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POLITICAL PULSE

Down Payment on a Miracle

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Bush's tax cuts went to the House, and are coming out better than ever. But the Senate's another matter.

The $550 billion tax package now on its way to passage in the **House Ways and Means Committee** would be at least as pro-growth as **President Bush's** original $726 billion proposal, but whether growth arguments will ultimately carry the day remains much an open question.

The $550 billion plan birthed by Ways and Means chair **Bill Thomas** can be seen as a down payment on the miracle we said last week it would take to get Bush's tax cuts through **Congress** intact, and a much-needed fixed point in a political process that has been alarmingly fluid (see "Self-inflicted Damage in the Tax Wars" April 30, 2003). But indications from the Senate still leave grave doubts as to whether the process will coalesce around this fixed point and result in a valuable pro-growth tax bill.

- The Thomas plan leaves intact the critical acceleration of the cuts in marginal personal income tax rates that were not scheduled for full phase-in until 2006.

  The good news is that reports suggest **Senate Finance Committee chair Charles Grassley's** position is to preserve this provision in the Senate version.

- The plan replaces the elimination of double taxation of dividends and retained earnings with a 15% top rate on both dividends and capital gains. While this is less dividend relief than Bush had originally asked for, it is more than half of it. And at the same time, it is probably at least *twice* the capital gains relief than was implicit in Bush's favorable capgains treatment for retained corporate earnings. It would appear that this is a very efficient finesse of the arbitrary models used to score the "cost" of proposed tax-cuts. This provision of Thomas' plan comes in at $296 billion -- $100 billion cheaper than Bush's $396 billion version.

  There are two very important ways that the Thomas version of dividend relief is better than the Bush original. First, the outright cut in the top capgains rate to 15% from the 20% now paid on most gains would have powerful supply side effects. Most critically, as a tax on expected but uncertain future income streams, capgains raises the risk premium in the cost of capital, resulting in less capital being put at risk. In our analysis, the cut in the capgains rate from 28% to 20% in 1997 was indispensable to the late-1990s' surge in productivity-boosting innovation, capital formation and wealth creation. This capgains cut would come in the wake of a three-year period when risk taking was suppressed first by the destructive forces of monetary deflation, and more recently by the geopolitical uncertainties surrounding the **Iraq** crisis. As such, the 25% lift to expected after-tax returns resulting from this capgains cut likely would go a long way toward restoring the market's animal spirits, with the biggest impact coming in the capital made available to riskier enterprises with the greatest growth potential.

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Also, the Thomas dividend cut would apply the new 15% top rate to *any* dividend paid, while the Bush version limited its tax exemption to dividends paid from post-tax earnings going forward. Under the Thomas version, companies with large cash hoards, such as **Microsoft**, would be able to dividend them out at the lower tax rate (they would not have been able to do so under the Bush plan).

The bad news is that dividend relief seems to be gaining little momentum in the Senate. Last week **Senate leadership** suggested that it intends to fight for Bush's original structure for dividend and retained earnings relief, and would seek to lower its "cost" by phasing it in over several years and building in an automatic "sunset" provision. Our **White House** contacts suggest that this is the **Bush administration's** preferred solution, and that they believe it would have more powerful pro-growth effects than the Thomas plan. We think this is a mistake. First, history teaches that phased-in tax-cuts create perverse incentives -- smart economic actors defer economic activity in the present, waiting for the expected lower tax rates in the future. And second, phased-in and automatically expiring tax rates increase the instability of the policy backdrop against which economic actors make decisions. Those are both very bad attributes at a time when the economy is struggling to pull out of recession and to renew its willingness to bear long-term risk.

What's worse, even Senate leadership's watered-down version of dividend relief seems to be getting no traction in the Finance Committee. A *Wall Street Journal* story this morning suggested that Grassley is willing to "leave it aside" altogether in favor of more "popular" elements of the plan. There remains the risk of a worst-of-all-worlds scenario in which the most pro-growth elements are sacrificed for the worst.

- The Thomas plan has made the right trade-off. It realizes "cost" savings by building in automatic expirations of the least pro-growth provisions of Bush's original plan, and that's just where the sacrifices should be made. The "kiddy credit" increases, the widening of the 10% bracket, and breaks for married couples would all expire in 2005. A sure sign of the extent to which the Thomas plan has effectively kept the pro-growth baby and thrown out the populist bathwater is the hue and cry from the media and liberal think tanks over the weekend that this plan is even more skewed to the benefit of "the rich" than Bush's.

The next step is for the Senate Finance Committee to pass its version of a bill -- and then it's really crunch time as the House and Senate come up with something they both can live with. At this point the reconciliation process may become a clash of absolutes with no logical solution -- the market will simply have to anxiously sit and wait for an illogical one… or a miracle.

At the root of the problem is the failure of Senate leadership and the White House to persuade Senate Republicans of the pro-growth merits of Bush's plan. It's more than just opposition to deficits. It that's all it were, then it would be a simple matter to pass only dividend relief and top rate cut acceleration -- about $350 billion worth of "cost" -- under the filibuster-proof reconciliation process, and leave the rest of the proposed cuts for later. But all indications are that Senate Finance is going to do just the opposite. TM