AMERICAN
SHAREHOLDERS
ASSOCIATION

# The Economic & Fiscal Impact of the 2003 Tax Cut

**April 2007**

**Daniel Clifton**
**American Shareholders Association**
**202-549-7803**
**dclifton@americanshareholders.com**
**www.americanshareholders.com**

# Overview

- **President Bush signed into law the economic growth and jobs tax cut package which:**

1. Accelerates scheduled income tax rate reductions
2. Increases small business expensing/depreciation
3. Equalizes capital gains with dividends
4. Reduces capital gains and dividend rates to 5/15 percent rates.

# Overview

- In the nearly four years since President Bush signed into law the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA), the tax cut has boosted economic growth, investment, equity markets and dividend payments.
- The tax cut had a significantly smaller impact on the deficit than had projected as higher levels of growth boosted tax revenues beyond the “static” estimates.
- Since May 2003, the federal government has cut taxes $383 billion from JGTRRA, WFTRA, FSC/ETI, and TIPA
- Revenues are now $196 billion above the adjusted baseline, indicating 51 percent of the cost has been recouped.

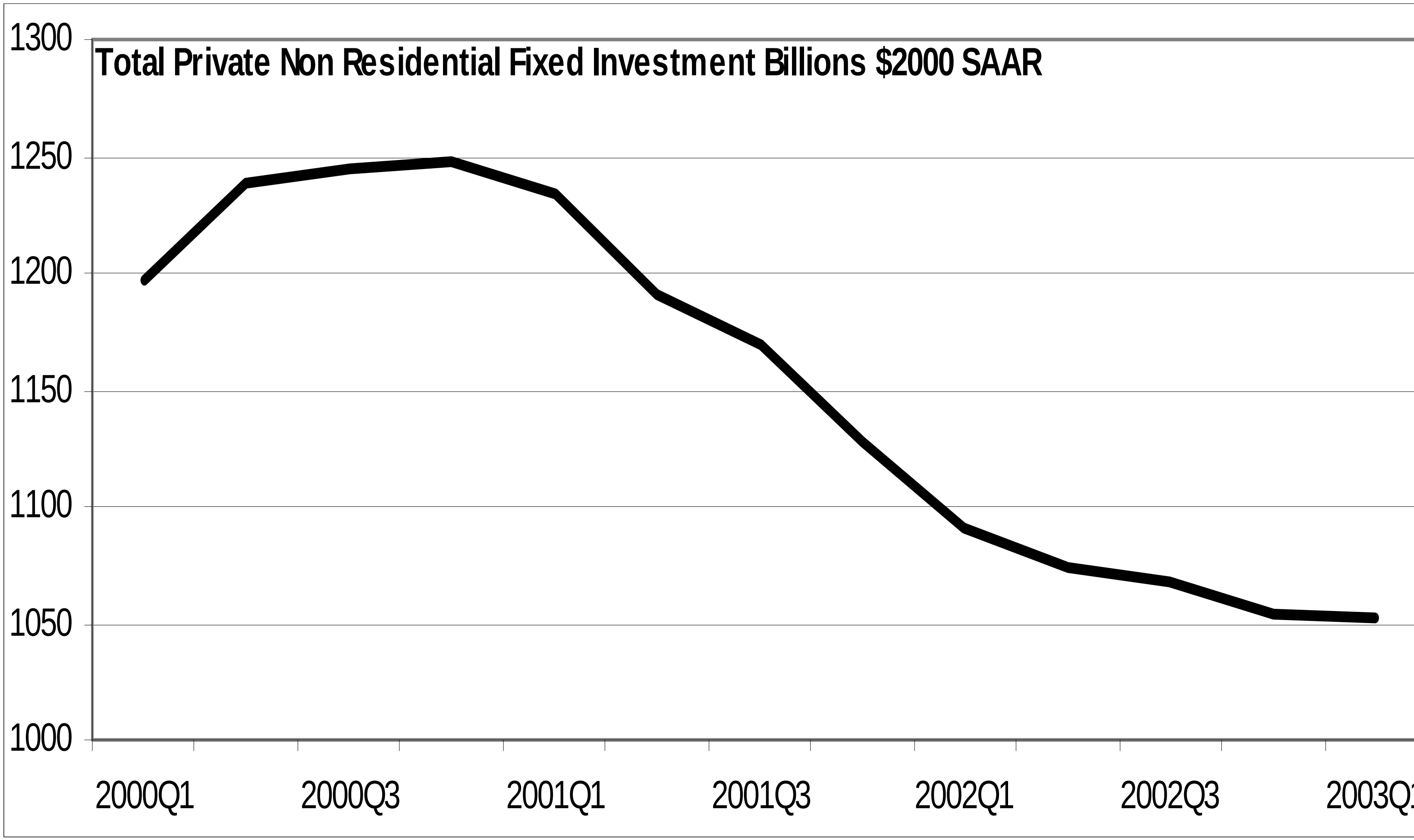
# Overview

- Capital gains tax collections have resulted in a $133 billion gain to the federal government from FY 03-FY 06 above the forecast and combined with the dividend tax cut had a positive effect on tax revenues.
- The federal budget deficit closed FY 2006 at $248 billion, down 18.3 percent since the 2003 tax cut was signed into law.
- The deficit currently stands at $203.5 billion - $101.5 billion lower than before the tax cut was passed into law and we expect the deficit to close FY 07 at $150 billion, roughly 1 percent of GDP.

