TrendMacrolytics

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POLITICAL PULSE

Self-inflicted Damage in the Tax Wars

Wednesday, April 30, 2003
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If the administration is going to sell its tax-cuts, it had better change its pitch.

The **Bush administration's** radical proposal to eliminate the double taxation of dividends and retained earnings is a brilliant thrust for pro-growth tax reform. By withdrawing the tax wedge from the returns to equity investment, the proposal delivers a triple win for economic growth:

- a windfall to equity *holders* in the short term through higher stock prices;
- a boon to equity *seekers* in the long term by lowering the cost of capital;
- and a boon to *wage-earners* in the long term by endowing them with more productivity-enhancing capital.

But the proposal is indeed *radical* -- it goes to the deep roots of the tax code's interference with capital formation. It is as much tax *reform* as tax *cut*. And it's hardly a reform that the man in the street has been clamoring for. For all these reasons, convincing the political establishment, the media and the public of its value is an unusually difficult challenge. So far the Bush administration has done quite poorly.

The administration has taken on the deficit hawks by asserting that small deficits don't matter, which gets played in the press as "deficits don't matter." A far more powerful argument would be for the administration to provide its own dynamically-scored analysis of the true deficit-cost of the elimination of double-taxation. It such an analysis were to aggressively embody the full impact of short-term and long-term supply side effects on the stock market, on investment, and on the labor supply, the almost $400 billion statically-scored cost would be dramatically reduced.

We know from meetings with **White House** officials -- including **the president** himself -- that the administration deeply believes in these supply side effects. Indeed, that's why they proposed this unusual type of tax reform to begin with. So why not provide the dynamically-scored costs? Our sources have told us for weeks that such an analysis is forthcoming, as a joint product of the **Council of Economic Advisors** and the **Treasury**. *But where is it?*

While we wait, the **Congressional Budget Office's** uninspiring dynamically-scored results are frequently cited as showing that even the administration's new "hand-picked" CBO head can't make the proposed tax-cuts look good. But the fact is that the CBO's report scores the *budget*, not the tax-cuts *per se*. So the **Senate** and the **House** committees working to craft specific terms of a tax-cut still don't have the information they need to make an intelligent decision.

Another mistake has been to try to frame the tax-cuts in terms of traditional "stimulus." Yes, the administration has backed off the worst of the "put money in people's pockets" blather that we used to hear all the time from **Larry Lindsey**. But the core principles and assumptions behind such blather continue to infuse the administration's economic analysis.

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For example, a February 4 report from the CEA was intended to show how many jobs would be created by the proposed tax-cuts. The headline showed an impressive 1.4 million new jobs created in the first two years, but then the details revealed that half those jobs would be lost in the next three years ("lost" relative to the normal rate of job creation in the economy). As a devastating story in Monday's *Washington Post* demonstrates, the administration's critics have been having a field day using the administration's own report to show that the tax-cut is not effectively "stimulative." And it all happened because the CEA report used a traditional Keynesian model that treats all tax-cuts as arbitrary demand-shocks -- "putting money in people's pockets." The report went to pains to specifically state that the

> "...statistical model used for the projections does not include any supply-side effects under which lower tax rates would be expected to boost labor supply and further improve job creation. Corporate income tax relief would likewise be expected to lead to positive supply-side effects through improved allocation of capital across the economy and thus higher growth and job creation—again, however, this is not reflected in the numerical projections."

In other words, the most important core reasons for proposing the elimination of the double taxation of dividends and retained earnings in the first place was *deliberately ignored* in the White House's *own* analysis.

Trying to tuck the administration's $726 billion tax-cut into a bed that's only $350 to $550 billion is going to be quite a trick. Things will get thrown overboard. The way the administration's been selling the elimination of the double taxation of dividends and retained earnings, there's every reason to fear that it will be pitched. And that's *not only* a tragic missed opportunity. We may still end up with some pro-growth tax-cuts of some kind, but the fact is that a lot of the other tax-cuts that are left on the list are pure pork, with no pro-growth attributes at all.

This administration's pulled off a few miracles over the last couple years, and maybe it can still pull off this one. The President is on the road trying to make it happen. But unless the whole administration changes its sales pitch, a miracle is what it will be. TM