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Bush into the Breach: using the wealth effect to resolve policy conflicts

- ?? The recovery from this recession has been troubled by imbalances in the household, business, and foreign sectors. Maybe the Bush tax plan should be seen as an attempt to deal with the three imbalances directly via the wealth effect?
- ?? While the Fed doesn't target asset prices, this tax plan can be understood as a direct attempt to move the equity market and thereby resolve sector imbalances.
- ?? Expectations play a key role in analyzing the impact of policy changes. Economic theory will be tested by this tax proposal because of its reliance on changed expectations.
- ?? "Don't fight the Treasury!" Is this 2001 déjà vu with fiscal policy playing the role of the Fed?
- ?? Implications for Investors: some short run and long run concerns

Whatever the final verdict on this Administration (which won't be known until November, 2004), no one will be able to say that Bush II fails for lack of boldness. This was hardly predictable in the contested election of 2000, but as we have seen in Foreign Policy, this Administration is bold. The new Bush tax proposals are also bold, almost beyond belief. While the full set of proposals will not be known until the President's speech on January 7th, several aspects of the plan are quite remarkable: size, orientation and timing.

Size: Rather than a $300 Billion tax relief package (over a ten year horizon), the Administration appears ready to propose a$600 Billion tax package, centering on the **full** abolition of the taxation of dividends. At this juncture, it was unclear whether this remission would be at the corporate level (by granting a deduction for dividends comparable to the interest deduction) or by relief at the individual taxpayer level. While most professional economists would argue that relief at the corporate level would be preferable, the magnitude of the proposal is impressive. The package will also contain acceleration of tax reductions at the individual taxpayer level already scheduled for 2004 and 2006 into 2003, including the child credit raise to $1000/per child. Additional tax relief may come from reducing the marriage penalty. How big a fiscal impact will this amount to? While no one knows for sure, a disproportionate amount may come in 2003/2004, perhaps more than a $100 Billion.

Sectoral Impact: This package has both demand and supply side effects. The latter may be the more important. The **direct demand side effects** will be limited by how the dividend tax relief is implemented since the effects are sensitive to the income distribution. Since more is saved at the upper end of the income distribution than the lower, and upper-end incomes generally receive most of the dividends paid to households, some will argue that per dollar's impact on the Federal Budget, there is far less of an aggregate demand kick than a comparable Federal deficit that winds up as direct relief to the lower and middle portions of the income distribution (e.g. by remission of payroll taxes).

No one would deny the relevance of politics in this argument, but maybe the Bush planners are looking a bit deeper? The **supply side effects may be the real focus of this plan**, because much of this tax plan seems to be directed at **offsetting the past three years of equity declines**. By improving the net of tax dividend return, any stream of future dividends is worth more. Therefore, some stock prices must rise. Substitution effects between stocks with different dividend returns will no doubt raise other equity prices, even when the corporation has not yet paid dividends.

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A rising equity market has some striking implications for aggregate demand but it also may have a positive impact on corporate governance issues that have so haunted us recently. (Think of what this might do for a Microsoft or a Cisco or other companies with large cash hoards that currently find less than totally appetizing uses for their cash hoard! What will shareholders demand? This raises the issue of who really controls the corporation, doesn't it?). Bold indeed.

Longer term, surely leveling the playing field between debt and equity will have beneficial effects because it will reduce the benefits of corporate financing through debt and perhaps improve conditions on the equity side. Since one of the 'imbalances' frequently cited as a barrier to ending this torpid recovery is reducing corporate debt-equity ratios, the tax plan may well have additional positive impacts on investor attitudes toward equities. And, we have not even delved into issues of corporate credit spreads! There is more here than meets the eye.

Foreign Sector Impact: Another overhang said to have created a "headwind" for this recovery is the rising current account deficit (as a percentage of U.S. GDP). This has induced some fears about where interest rates will have to settle going forward, but in the short run, it has led to a demand to change the U.S. "strong dollar policy." This overhang reflects the inherent problem of trying to use the exchange rate as an aggregate demand management tool. If the U.S. exports 'too little' and imports 'too much,' the growing imbalance on the current account side is said to be a threat to long-term interest rates! But a direct incentive to raise the equity market can be a significant offset to this headwind. While it may be true that many foreign investors in U.S. equities may escape taxation of dividend income, most of them should be attracted to a rising equity market. Thus, the Bush tax proposal could well have positive effects for the dollar, in spite of a rising current account deficit, or at the least, mitigate the potential for rising long-term rates. If the rise in long-term rates could be delayed, and rising aggregate demand here at home expanded the current account deficit, this could well be positive for world economic growth. Many other countries find their policy apparatus thwarted by their domestic politics and their last resort in aggregate demand management is to rely on export-led growth as a fall back, policy position. In the short run, the U.S. might not like the implications for financial reform in Japan, but there is some gain from a more zesty Japanese economy, albeit it is led by exports.