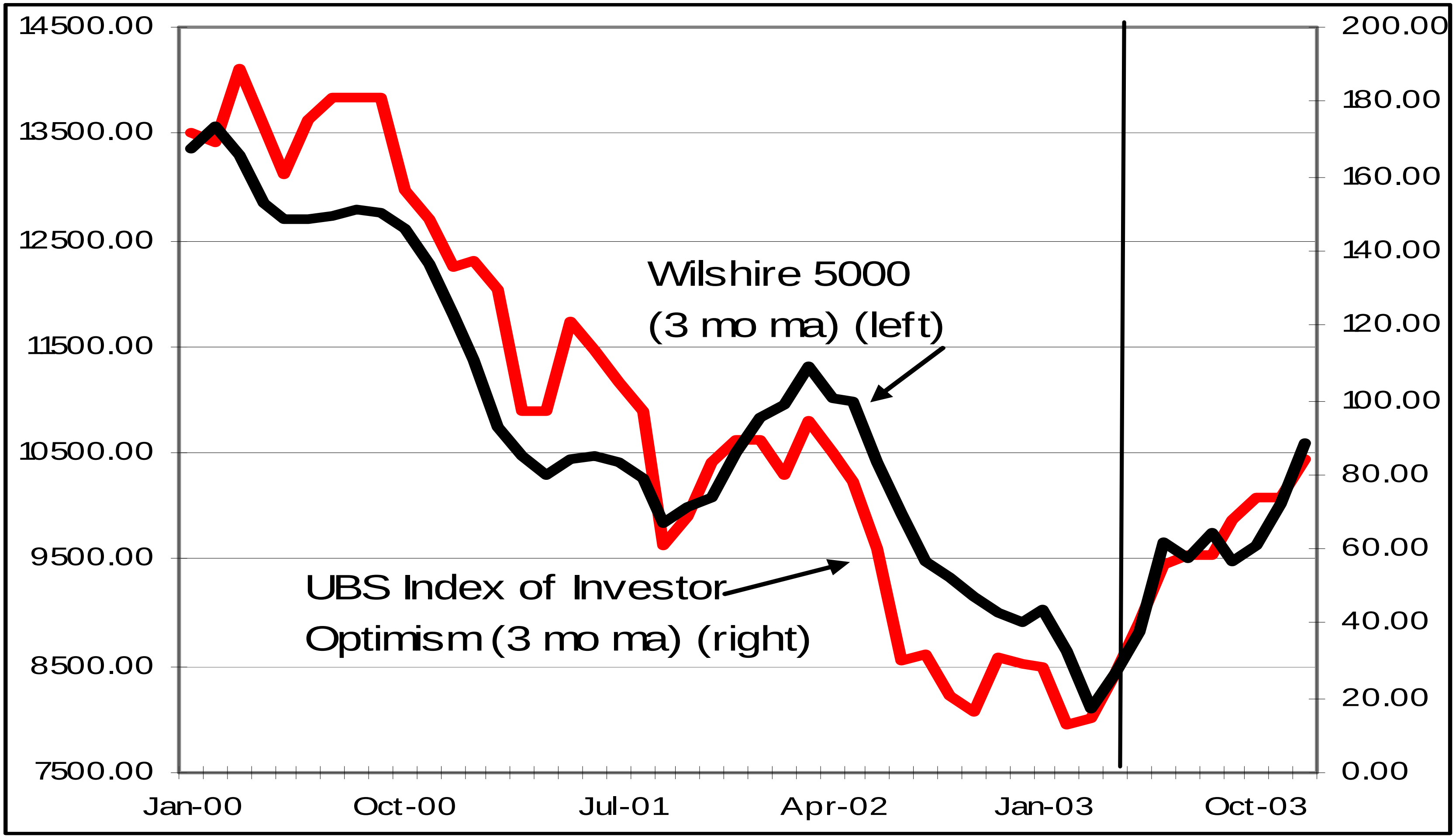
# Pre-Tax Cut Economy

- Economic recovery taking hold, but very slowly.
- Shaken confidence due to geopolitical events.
- Strong consumer spending due to substantial income growth, despite declining wealth.
- Declining stock market which was increasing the cost of capital and reducing wealth.
- Unusually weak business investment w/higher cost of capital, excessive debt facing many companies.
- Strong long-run fundamentals (low inflation, rising productivity).

# Business Investment Crashed



# Investor Confidence & Markets Were Tanking



# Tax Cut Objectives

- Provide support to economy’s short-term risks.
- These risks include delayed business investment, slowing consumer spending, and sluggish stock market.
- Significantly improve long-run growth potential.
- Increase incentives for savings and investment.
- Reform the tax code incrementally.

# Attacking Imbalances

**Weakness In The Economy**

- Business Investment
- Slowing Consumer Spending
- Declining Stock Market
- Jobless Recovery

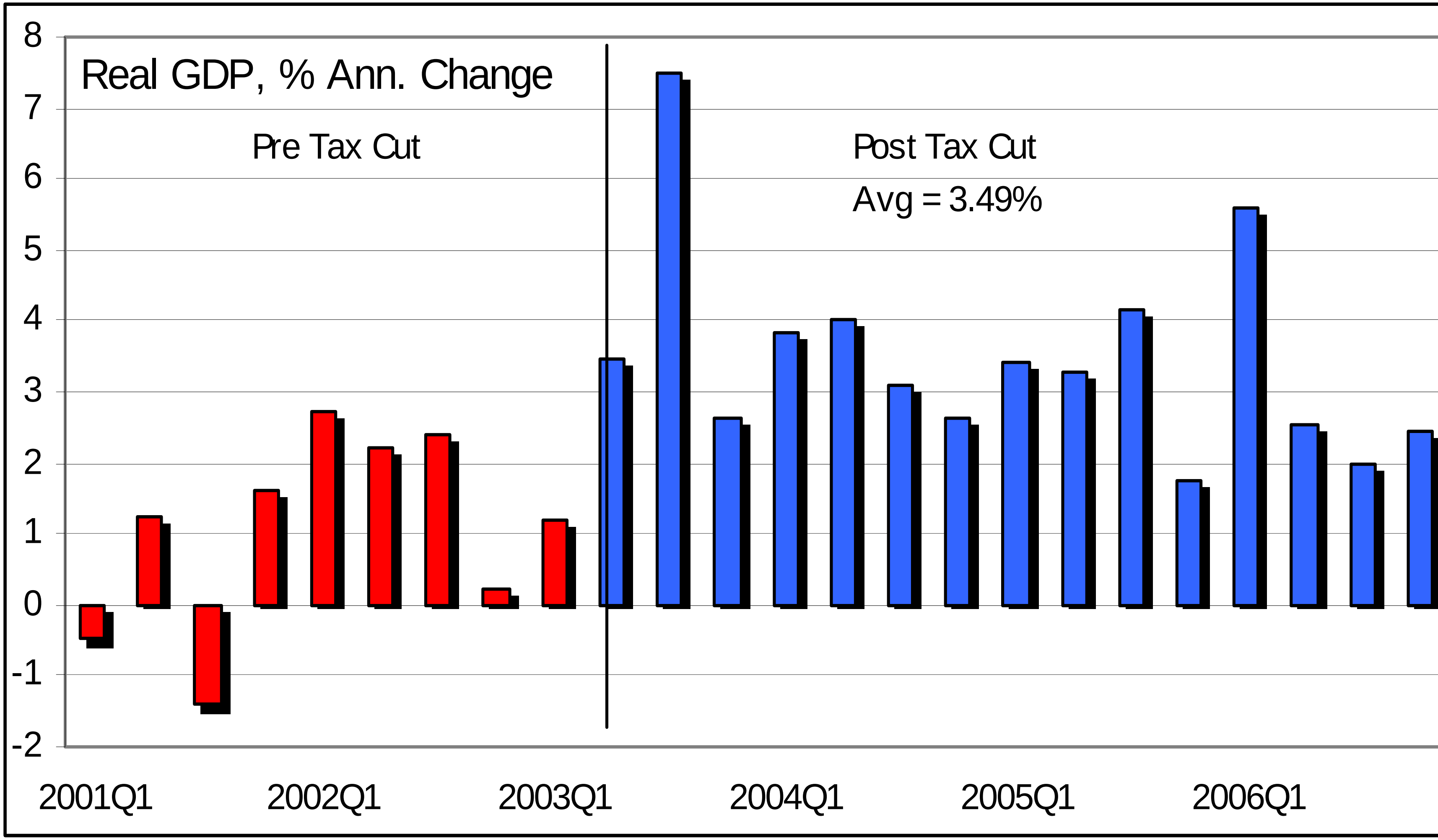
**Remedy**

- Expensing/Depreciation, Rate Cuts, Dividends/Cap Gains
- Rate Cuts, Dividends/Cap Gains
- Dividends/Cap Gains, Rate Reductions
- All

# ECONOMIC EFFECTS

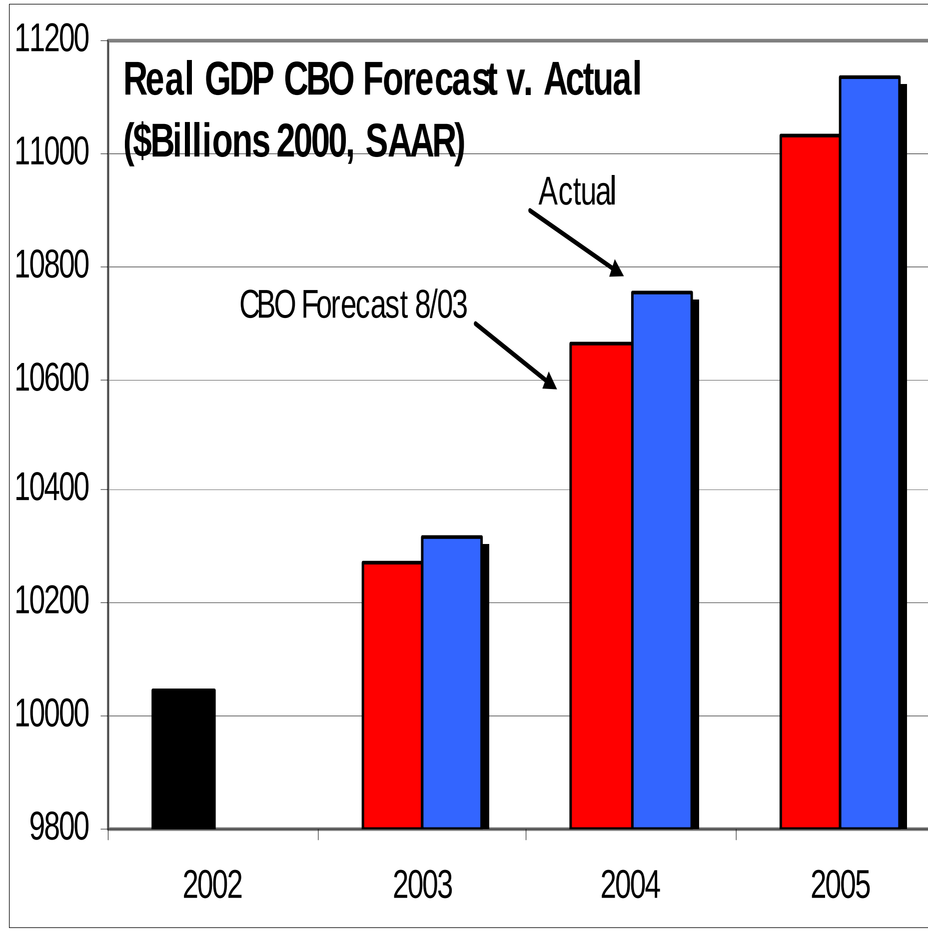
*TAX CUT BOOSTS GROWTH, INVESTMENT, & JOB CREATION*

