TrendMacrolytics

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POLITICAL PULSE

Born-Again Growth Advocacy

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Bush's stodgy tax plan is blossoming into an important pro-growth initiative.

A story in the *Wall Street Journal* this morning suggests that the **Bush administration's** plans to eliminate double taxation of dividends may include a provision that would effectively be a capital gains tax cut.

Our contacts both at **Treasury** and the **White House** confirm the *Journal* account, although some final details remain to be worked out. This would overcome the crux of our concern that the plan would skew capital allocation incentives toward mature, lower-risk, dividend-paying companies and away from immature, higher-risk businesses with the fastest growth potential.

The provision would create what Treasury documents we have seen are calling "deemed dividend reinvestment plans", or DDRIPs. These should not be confused (as the *Journal* article does) with actual shareholder accounts or stock purchase plans. Rather, a DDRIP would be a notional "account" on the books of a public company that records the value of retained earnings that had been subject to corporate income taxes. When a shareholder sells stock, per-share growth in the company's DDRIP account would be deemed a tax-free dividend, thus reducing the amount of capital gains subject to taxation.

Essentially, this would raise the cost basis in the calculation of capital gains to account for retained earnings, providing a crucial incentive to put capital at risk in entrepreneurial enterprises. Imagine, for example, investing in a recently listed firm with little or no current profit but good prospects for earnings growth over time. If the stock is held until those expectations are realized, to the extent any price appreciation in the interim corresponds with profits booked as retained earnings, the capital gains liability would be zero.

There are many details that remain to be worked out, including deciding whether to start DDRIP accounts at zero, or to grandfather in some number of years of past taxed retained earnings. It is also not clear how the tax advantage of DDRIPs would accrue to a shareholder who realizes a capital loss, or for whom the change in basis due to DDRIPs converts what otherwise would have been a capital gain into an effective capital loss. And most important, it isn't law yet.

But no matter how you slice it, if enacted, the DDRIP concept would very positively change our gloomy view about dividend tax relief (see "Bush's Tax Cuts: Curb Your Enthusiasm" January 2, 2003). We had argued strongly that dividend tax relief -- in isolation -- would be, at the margin, an asymmetrical subsidy for large, mature, profitable companies at the expense of small, young upstart companies whose success is expressed in capital gains rather than dividends. It would encourage investment in conservative ventures at the expense of more aggressive ones, just at a time when the economy is already seized by pathological risk-aversion. The DDRIP concept goes a long way toward transforming Bush's tax plan into a symmetrical marginal incentive for investments *of all types* -- both risky and conservative.

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Our hunch is that this provision was a late addition responding to concerns such as ours. The retained-earnings provision, together with the acceleration of the cut in the top marginal rate and the elimination of double taxation of dividends, would have major supply-side effects, significantly improving incentives for capital formation and wealth creation. It would mean a materially more positive outlook for the economy and equity markets.

Our long-held skepticism about this administration's convictions in the realm of advocating pro-growth economic policy change is undergoing significant revision. The White House tax plan would, if enacted without major modification in its key provisions, amount to one of the more positive, pro-growth changes in tax policy since the **Reagan** years. We will obviously be keeping close watch on the package as it wends its way through the congressional legislative process. TM