TrendMacrolytics

Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

MACROCOSM

# Aftermath of a Tax Cut Miracle

Tuesday, May 27, 2003
**Donald Luskin**

**After the dangerous journey to achieving an historic tax cut, can the market let itself enjoy the good news?**

Maybe today the market is finally showing some excitement about the tax bill that **President Bush** will sign into law tomorrow. The bill includes tax cuts that significantly enhance the economy's long-term growth prospects, and should therefore be an immediate boost to the stock market. So why has the market been so slow to react to the good news? Or has it *already* reacted -- is *this* all there is?

Efficient market arguments and a little empirical evidence suggest that the market may well have already discounted for at least the first-order "windfall" effects of the tax cuts. We estimated in January that the total and permanent elimination of the double taxation of dividends would have caused a re-equilibration of stock prices boosting the value of the S&P 500 by about 15% (see "Assessing the Tax-Cut: Part 1 -- The Dividend Windfall" January 22, 2003). The final version of the bill, however, caps dividend taxes at 15% through 2008. As we pointed out last week, depending on how seriously the market regards the 2008 sunset provision, the re-equilibration should be somewhere between 4% and 8% (see "Another Quarter, Another Crisis?" May 20, 2003). Considering how far the market has come since the March lows, and the breakaway in the high-dividend utilities sector over the last week, there's reason to think the re-equilibration may have already occurred. At the low end -- 4% -- it's noise, anyway.

So the real question is whether the market is properly assessing the *long term* effects of the tax bill. In that domain there's certainly room for a strong argument that the market has not yet come to appreciate just how pro-growth these new tax cuts really are.

Consider, as a rough proxy for the mind of the market, the reaction in the media over the last several days. The most prominent accounts treat the tax cuts as somewhere between a disappointment and an economic disaster. Some reporters have stated, as though it were a fact, that the 2008 sunset provisions on the dividend and capital gains tax cuts will cause economic participants to treat the tax cuts as merely temporary, so they will fail to create long-term supply-side incentive effects. Other reporters have stated, also as fact, that the tax cuts will undoubtedly be renewed before their sunsets, leading to an unbudgeted balloon in federal deficits from 2009 onward that would exert a chilling effect on growth. Temporary cuts or permanent cuts, you just can't win.

We believe that the market is a lot smarter than the media, so if the tax cuts are a lot more pro-growth than the media is giving them credit for, we'd expect the market to eventually sniff out the truth. But what is *truth* -- and when is *eventually*?

With respect to the deficit issue, we have a deeply held -- nearly axiomatic -- conviction that any reduction in the tax burden on investment capital will lead directly and multiplicatively to an increase in long-term economic growth, and that increased growth will swamp any short-term deficits. But we cannot fail to recognize that this is simply our opinion, and that many successful

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Stamford CT

Phone:
650 429 2112
973 335 5079
203 322 1924

market participants seem to completely disagree with us. Market prices will reflect some kind of average of our view and theirs -- and no doubt others, as well. As we are proven right over time, when economic growth accelerates and today's rampant deficit-phobia recedes (or as more investors come to our views, which could happen sooner), market prices will adjust upward. As ever, it's a matter of being right and daring to bet against an average consensus that initially disagrees. Nothing new about that -- we're not afraid to reiterate what we've said all along: these tax-cuts set up the economy and the stock market for some *very* nice upside surprises over the coming months and years.

With respect to the sunset issue, we have some sympathy with the more pessimistic elements of the consensus -- although not precisely for the reasons given by the hysterical media. 2008 is a long way out, and our sense is that a sunset deferred that far into the future probably converges with the background political uncertainty that always attends any provision of the tax code anyway. In our view the problem isn't 2008 *per se*, but rather the political uncertainty itself. The sad fact is that we live in a time when political uncertainty is very high, thanks to the razor-thin hanging-chad margin of control that can be effectively exerted by President Bush. In this kind of environment -- tax cut or no tax cut -- it's difficult for economic actors to make long-term plans and take long-term risks.

Getting these tax cuts enacted was a miracle. We steadfastly urged clients to "bet on a miracle," but at every point along the way it *seemed* out of reach. The legislative process was mired in arcane budget rules that made it functionally impossible for legislators or citizens to grasp the true value or cost of the tax cuts. The **Bush administration** never made public its own research on this, and instead varied its public messages wildly, seemingly in response to whatever criticism the opposition had most recently mounted -- sometimes the story was tax reform, sometimes supply-side incentives, sometimes building consumer demand, and it finally devolved into that horrible slogan of the welfare state, "putting money in people's pockets" (see "Self-inflicted Damage in the Tax Wars" April 30, 2003). In the end, it was only clever budgeting workarounds and the shock-and-awe application of President Bush's personal political capital in the home states of senators with swing votes that did the trick.

So after all that, it's no surprise that the market would have some trepidation in accepting the good news. How good would you feel if you had been a passenger on a flight from New York to Los Angeles on which one wing fell off at take-off and you lost an engine over the Rockies, and during which the pilot acted as though he had no idea where he was going -- but you nevertheless landed safely and on-time in LA? You'd be thankful for the miracle, but you'd stumble into the terminal at LAX swearing you'd never take another flight. But... over the coming days, you'd tell the story of your miraculous flight to all your friends (probably embellishing it to make it seem all the more miraculous). The fear would turn into a kind of pride (what doesn't kill you, strengthens you). And just when you started to run out of people to tell, it would be time for another business trip -- and what do you know? -- you'd find yourself looking forward to that flight.

Nothing will make the market act as though these tax cuts were the work of a stable pro-growth political consensus. But the dismay at the ugliness and riskiness of the process *will* wear off -- and the market should come to appreciate, more than it does today, that the tax bill contains even better pro-growth incentives than those contemplated in the President's original proposal. Yes, somehow this sausage factory managed to produce filet mignon.

Bush's original proposal called for complete elimination of taxation of dividend income at the individual taxpayer level, and the final bill instead only caps dividend taxes at 15%. But the final bill has features that more than compensate.

- The final bill does not limit the amount or character of dividend income qualifying for tax-advantaged treatment, as Bush's original proposal did. The issuing company needs not limit the dividend only to the extent of earnings that had already been taxed at the corporate level, nor to earnings booked subsequent to the tax bill. So a company that pays no corporate taxes or that has no earnings at all could still pay a tax-advantaged dividend. This means, first, that lower taxes on dividend income for individuals will not trigger higher taxes for corporations (because corporations will have no incentive to pay more corporate taxes simply to be able to pay out more tax-advantaged dividends). Second, companies with large cash hoards such as **Microsoft** and **Cisco**, or smaller technology companies still long on IPO cash but now short on business prospects, can now return that cash to shareholders through dividends with a far smaller tax burden.

- The final bill cuts the top tax rate on capital gains from 20% to 15%, something that was not contemplated at all in Bush's original proposal. Trading about half the originally planned dividend tax cut for a 25% cut in capital gains taxes is an excellent deal. A capital gains tax cut is a direct incentive for fundamental entrepreneurial risk-taking, a targeted reward for the kinds of investments that produce non-linear increases in expected wealth. Also, the lower capital gains tax rate creates another incentive for cash-rich companies to return idle cash to shareholders, through open-market repurchases. For technology companies this may be a preferable route: paying large dividends would diminish the value of outstanding employee stock options, while repurchases would both enhance the options' value and would soak up dilution arising from the options' issuance.

The answer to the question posed at the outset -- is *this* all there is? -- is *no*. There's lots more.
TM