# Economic Growth Soars

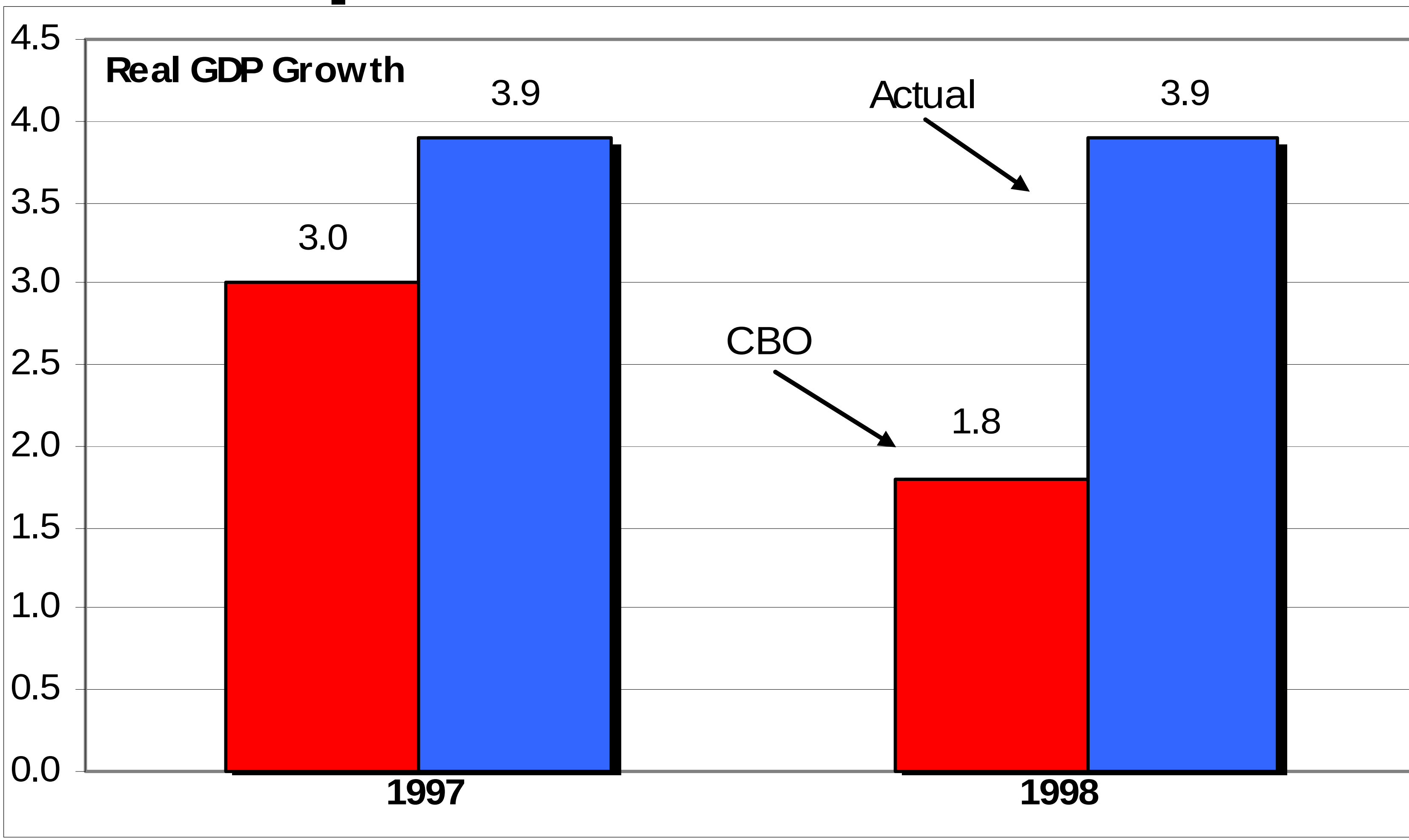


# An Unexpected, Additional $2,000 of GDP Per Household

- Four months AFTER passage of the 2003 tax cut, the Congressional Budget Office (CBO) predicted GDP growth to be just 2.2 percent for 2003 and 3.8 percent for 2004.
- Yet, GDP finished with 2.7 percent growth in 2003, 50 basis points higher than expected.
- 2004 exceeded the CBO forecast by an additional 40 basis points in 2004.
- The 90 basis point difference is a cumulative $247 billion through 2005 or $2,038 per household.

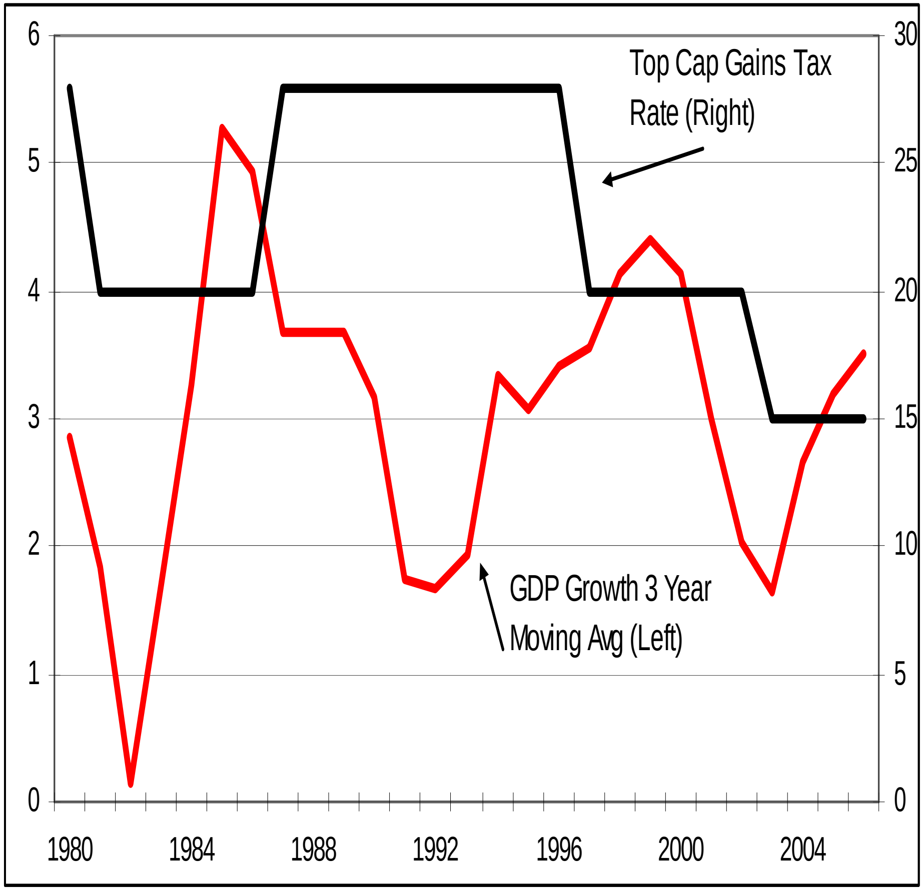


# Similar to the 1997 Capital Gains Tax Cut



# Lower Cap Gains Rate = Higher Economic Growth

- Lowering the capital gains tax lowers the cost of capital for firms to make investments and fund new projects, while providing capital for investors to make investments in new firms and startup businesses.
- Since 1980, the capital gains tax rate has been changed four times, resulting in five different periods. Increases in capital gains tax rates were followed closely by a falloff in growth. Similarly, capital gains cuts were followed directly by often-dramatic increases in economic growth.



