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Bush's Tax Cuts: Curb Your Enthusiasm

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Hopes for pro-growth tax policy initiatives are worse than dead -- they've never even been born.

Since July we've been alerting clients to the risks arising from the growing body of evidence that the **Bush administration's** policy initiatives will not support a return to robust economic growth. We warned that the **Republican** sweep in November would be a missed opportunity to adopt a more pro-growth philosophy -- this was soon reinforced by the uninspired selections of senior White House economic officials, and is now being borne out almost daily in the policy development process.

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A series of leaks in the past week signals that the **White House** is caving to the **Democrats'** class warfare appeals, and to the widespread **Rubinomics** mythology that tax-cuts are deadweight costs that will widen the federal deficit and raise long-term interest rates. Major new cuts in the top marginal personal tax rate were never on the table. Now it seems that the administration will not even pursue an acceleration of the cuts in top marginal tax rates already scheduled to phase in through 2006. This bears the fingerprints of the newly installed director of the White House's **National Economic Council, Stephen Friedman** -- and confirms the worst fears of those critical of the appointment of this former vice-chair of the deficit-phobic and anti-tax-cut **Concord Coalition**.

In the face of estimates of rising budget deficits and the need to seek another hike in the debt ceiling early in the new **Congress**, the Bush administration may be attempting to split the partisan differences from the outset. But this tactical approach didn't work last year when post-9/11 "stimulus" was being debated, and it won't work now. Indeed, we must conclude that it is not a tactical approach at all -- we fear that the reason the Bush administration is so eager to split the difference is that *there is no difference in the first place*. Face it -- this administration is simply not philosophically committed to pro-growth supply-side tax cuts.

The staged top-rate cut incorporated in the 2001 tax bill -- from 38.6% currently to 35% in 2006 -- is surely a modest one by any objective standard. But of the realistic options on the table for possible action next year, moving forward the effective date of the full cut (the top rate was 39.6% prior to the 2001 tax cut) would have the largest positive impact on supply-side incentives. Lifting the reward on the marginal dollar earned from $.61 to $.65, it would mean a nearly 6% boost to after-tax returns in the top bracket. The class warriors and their media handmaidens dwell on the benefits of such action accruing to "the rich." The fact is, though, that "the rich" pay the bulk of tax dollars, and so any tax cut must necessarily accrue in large part to their benefit. But more important, top-bracket taxpayers are the people who are most able to alter their economic behavior in response to changing incentives. By enhancing marginal

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expected after-tax returns, reductions in the top rate encourage capital and labor to undertake higher-risk activity that would not otherwise occur, resulting in a higher rate of economic growth.

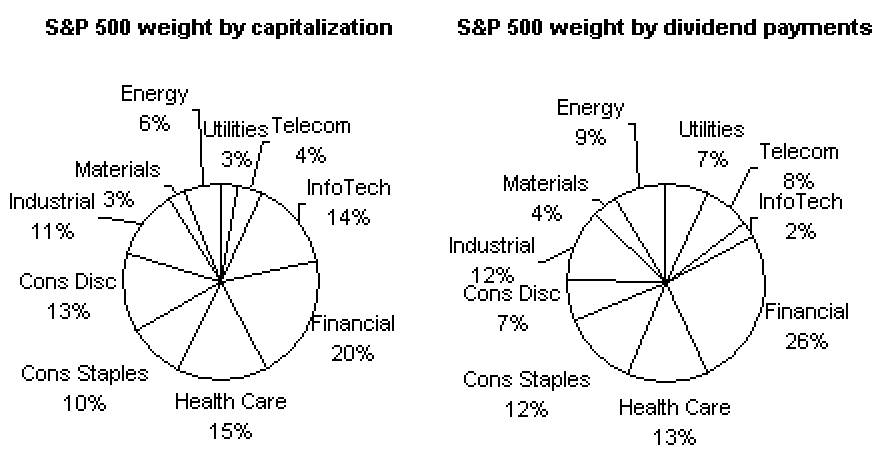
The administration has apparently concluded, though, that accelerating reductions in the top rate would detract from what it has chosen to highlight as the centerpiece of its "growth" strategy -- relief from the double taxation of corporate dividends. Yes, if this were an abstract exercise in designing an optimal tax system free of distortions favoring debt over equity, or capital gains over dividends, we would advocate elimination of *all* forms of multiple taxation, including the corporate income tax and the capital gains tax. But this is not an abstract exercise, this is *reality* -- relieving taxes on dividends will contribute nothing to the most sensitive challenges of today's economic environment.