Investment Demand: While the dividend tax remission is largely a 'supply side' measure, it also has some demand side impact, through the operation of the wealth effect directly on the spending of consumers and by induction, on the spending by business. A rising equity market may well change managerial expectations as to what 2003/2004 may look like and as a result alter investment spending going forward. This is an untested sea on which to sail, but conceivably, the prospects of more spending power in the household sector may unlock some currently tabled investment plans and revive capital spending more quickly. The over-dependence upon the consumer in this recovery has clearly worried many analysts and policy makers. A rising stock market can work positively for both consumer spending and indirectly on investment spending. One doesn't need to reach for the Laffer curve to motivate this argument, since it is possible for the budget deficit to grow and the economy expand at the same time. A positive wealth effect will be like a little '*kickapoo*' joy juice. It can only work to improve some animal spirits.

Importance of Expectations: Forgetting about whether this plan will get through the Congress intact, or seeing it only as an opening chip in the game between Republican and Democrat tax alternatives, what strikes one is the potential, direct stimulus to expectations. There is a certain irony here, because it is often said that the power of a Central Bank to influence the economy comes from its power to influence expectations. Wouldn't it be interesting if Fiscal Policy's impact was a largely, parallel impact on expectations. One currently expressed fear to recovery in this business cycle is that the consumer is getting stretched and has been kept in the game only through heroic policies by the Fed to lower short-term rates. In a best case scenario, the direct impact on equity prices stemming from such a policy might well "loosen" financial conditions and allow the Fed to begin the process of interest rate normalization without throwing the economy into a tail spin. This is

conjectural, and if the truth were known, economic theory is really not very good at predicting how expectations will change as a result of a policy change. Expectations are said to count, but we have trouble mapping them. We might get the direction, but putting a reliable metric on the impact is not yet within our capabilities.

Nearly all short-run stabilization models are framed for flows, not for asset price impacts, but the asset price impact could eliminate some of the well-known policy contradictions. Working on the 'capital account' by influencing expectations is unusual policy, but there may indeed be a case for this plan. Because of its distributional consequences, this plan will be a hard sell politically. Maybe the real issue is not the distribution of benefits, but the impact on equity prices. That will be determined in the markets where equities are traded if the politicians allow this proposal to pass. Can this create a self-fulfilling prophecy, a new virtuous circle? In principle, yes, but in fact no one really knows. We are sailing on un-chartered waters.

Short run impacts on equities and longer-term considerations: There is a certain ***dejá vu*** quality to this aspect of the current fiscal proposals. Consider the first weeks of 2001 when the Fed made a 50 basis point cut and the equity market took off early in January? Post hoc, we have reasoned that portfolio managers operated under the proverbial maxim "Don't fight the Fed!" In fact, the effects were strictly short run, largely because, we believe, the underlying collapse in investment demand was so pervasive. Sooner or later, it took down corporate earnings across the board. The Fed's continuation of an aggressive monetary policy probably kept the economy from going into a typical, post-investment boom liquidation phase, but it took time to revive consumer spending on durables and for the 're-fi' boom to catch fire. Since then, the market has suffered from a long period of re-valuation of growth prospects with consequent impacts on multiples. The Fed could stem the tide, but not entirely reverse it immediately. The real economy has performed much better than the asset markets that are supposed to reflect the real economy.

In the short run, if this tax proposal is characterized by its impact on valuation, this could be a powerful offset to the downdrafts through which the equity markets have proceeded. Earnings may not grow as fast as hoped, but on an after tax basis, they will be worth more! At the least, it is another 'stopper,' and it may indeed have more fortuitous consequences for equities as an investment class.

In the long run, by permitting debt-equity ratios to come back into historical balance, it may also mean that risk will be re-evaluated, allowing some credit spreads to be reduced. Again, this has a powerful investment spending implication. This is true, supply side economics, but the focus is on its consequences for asset prices.

Conclusion: The boldness of the Bush plan lies in its size, its focus and the channel through which it can have major impact on the economy. Undoubtedly, the political debate will be over distribution, but the economics suggest that the argument ought to be about its supply side impacts and the implications for equity prices. Directionally, it is correct. Magnitudinally, we cannot be sure. The real game begins tomorrow and it is all in the presentation. We think that is what is worth watching, but equity traders should think deeply about how this process could unfold. Whether the Bond Market Vigilantes will now put pressure on the long end is an interesting question? If the equity market is revived, some of the predicted tax short falls may be considerably less than now forecast. It's all about the Wealth Effect, Stupid!

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