# Cost of Capital Reduced 17.4%

- The Treasury Department quantified the cost of capital reduction from lower income, capital gains, and dividend tax rates by measuring the share of an investment's economic income needed to cover taxes over the course of its lifetime (termed Marginal Effective Tax Rate METR). METR in the corporate sector was reduced by 15.5 percent and in the economy overall by 17.4 percent after the tax cut was implemented. This sharp reduction led to more investment and capital accumulation, and ultimately resulted in greater economic growth.

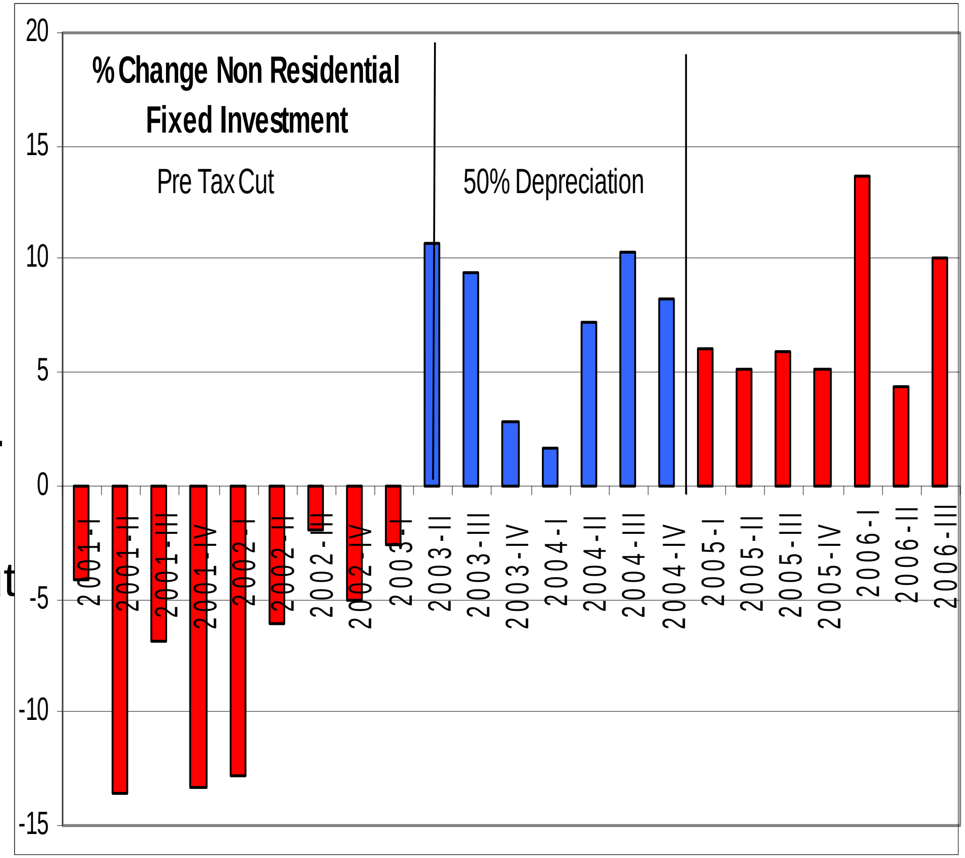
| | Business Sector | | | Owner-Occupied | Economy- |
|---|---|---|---|---|---|
| | Corporate | Noncorporate | Total | Housing | wide |
| Without Tax Cuts | 33.0% | 20.6% | 28.0% | -2.7% | 17.2% |
| With Tax Cuts 1/ | 27.9% | 17.5% | 23.6% | -2.0% | 14.2% |
| *% Reduction* | -15.5% | -15.0% | -15.7 % | +25.9 % | -17.4% |

1/ Includes the effects of lower regular tax rates and lower tax rates on dividends and capital gains income, but not the temporary 50 percent bonus depreciation provision.

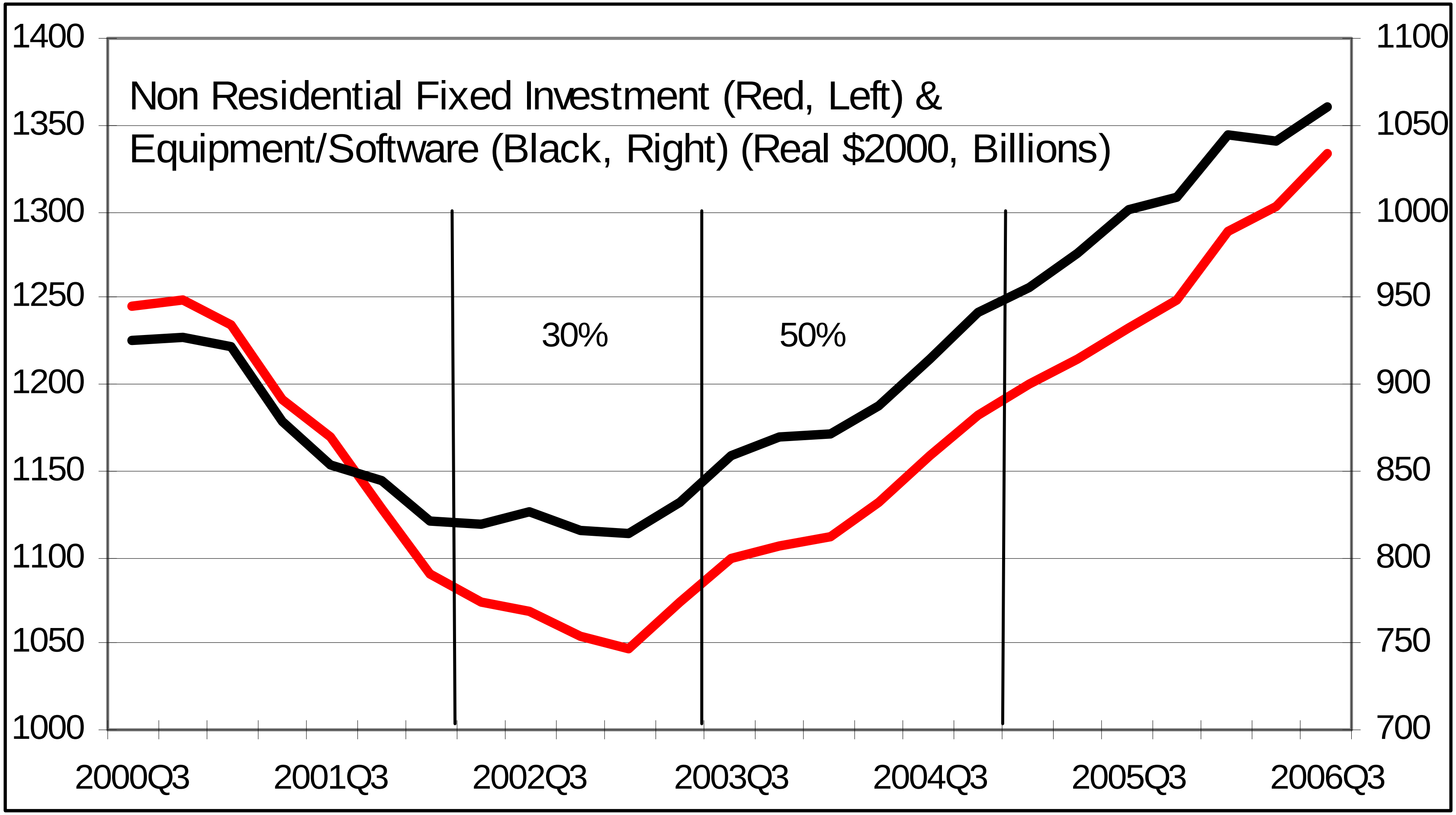
Source: U.S. Department of the Treasury, Office of Tax Analysis