Reality is the challenge of revitalizing an economy now entering a third year of sub-par growth, a record that for **George W. Bush** coincides increasingly uncomfortably with his term of office. To suggest that what this economy needs most is relief from the double taxation of dividends -- at the expense of crowding out almost all other major tax-cut initiatives -- reflects a severe misdiagnosis of what is ailing it. What is ailing the economy -- what should urgently be addressed by tax policy, and what is almost total *unaddressed* by dividend tax relief -- is the disruption of *the market's capacity to bear risk*.

As we have written over and over these many months, the market's acute level of risk aversion -- while now moderating somewhat from the worst levels early last autumn -- has multifaceted cause and effect links to the economy's lackluster performance. At one level, the risk premium made available in higher-risk market segments has risen to levels that should present appealing prospective returns. The fact that the premiums have not been captured to any significant extent indicates that growth expectations remain insufficient to attract substantial investment commitments to riskier asset classes. The price of risk, in other words, remains too high.

If anything, dividend tax relief seems perversely mis-targeted to encourage *less* risk-taking in the economy. Indeed, *dividend disbursements can be viewed as representing capital no longer at risk*. At the margin, dividend tax relief is a subsidy for taking risk capital off the table.

Yes, reducing the tax burden on such capital would boost the after-tax returns on expected dividends, and stock prices of dividend-paying companies would rise as the market adjusts to equilibrate. That would be a one-time windfall for the holders of those stocks, and it would lower the cost of equity capital for these companies.

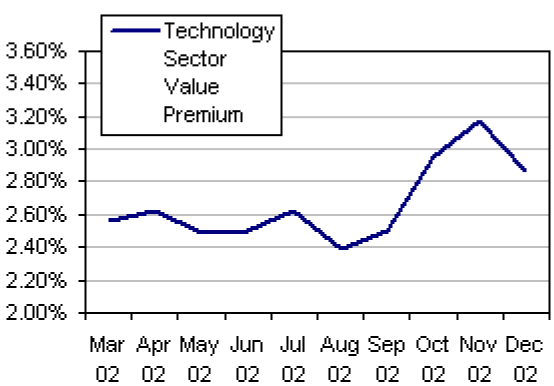


But this effect would be somewhat muted by the fact that many companies already employ stock repurchases to work around dividend taxes, and that many investors who receive dividends are tax-exempt anyway. And the bulk of the value of these effects would be very narrowly focused on a small number of lucky companies. In the S&P 500, more than 50% of the dividends are paid out by just 28 companies.

What's worse, dividend-paying companies tend to be mature companies -- most notably in the financial, utilities, industrial and consumer staples sectors -- who won't make the most productive possible use of the equity capital that will be made cheaper for them thanks to tax relief. If they needed capital and had anything productive to do with it, then they wouldn't be paying it away in the form of dividends in the first place.

Advocates of dividend tax relief are hopeful it will motivate less mature, more entrepreneurial and potentially faster-growing companies -- such as those in the technology sector, which makes up 14% of the S&P 500's capitalization weight but only pays our 2% of the S&P 500's dividends -- to increase their dividends. But for these companies, choosing to return cash to shareholders that could alternately be employed in positive-return investments would be tantamount to wasting corporate resources.

If the Bush administration has its way, then, the market's capital allocation function will shift at the margin toward less risky enterprise, and against putting capital to work in its most growth-enhancing and potentially productive uses. There are indications that the market is already absorbing this reality and responding accordingly.



As the chart at left shows, the relative valuation premium between technology and non-technology stocks expanded vigorously from the October bottom through the GOP electoral sweep last November. Buoyed by hopes that a Republican-controlled congress would be able to advance pro-growth fiscal initiatives, the market valued the most growth-sensitive sector more highly -- relative to the rest of the market -- than at any time in the last 18 years with the exception of the very top of the so-called "bubble" in the first quarter of 2000. But over the last month, as it became clear the Bush administration would squander its pro-growth policy opportunities, the valuation premium on the technology sector has begun to evaporate -- and with it, stock prices across the board have retreated.

On November 25, near the very top of this valuation premium, we established a **Model Position** designed to exploit the inevitable collapse of pro-growth hopes -- short the NASDAQ 100, and long the S&P 500. Through year-end, the NASDAQ 100 has fallen by 12.7%, while the S&P 500 has fallen only 5.69%.

Looking across this policy morass and ahead to the new year, we can say two positive things for stocks. First, **the Fed's** new commitment to deflation fighting has taken monetary policy off the risk radar for the time being. Second, most stocks are cheap by historical valuation standards, and as military risks resolve valuations could improve. This could set the stage for a terrific bull move -- if it were not for the irony of a Republican president and a Republican congress that can't -- or won't -- give the economy the pro-growth tax relief that it most needs. TM