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Thank you for inviting me to speak to you today. It is rare that one gets to address a crowd that is so knowledgeable about the topic on which one is speaking. This is both intimidating and enjoyable.

Recently, Congress voted to extend the rate cuts on dividends and capital gains that were enacted by the Jobs and Growth Tax Relief Reconciliation Act of 2003. That was very good news. The President was delighted yesterday to sign the tax reconciliation bill making those lower tax rates effective through 2010. Lower tax rates on dividends and capital gains are playing an important role in encouraging investment and economic growth in the United States. In a time when many people are concerned about our international competitiveness, hiking these taxes would have taken us in the wrong direction. I would like to return to a discussion of those tax cuts in a few minutes, but before doing so, let me lay the groundwork for the way that I think about structuring taxes in general and tax reform specifically.

Let me begin by stating what to most tax experts is the obvious, but has been lost in the context of twenty years of tax legislation. The goal of a tax system is to raise the money that is necessary to run government, and to do so in the most efficient way possible with the minimum amount of economic distortion. The Tax Reform Act of 1986

that dramatically restructured taxes took some important steps in that direction. Since that Act there have been about 15,000 revisions to the tax code that have made it not only amazingly complex, but laden with provisions that subsidize one group, tax other groups, and create incentives to do things that no normal person or business would do absent tax considerations. Although you are aware of the many principles of minimizing tax distortion, I would like to just run through a few of the ones that motivate my thinking about tax reform.

First, an efficient tax system should not favor current consumption over future consumption. In plain English, that means that it should not discourage saving. The current tax system, by taxing the return on capital either in the form of interest taxation or capital gains and dividend taxation, biases the system toward present consumption over saving. The personal saving rate in the United States is negative, although there is some disagreement over whether it is truly negative when capital gains in housing and the stock market are taken into account. Still, it is hard to argue that our saving rate is commensurate with what one would expect in a country as rich as ours. Indeed, one of the anomalies that we observe in the world is that the very poor countries which should be borrowing from us to finance current consumption given their high rates of growth and prospects for a rich future, are instead the lenders. We, who are at the top of the world income distribution, are the borrowers. Our tax system does not help that situation.

Second, all focus of capital investment should be treated similarly. There is no reason to favor one type of investment over another.

Third, the tax system should not push any particular form of corporate governance. Instead, such decisions should be made on the basis of business considerations.

Fourth, the tax system should not discourage investment in human capital, which is so essential to economic growth.

The financing of investment is also an issue. Firms generally have the choice of funding investment through borrowing (debt) or the use of retained earnings (equity). The tax system can influence their choice. To the extent that businesses can deduct interest payments on their debt while dividends and capital gains are taxed, firms have an incentive to finance through debt rather than equity. For example, the CBO estimates that the effective tax rate on debt-financed corporate capital is -6.4%, whereas the effective tax rate on equity-financed corporate capital is +36.1%.

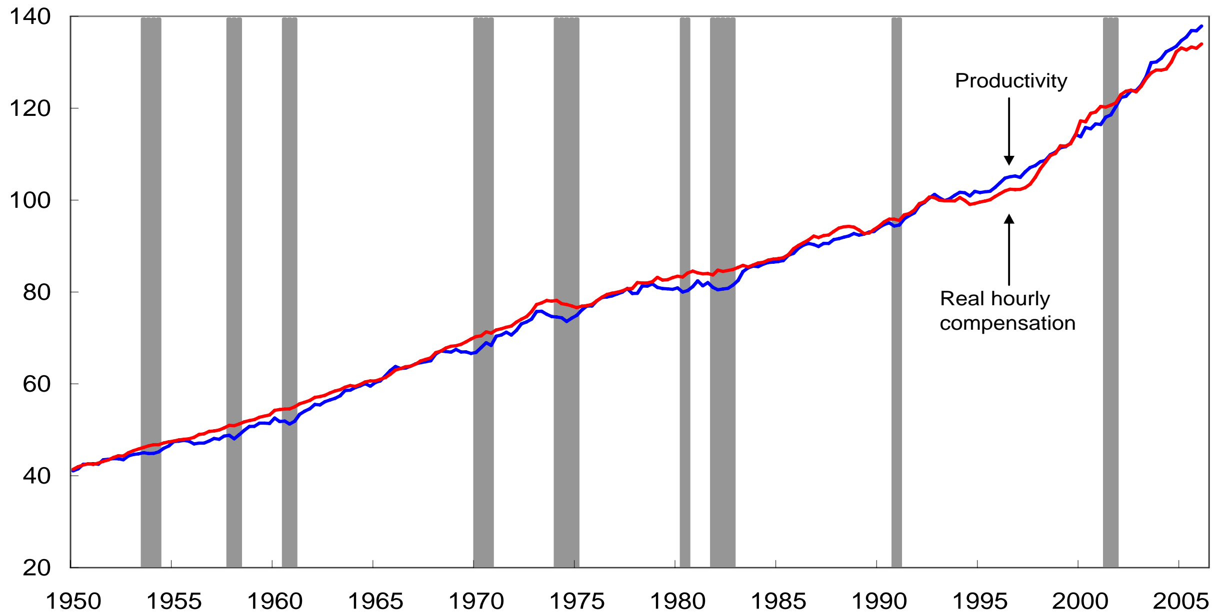
When one considers the tax system more generally, most peoples' immediate reaction is that it is unbelievably complex and burdensome. And indeed those sentiments are correct. Complexity in the tax code has a very real cost. Estimates of the compliance costs associated with tax preparation are in the range of $100 to $150 billion per year, or about 1 percent of GDP. This is a very substantial cost and simplification of the tax code would reduce this cost, providing benefits for all taxpayers.

But I believe that the economic growth effects of a tax system are more important than simplicity. Growth means higher productivity, and higher productivity translates directly into higher wages--even over the relatively short run. Over a period of five years or so, the potential saving through tax simplification is dwarfed by any reasonable growth effect associated with a more efficient and more pro-growth tax system. To get

the sense of why economic growth is so important, look at Figure 1. In Figure 1 the relation between compensation and productivity is plotted over about a 55-year period. The compensation series used here is called the real product wage, which is a comprehensive measure of total compensation. Although these curves do not line up on a daily basis, it is quite clear that wages and productivity are highly linked. Figure 2 makes the point even more dramatic. In Figure 2 the Bureau of Labor Statistics production worker wages are plotted against productivity growth. As one can see, when productivity growth is high, real wage growth tends to be high--even in the relatively short run.[1] The point is that if we are interested in raising the wages of the average American, the way to do it is to ensure that productivity grows at a rapid rate. And to return to the earlier point, in order to do that it is essential to encourage investment and saving. Because we have a global capital market, investment and saving are distinct. We are able to finance high levels of investment despite our low saving rate because others are willing to invest in us (See Figure 3), but they will not be willing to continue to do that if the after-tax rate of return to that investment is reduced to levels that are not internationally competitive. So it is important to focus not only on the parts of the tax system that encourage domestic saving, but also the parts of the tax system that encourage global investment.

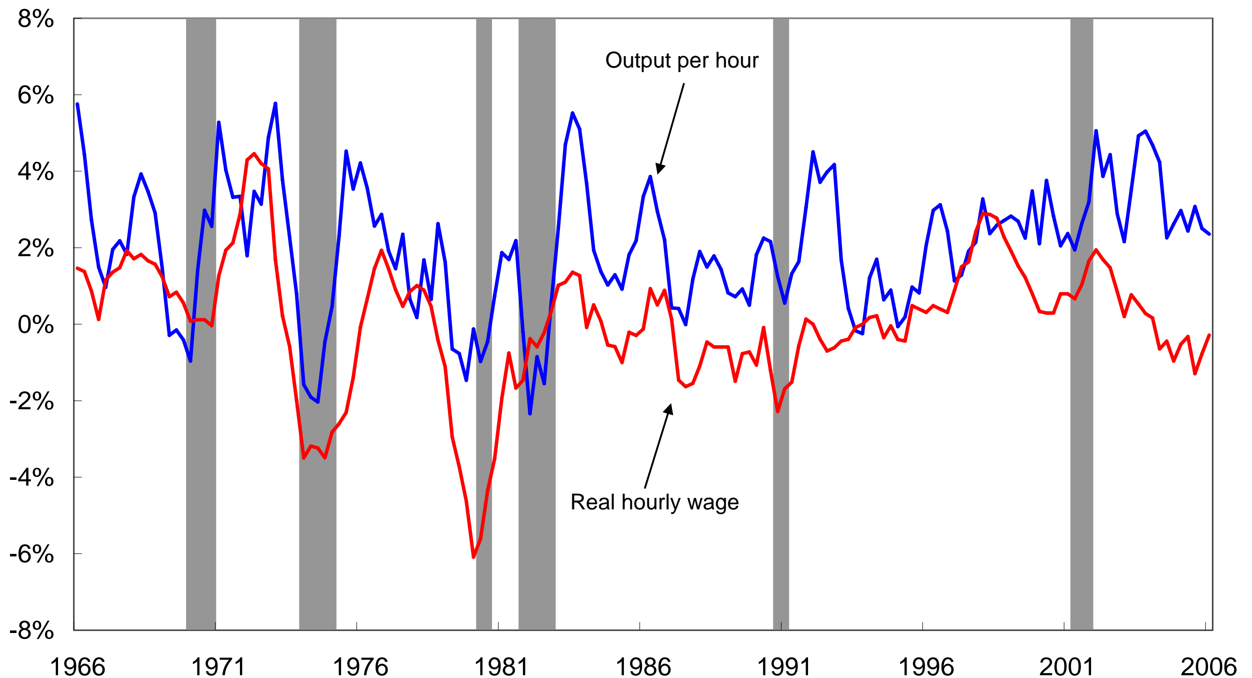
[1] This series is a 3-year moving average, so it tends to smooth out to some extent quarter-to-quarter variation.

Productivity and Real Compensation Grow Together

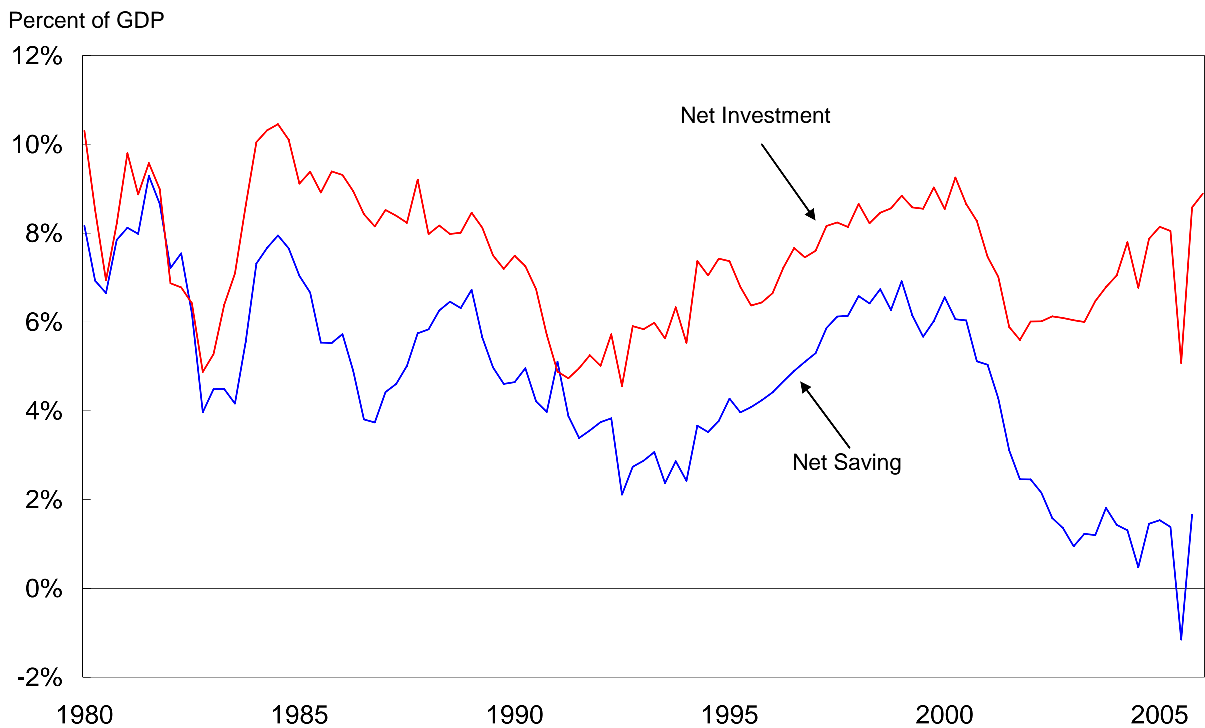


Note: These data cover all persons (including supervisory and proprietors) in the nonfarm business sector. The real product wage is hourly compensation deflated by the price index for nonfarm output. Shaded areas denote recessions.
Source: Bureau of Labor Statistics.

Productivity and Real Wage Growth



Note: Productivity and wage growth are both calculated as 4-quarter percent changes. Wage growth is defined as the average hourly earnings of production workers.
Source: Bureau of Labor Statistics



What is the record on the capital gains and dividends tax cuts? Did they move us in the direction of a more efficient tax system? Most of the evidence, especially that on firm behavior and the dividends and capital gains tax changes, suggests that the 2003 Tax Act did stimulate economic growth. Since the tax cuts, fixed investment has increased in every quarter, and most recently those increases in investment have spread broadly to include very high levels of investment across the board and also in exports.

Additionally, there is evidence of beneficial effects in the labor market. Job growth is very strong with nearly 5 million new jobs over the past two and a half years. Moreover, we are on pace to have another year that will see about 2 million additional jobs created.

Productivity is also up. Since 2001 productivity has been growing in the middle 3 percent range, and the very high rates of output during Q1 of 2006 suggest that productivity growth and GDP growth will continue. Also real wage growth which sometimes lags behind productivity growth in the early parts of an expansion, took off in the last quarter. Real total compensation grew at a 3.6 percent annual rate during Q1 of 06, with the nominal rate of compensation growth being over 5-1/2 percent.

The strength of the economy confirms that low tax rates help to stimulate investment, create jobs, and support economic growth. With the surge of revenues we are now experiencing we can also say that low taxes are consistent with rising federal revenues, which helps bring the deficit down. April receipts have been reported to be very strong, reflecting an economy that is growing, expanding, and creating jobs. Significantly, the CBO is now projecting the 2006 budget deficit to be down to $350 billion or perhaps as low as $300 billion or about 2.3 percent of GDP. (Treasury estimates will come out after the Mid-Session Review.) These numbers are encouraging, particularly since this was a year during which we are fighting a war and rebuilding after unanticipated natural disasters on a major scale that strained the Federal budget. Indeed the evidence suggests that strong economic performance is improving revenues and we are growing our way out of the deficit. Higher taxes are not the solution.

For all these reasons, the reduction in taxation of dividends and capital gains were important. But there are some additional and more subtle tax effects. Reducing capital gains and dividends taxation also mitigates the push toward debt financing over equity. The overuse of debt relative to equity increases the chance of bankruptcy, which leads to worker displacement, lost jobs and lower wages.

Second, encouraging dividend payouts means a more efficient capital market. Although not a necessity, there seems to be a tendency for retained earnings which are encouraged by high dividend taxation to be invested in larger firms rather than smaller ones. The lower tax rates may be an indirect stimulus to entrepreneurship by making capital more available to small firms.

Finally, and not to be ignored, keeping the money in the hands of the people rather than in the hands of government is a good thing. The public invests its money efficiently because the costs and returns are borne by the investors themselves. All 57 million American families who own stock directly or indirectly benefit from the tax cuts on capital. It is estimated that around 35 million taxpayers—about one-fourth of whom are elderly—will benefit directly from lower taxes on their dividend income. Among that group of the elderly, the tax saving relative to taxes that would be paid under the old structure would mean about $1,100 average to each.

The President has placed his initial focus on capital taxation and reducing dividends taxes as a specific component of it. It was particularly important that extensions of the capital gains and dividend tax cuts were pushed initially as part of the President's agenda in order to promote economic growth. The general reason that economists believe that capital gains taxation and dividends taxation is an important impediment to growth is that capital investment elasticities tend to be high. Small changes in tax rates can affect in a significant way the amount of investment that occurs.

There have been a number of additional proposals that the President has made that are steps on the path to tax reform. One involves extension of health savings accounts, and this is also consistent with efficient taxation. Under the current system, the health

structure of taxation is distortionary because workers and firms that do not offer employer-sponsored health insurance must buy their insurance in after tax dollars, whereas those who are in employer-sponsored plans get to use before tax dollars. This induces a push toward employer plans over other plans. Although there is some alleviation of this problem through Flexible Spending Accounts, the fact that FSAs are "use it or lose it" means that people put too little money into these accounts for fear that they may not be able to receive all of the benefits. In the absence of full-blown and comprehensive HSAs, insurance is favored rather than out-of-pocket expenses which tends to mean that there is an excessive use of the healthcare system, and this drives health care costs up. If instead the playing field were level so that people could choose more consumer directed health plans which would combine the financial protection of catastrophic coverage with out-of-pocket payment for normal health expenditures, then patients and doctors would make more informed decisions, and would take into account the economic incentives that are necessary to guide rational behavior.

Dividends and capital gains taxation, HSAs and other kinds of plans that remove the disincentive to save are all important components of an efficient tax structure, but it is also necessary to keep the marginal rates on wage income low. Not only is this a fairness consideration, but it is important for the most significant kind of investment for an economy, which is investment in human capital. Virtually all studies of economic growth show that education specifically, but human capital in general is the most important component in ensuring that an economy grows at high rates. To further investment in human capital, it is necessary that the progressivity of the tax system not become too pronounced. If high incomes are taxed at too high a rate relative to lower

incomes, the incentives to invest in human capital decline. One can see the effects of tax created impediments to human investment in countries where salary compression was highly pronounced, such as the Eastern European economies around 1990. Many highly skilled individuals chose to drive taxis for tourists rather than to use their skills because the wages were higher in the tourist industry than they were in the professional occupations. Had that pattern persisted into the long run, it would imply chilling effects on investment in education. Indeed many of the professionals in those countries migrated to the West in order to take advantage of the higher wages associated with high skills.

Let me conclude. We have already taken a number of steps toward more efficient taxation since 2001. The effects have already panned out in high economic growth and growing wages. The 2003 Growth and Jobs bill produced the desired effects. It stimulated dividend payout, investment, and economic activity. The extension of the low rates on capital is a step in the right direction. Additionally our marginal rates on wages are down to reasonable levels, although of course, lower is always better. And our deficits are coming down. It is important that we continue to maintain low taxation so that the United States remains the best place in the world in which to invest in both human and physical capital.