# Lower Cost of Capital Boosts Investment

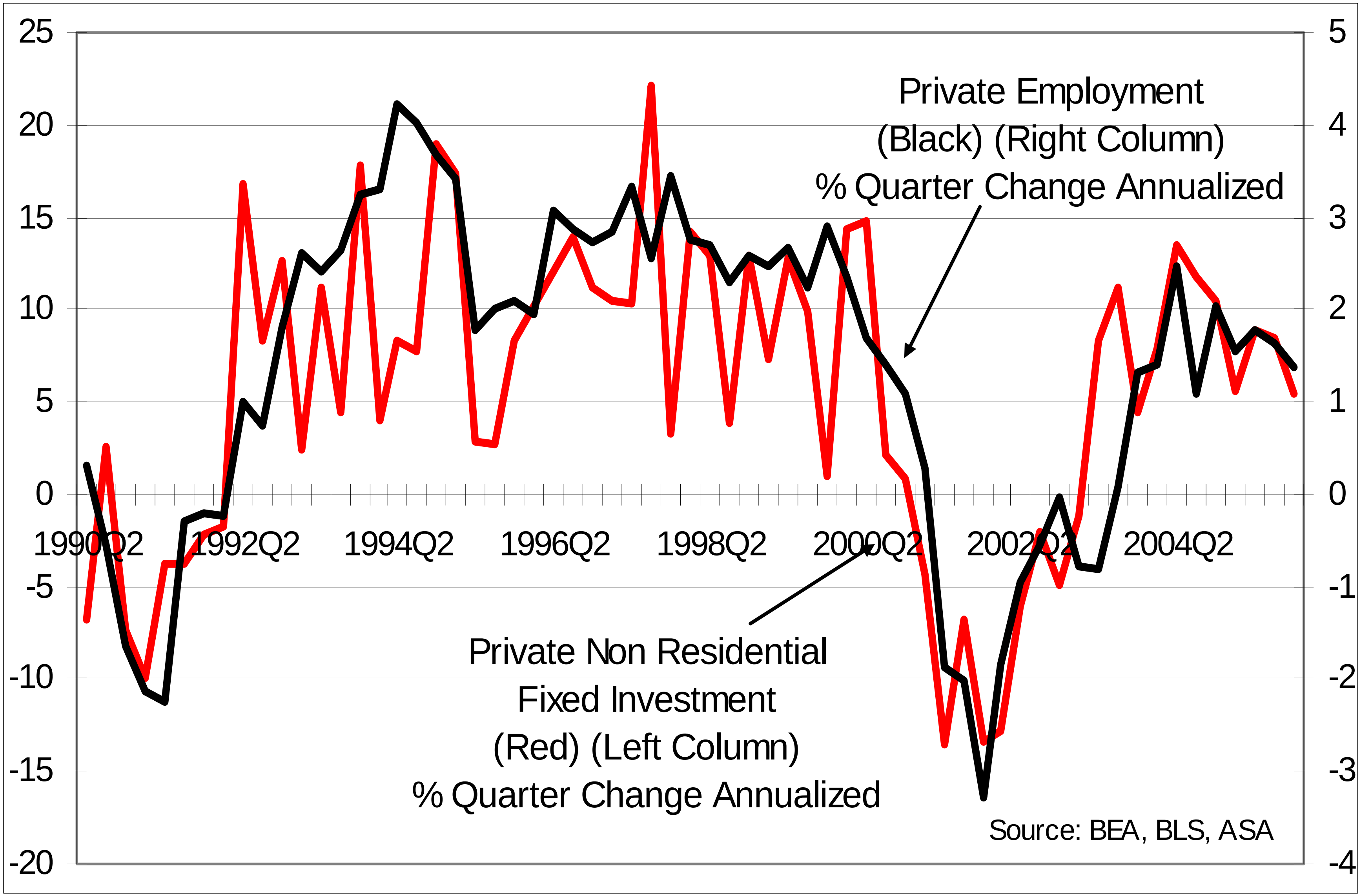
- Business investment spending declined nine straight quarters and was contracting at a 1.14 percent annualized rate over the 14 quarters prior to the 2003 tax cuts.
- The tax cut reversed this effect by accelerating depreciation allowances and a lower cost of capital stemming from income, capital gains, and dividend tax cuts.
- Non residential fixed investment has increased at a rate of 6.7 percent per quarter since the tax cut was put into place, manufacturing output soared to its highest level in 20 years, and factories remained backed up, which is requiring more companies to hire more workers.



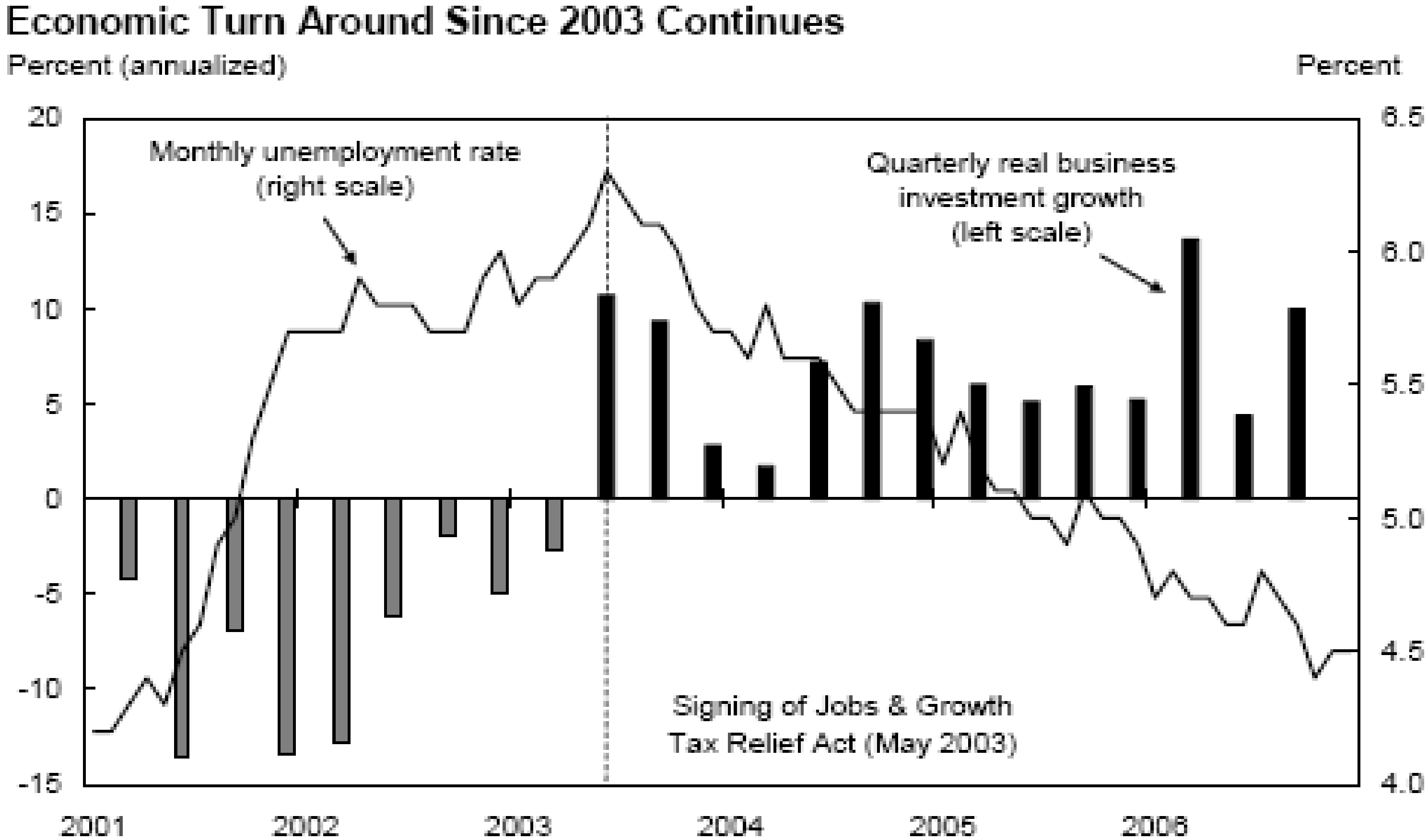
# Depreciation Acceleration Helps End Investment Slowdown



# Investment Spurs Job Creation

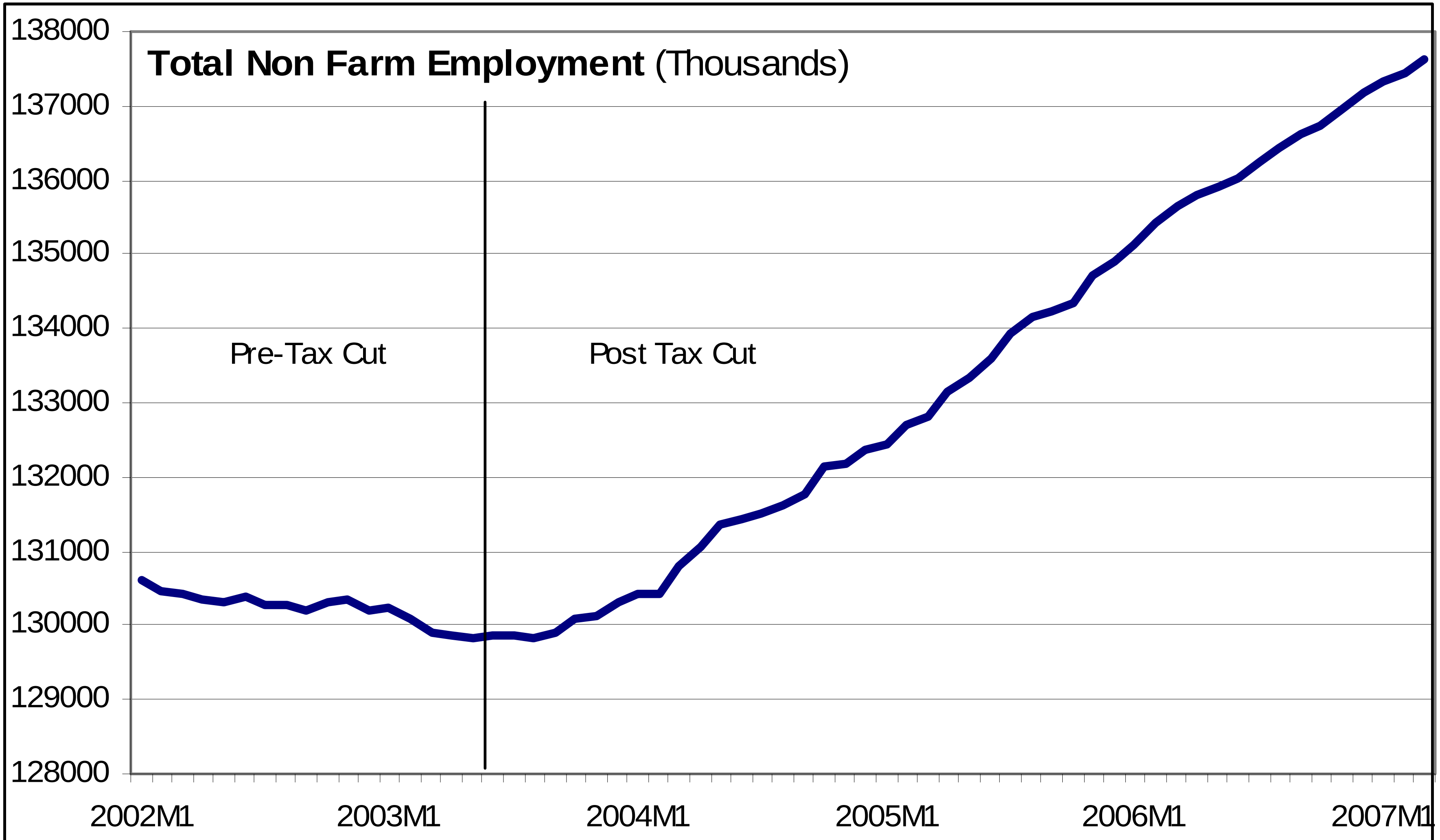


# Investment Up, Unemployment Down



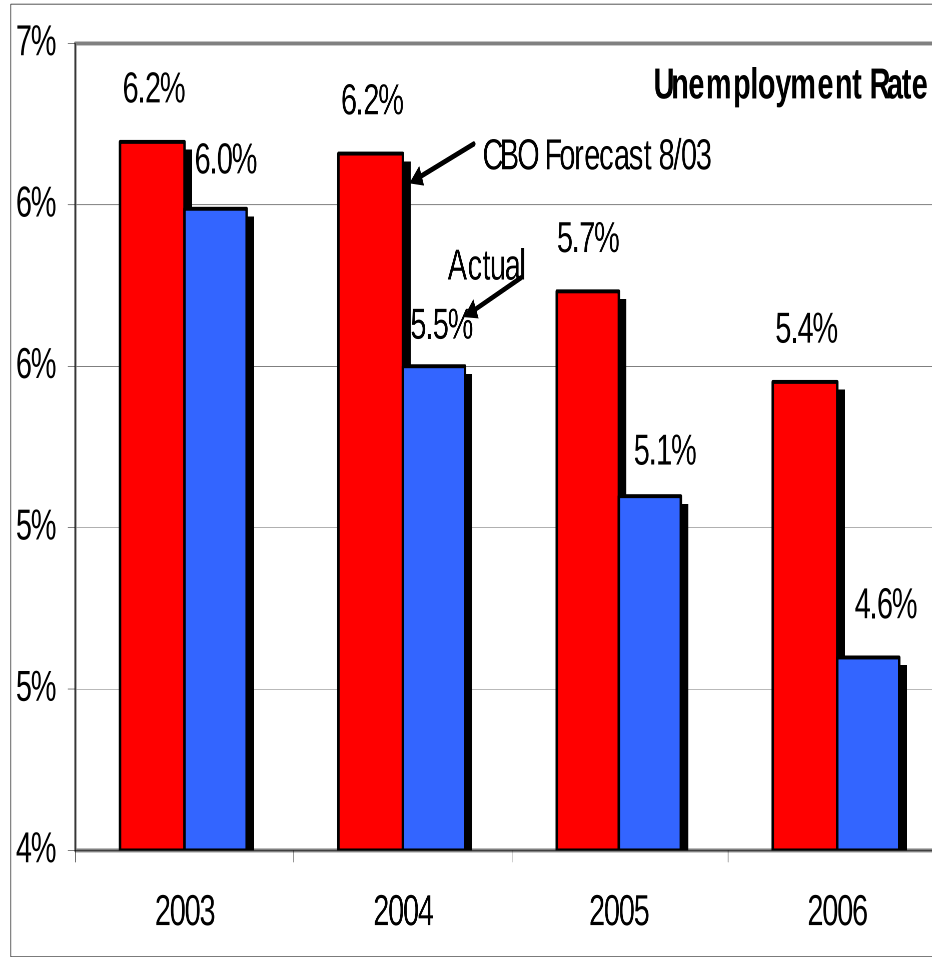

Sources: Bureau of Economic Analysis, Bureau of Labor Statistics.

# 7.8 Million New Jobs

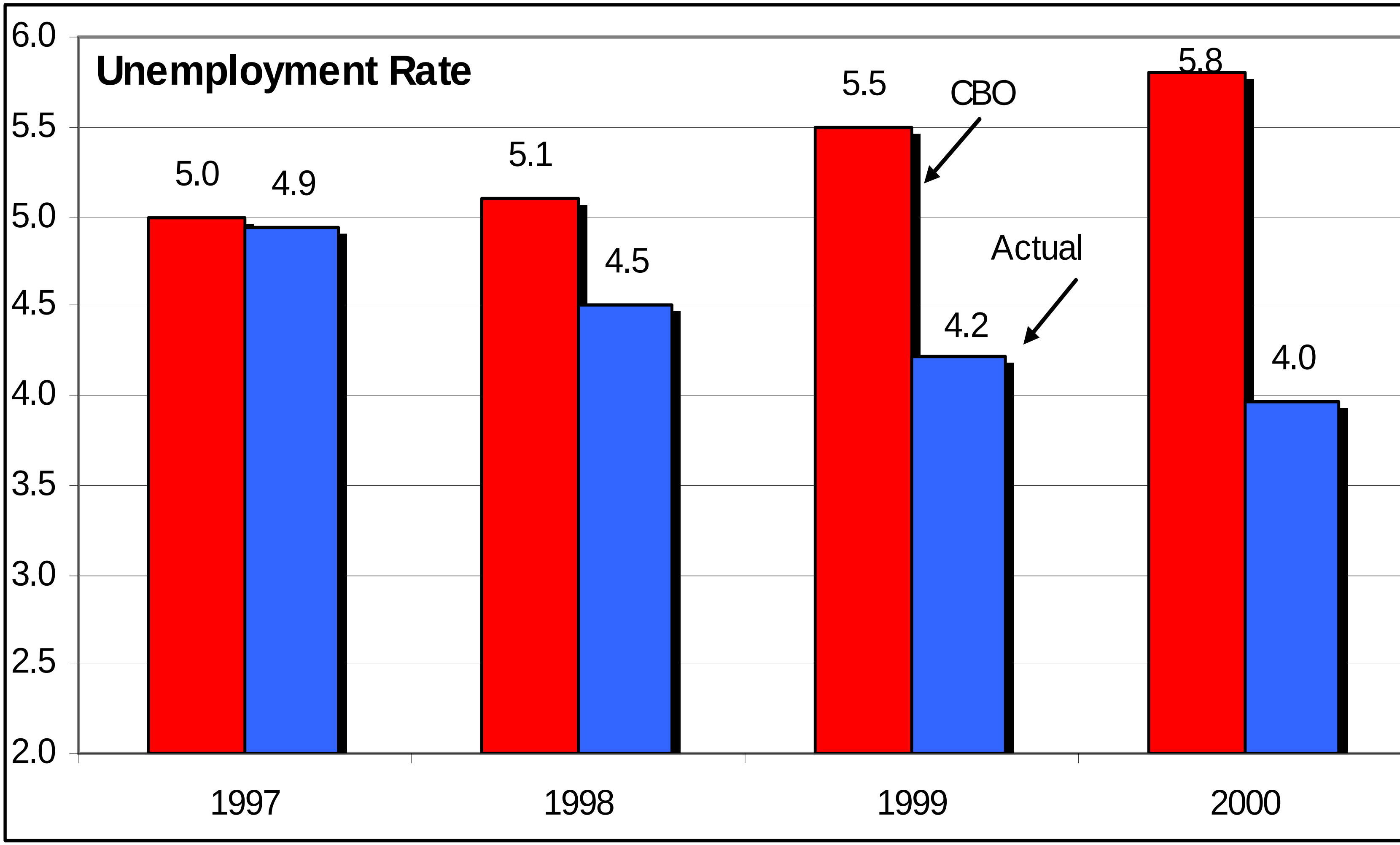


# Unemployment Rate Dropping Faster Than CBO Forecast…

- CBO expected the unemployment rate would average 6.2 percent in both 2003 and 2004.
- The unemployment rate has declined 190 basis points from 6.3 percent to 4.4 percent.
- The unemployment rate finished 2003 more than 20 basis below CBO's forecast, 2004 and 2005 by 60 basis points, and 2006 by 80 basis points.
- With all the added job creation missing from the forecast, the projected tax revenue numbers failed to take into account all the new people working and paying taxes.



# …Similar to the 1997 Capital Gains Tax Cut

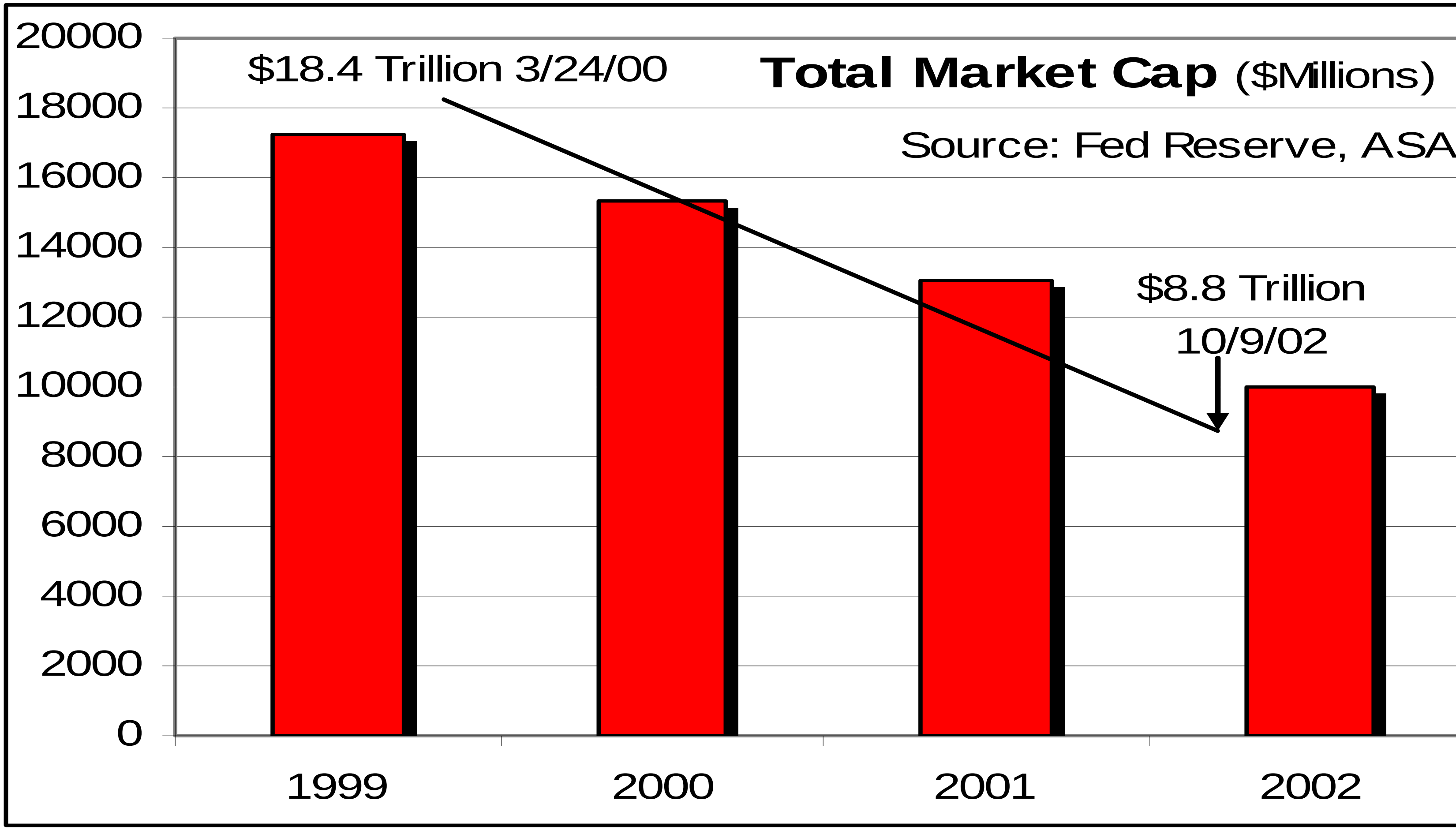


# Wages Are Rising

# STOCK MARKET EFFECTS

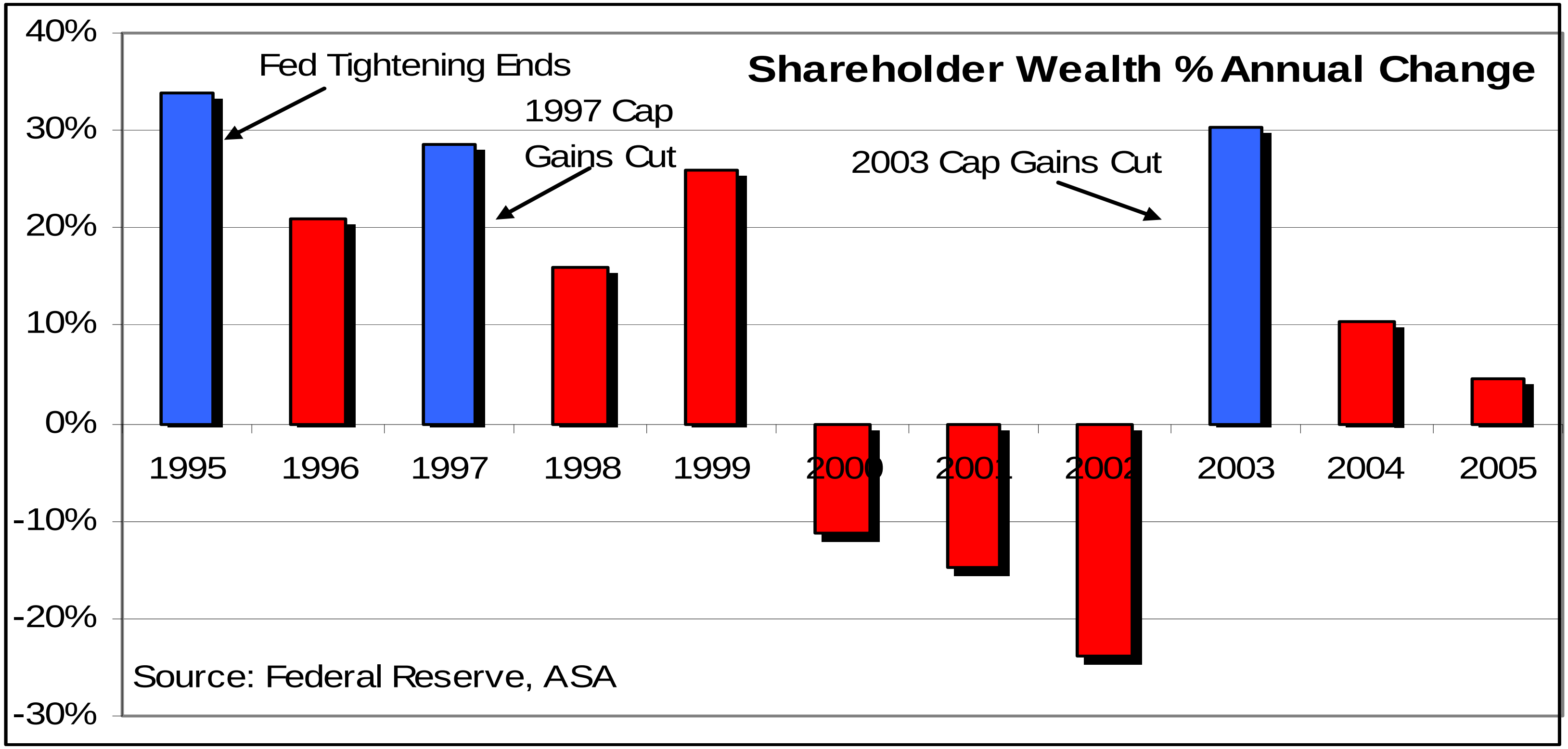
*TAX CUT BOOSTS STOCKS, HOME PRICES, WEALTH, DIVIDENDS, AND CORPORATE GOVERNANCE*

# Prior To Tax Cut, Shareholders Lost $9.6 Trillion of Wealth (52%)



# Lower Cost of Capital Boosts Equity Returns

- Since 1995, the three largest annual gains in shareholder wealth have been associated with cost of capital reductions.
- In 1995 the Fed ended its tightening campaign (33.9%), 1997 capital gains tax cut (28.7%), and 2003 cap gains/dividend tax cut (30.2%).

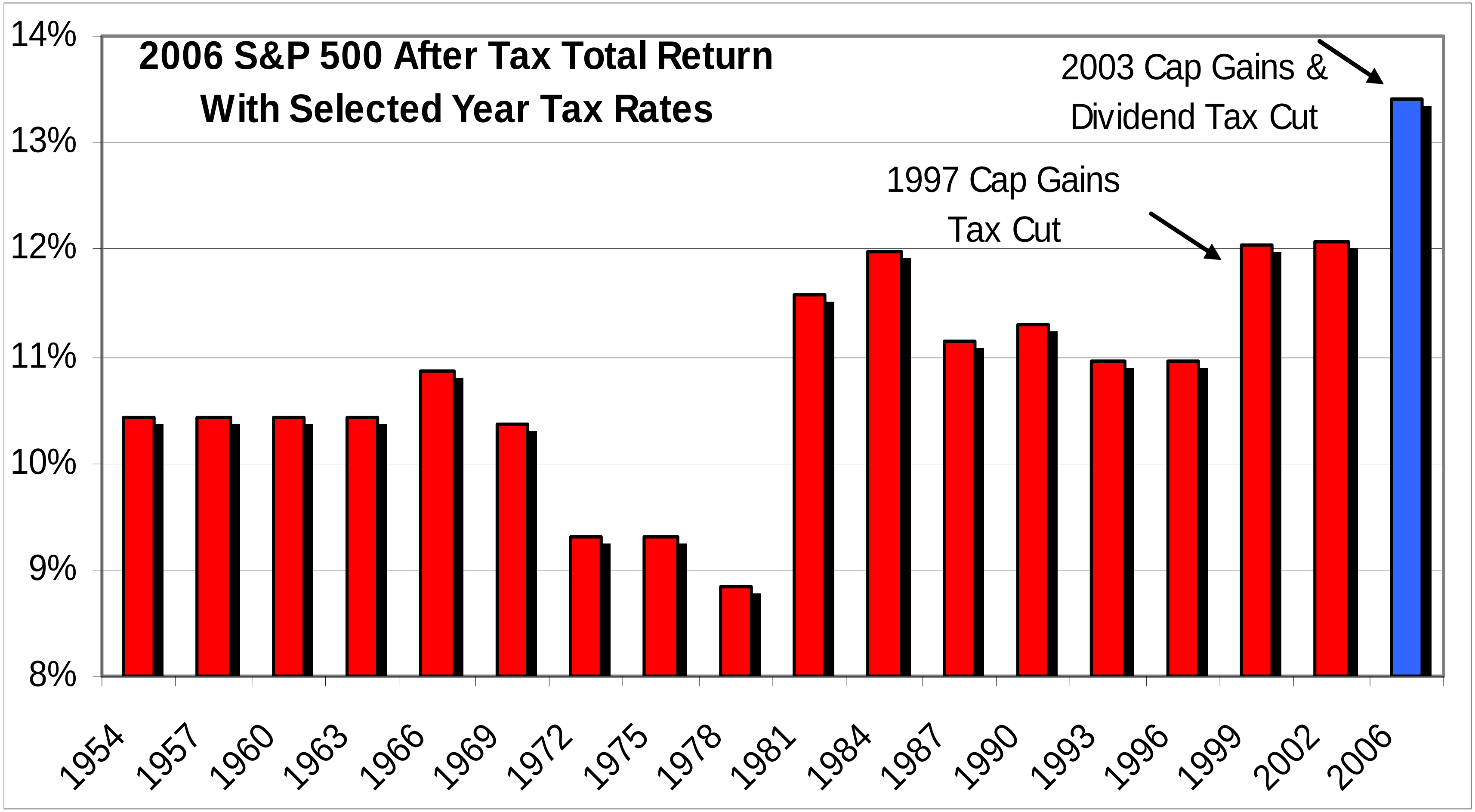


# After Tax Return on Equities Up 12 Percent

- Jason Trennert concluded the tax cut boosted the after tax return on equities by more than 12 percent which makes stocks more attractive to bonds. As a result, more cash flowed into the stock market and pushed equity values higher.
- *Source: Jason Trennert. New Markets, New Strategies: Wealth-Building Habits for Intelligent Investing. New York: McGraw-Hill, 2005, 21.*

| | | Old Tax Code | | | New Tax Code | | | |
|---|---|---|---|---|---|---|---|---|
| | | Return | 1 Minus Tax Rate | After-tax Return | Return | 1 Minus Tax Rate | After-tax Return | Change |
| Bonds | Total | 4.00% | 0.61 | 2.44% | 4.00% | 0.65 | 2.60% | **4.48%** |
| Stocks | Earnings | 7.00% | 0.80 | 5.60% | 7.00% | 0.85 | 5.95% | |
| | Dividends | 2.00% | 0.61 | 1.22% | 2.00% | 0.85 | 1.70% | |
| | Total | | | **6.82%** | | | **7.65%** | **12.17%** |

# