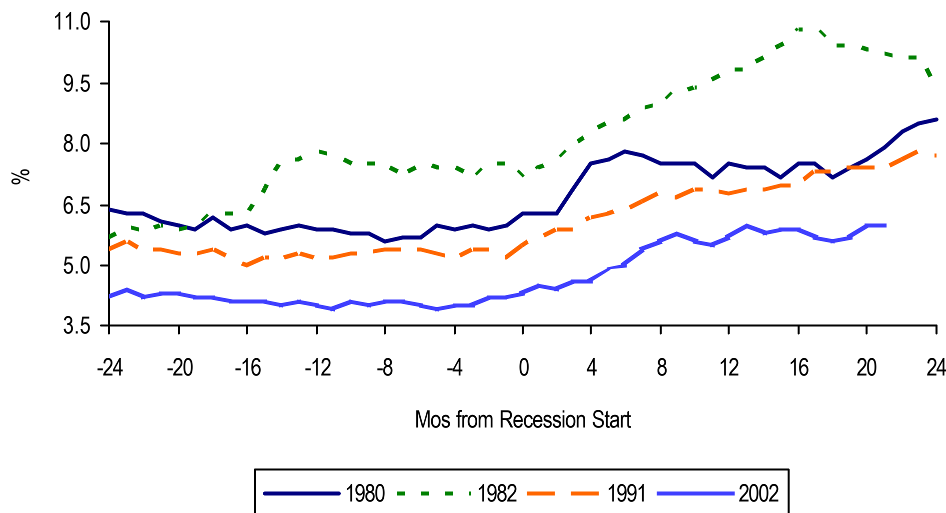
Changes in Employment; Peak to Trough (Millions of Employees)

Date	Peak	Trough	Chg, Mns	Chg, %
1970	71.4	70.3	-1.1	-1.5%
1974-75	78.6	76.3	-2.3	-2.9%
1980	91.0	89.7	-1.3	-1.4%
1981-82	91.4	88.7	-2.8	-3.0%
1990-1991	109.9	108.1	-1.8	-1.6%
2001-2002	132.4	130.7	-1.7	-1.3%

Sources: Bloomberg; Bear, Stearns &Co. Inc.

Today's 6% unemployment rate is well below the recent post-recession peaks in 1992 (7.9%), 1982 (10.8%), and 1980 (7.8%). Of course, I would like to see the unemployment rate substantially lower. Given the strong productivity growth taking place, I think the U.S. economy will be able to enjoy sub-5% unemployment in the future without it being inflationary.

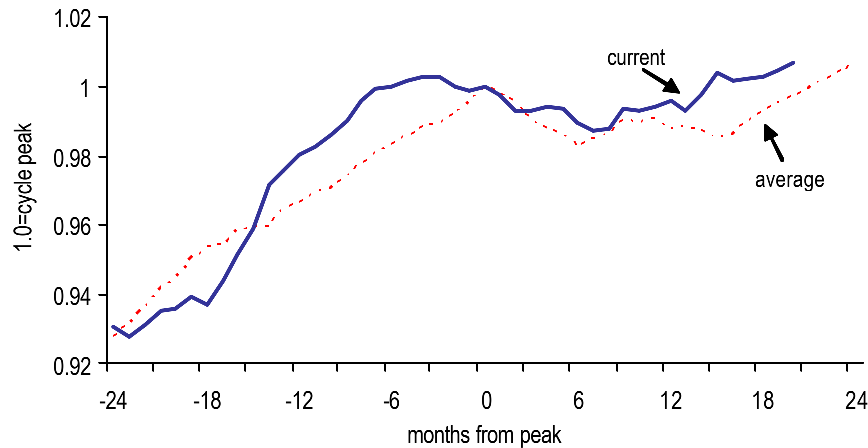
U.S. Unemployment Rates in Recession



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

With employment levels much higher than in previous recessions, personal income growth during the 2001 recession was stronger than the average. Tax cuts and extended unemployment benefits also helped support personal income in the current cycle.

Personal Income: Current Cycle vs. Average



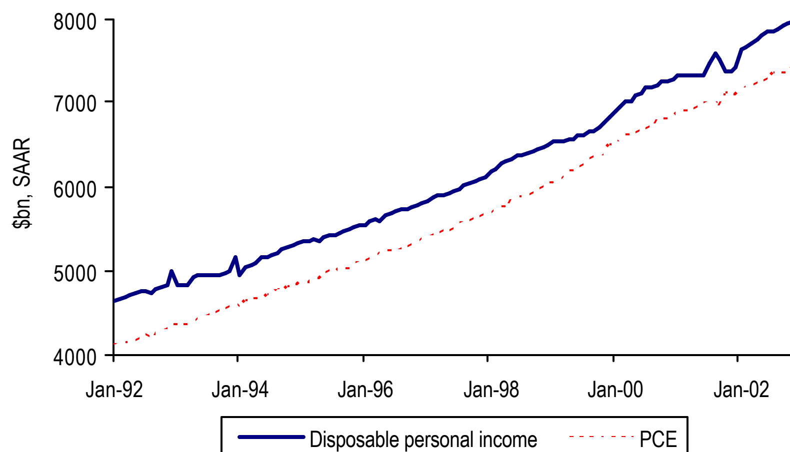
Source: Bloomberg, Bear, Stearns & Co. Inc.

Consumers haven't been as spendthrift as official figures show

Some argue that the sluggishness of the 2002 recovery is a shortage of cash in the hands of the consumer. This influences their economic outlook, the tax debate, and the debate over private savings accounts within social security. A common perception is that consumers wasted their money in the 1990s, justifying government efforts to give tax rebates and control retirement programs. Before getting into tax policy issues, it's important to evaluate consumer savings and balance sheets.

I think consumers tend to consume based on their life-time earnings expectations. There were two important changes in that outlook in the 1990s. First, the unemployment rate fell to much lower levels, establishing what I think will be a new lower non-inflationary rate of unemployment. Second, personal income grew through the 2001 recession. Combined, these two factors justified steady growth in consumption in 2002 and suggest that consumption will grow in 2003 and beyond.

Personal Income and Personal Consumption



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

A frequent argument is that the private savings rate went negative in the late 1990s, creating a shortage of consumption and arguing for Keynesian-style short-term stimulus in 2003. I disagree.

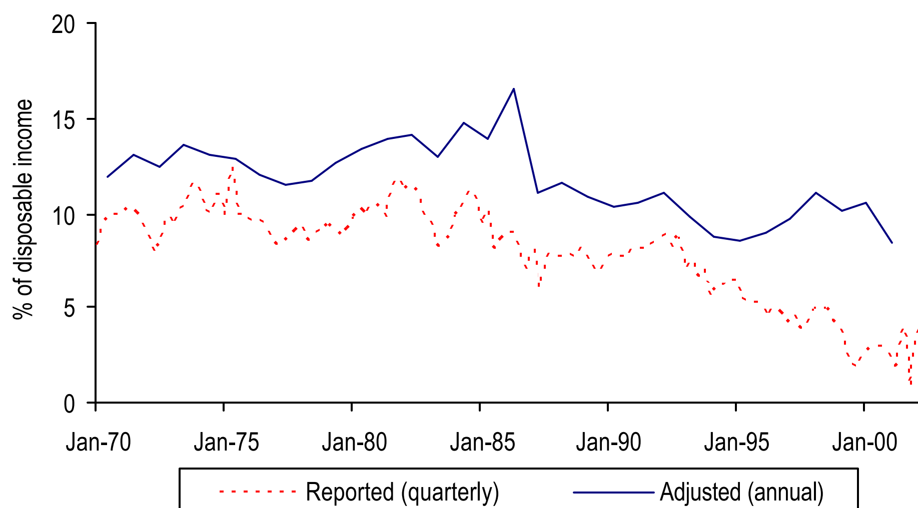
The official savings rate (released by the Commerce Department with the monthly report on personal consumption and income) is a misleading measure of savings and the consumer's financial health. The savings rate is calculated by subtracting consumption from a measure of disposable income. One of the major deficiencies in the personal savings data is that they ignore realized capital gains in calculating disposable income and therefore severely understate personal savings when equities rise.

Consider this example:

- A consumer realizes a $1,000 capital gain, pays $200 in taxes, and increases his savings account by $800. The government data on personal savings would, believe it or not, show a decline in savings. The capital gain is not included in the calculation of income, but the tax on the gain is deducted from disposable income. In this example, the government's measure of disposable income fell by $200, so personal saving is presented as having fallen by $200 (even though it actually rose by $800).

To get a better picture of savings in the 1990s, we adjusted the personal savings rate for just one of the missing items -- by including realized capital gains in disposable income. The graph shows a dramatic, positive effect on the savings rate in the 1990s, when capital gains realizations were strong. This is consistent with the recession experience of 2001 and 2002, in which consumer balance sheets were strong enough to support consumption growth despite cries that the consumer must be "tapped out."

Savings Rate Adjusted for Capital Gains Income



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

The reported savings rate has been rising in recent months. We think this reflects the crash in capital gains realizations more than a change in consumer savings behavior. As adjusted, the savings rate was relatively stable in the 1990s and, we think, remained in normal ranges in 2002.

The Fed has just released its survey of consumer finances for 2001 (Federal Reserve Bulletin, January 2003). It helps explain the strength of consumption in 2001 and 2002. The Fed survey found that the consumer's balance sheet improved dramatically from 1998 to 2001.

The Fed samples family net worth on a three-year cycle that includes 1992, 1995, 1998, and 2001. The real net worth of the median family rose 10.4% from 1998 to 2001, reaching $86,100. This is slower than the 17.4% increase between 1995 and 1998 but above the 8.3% increase between 1992 and 1995.

- The survey also showed that the real income of the median family jumped 9.6% from 1998 to 2001, nearly four times the 2.5% increase in the preceding three-year period.

- The level of debt carried by families rose from 1998 to 2001. However, despite the 2001 bear market, the value of equity holdings and principal residences rose more. This lowered the debt-to-asset ratio and allowed family net worth to increase substantially.

- The Fed survey showed that debt-servicing burdens also fell. The percentage of disposable income devoted to debt servicing fell to 12.5% in 2001 from 14.4% in 1998. This measure of debt burden declined for almost every demographic group examined by the survey. It reflects in part the growth in personal income, the decline in interest rates in 2001, and the 2001 tax cut.

We continue to disagree with the view that the consumer is close to a double dip or is near a financial crisis. Instead, we think consumption growth depends heavily on current and future employment, real wage growth, and expectations about taxes. We expect consumption to grow moderately in 2003, especially in the event of a retroactive income tax cut.

Improving the Capital Structure

Much of my testimony has lauded various structural aspects of the U.S. economy. It stands out around the world in terms of productivity and flexibility, auguring well for long-term growth.

However, one area where the U.S. is sorely deficient is the tax code. We suffer from very high marginal income tax rates, a heavy payroll tax on both the employer and employee, and huge tax incentives encouraging all types of debt – high-yield corporate debt, state and local debt, mortgage debt, etc.

As a result, one of the key variables in the economic outlook is whether the federal government can find a process to rebalance the playing field in terms of the capital structure.

The President's proposal to eliminate the double taxation of dividends and reduce the double taxation of corporate earnings would, if enacted, have a far-reaching, positive impact on the economy and equity markets, both near and longer term.

When you tax something less, you get more of it, in this case more capital and labor. That would mean more productivity, jobs and economic growth.

- The Bush proposal would lower the taxation of labor and small business entrepreneurism (by lowering marginal rates).

- It would also lower the taxation of capital (by eliminating double taxation and allowing an increase in basis for deemed dividends.)

- On the same principle, the proposal would encourage taxable income (in order to provide tax-free dividends) and more corporate earnings. It would discourage U.S. companies from moving their headquarters off-shore to avoid U.S. tax.

- At present, there's a wedge, an expensive toll gate, between corporate earnings and shareholders. Reducing the toll would increase the value of equities, including companies with current earnings and those with the prospect of becoming profitable.

- With 52% of all U.S. house-holds owning equities in some form, steps to encourage dividends and equity appreciation should provide a broad stimulus to the economy.

One of the criticisms of the tax proposal is that it might disadvantage municipal bonds. I disagree on two grounds. First, in economic theory and practice, municipal bond yields are related to the after-tax return on U.S. Treasury securities. The proposal to eliminate double taxation of dividends wouldn't affect that calculation. Second, municipal bonds are substantially different from dividend-paying equities in terms of creditworthiness and volatility. The two instruments aren't very good substitutes for one another.

We also disagree with the criticism that the stimulus from the tax cut depends on consumption or cash rebates. Consumption wasn't a weakness in the economy in the 2001 recession, so the key impact will come from improving the U.S. growth outlook.

Double Taxation Abroad

Policy makers in most other industrial countries have recognized that high rates of taxation on the earnings of capital distorts saving and investment and as a result, restrains economic growth. Of the thirty developed countries tracked by the OECD (Organization for Economic Coordination and Development), only three—the U.S., Switzerland, and Ireland—do not offer any relief from the double taxation of dividends.

Relief from double taxation takes on several forms:

- The most popular form is to tax dividends received by individuals at lower rates than other income. At least fourteen nations have chosen this type of relief.

- A close second in popularity is to provide individuals a tax credit based on the taxes paid by the firm.

- Three nations (Germany, Greece, and Luxembourg) offer partial or complete exclusion of dividends from individual taxation.

- And two nations have chosen to allow firms to deduct part of the dividends they pay to individuals, a parallel treatment to the one given to interest expense.

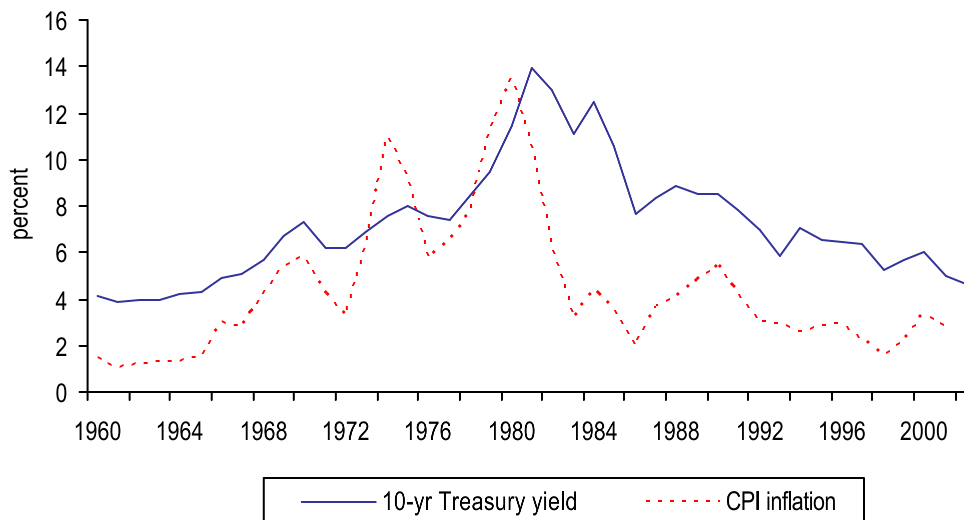
Of the countries studied by the OECD, the U.S. has the second highest combined top tax rate on dividends—exceeded only by Japan. Capital flows easily all around the world, so we should expect the higher U.S. tax rates on capital to gradually reduce investment in the U.S. from what it might otherwise be.

Deficits and Interest Rates

President Bush's tax cut proposal has rekindled the long-running debate over the relationship between the government's budget position and long-term interest rates. The relationship is complex. Interest rates and bond yields respond to expectations for currency levels, inflation and economic growth. Budget deficits, especially the quality of government spending and taxation, can affect these. For example, to the extent that a tax rate cut is viewed as growth-oriented, it may strengthen the currency, lower the inflation expectations, and lead to lower interest rates. We saw this phenomenon in the 1980s.

When inflation, or expectations of future inflation, rise, so will interest rates regardless of the size of government borrowing. I expect long-term U.S. interest rates to rise during 2003, but not because of increased government borrowing. Rather, the private demand for credit should rise as the expansion gains traction, putting upward pressure on interest rates. In this case, higher interest rates would be a good sign for the economy, since it would be the result of robust growth. It would not be a constraint on growth as many contend.

Treasury Note Yields and CPI Inflation



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

It is important to note that the empirical data do not show a relationship between interest rates and the budget deficit. This makes sense. The U.S. is part of a global capital market. Government debt is only a part of the demand on the global capital base. For example, at the end of the third quarter of 2002, the total stock of outstanding debt in the U.S. (public and private) totaled about $20.4 trillion, of which $16.7 trillion had been issued by private-sector borrowers and $3.7 trillion by the government. When you consider government debt, the world's seven largest governments alone have issued roughly $12 trillion of debt, of which less than a third has been issued by the U.S. government.

The Administration's tax cut proposal is projected to add about $67 billion per year to the federal government's deficit over the next ten years. This amount of additional borrowing will add only 0.3% to the stock of outstanding global public and private sector debt (ignoring private foreign borrowing and other capital market demands like equity issuance). It is hard to see how such a small increase in the debt outstanding can push interest rates up enough to hurt the expansion.

Consider the recent experience of the U.S.:

- The yield on 10-year bonds fell throughout the 1980s, even as the fiscal deficit moved above 4% of GDP over a number of years.
- The August 1993 tax hike was followed by an increase in 10-year bond yields to nearly 8% by November 1994 from 5.5% when the tax hikes were passed.
- Note yields rose to 6.7% by early 2000 from a low of 4.5% in late 1998, even as the budget was producing surpluses.
- Note yields have fallen despite the return of the deficit over the past two years.

Longer-Term Stimulus Ideas

The Administration's tax proposal will, in my view, provide substantial near-term and long-term stimulus for the economy. Reducing the distortion in the U.S. capital structure will boost the U.S. growth rate.

Other important reforms, in my view, should cover the tort system, the tax code, social security, and Congress's scoring system (which causes a strong bias toward bigger government).

On the international side, we should recognize the importance of currency stability, growth-oriented IMF reforms to end its bias toward austerity and impoverishment, labor flexibility in Europe, and a non-deflationary monetary policy for Japan. In combination, these policies would create more prosperity abroad, encouraging U.S. exports and reducing some of our national security burdens.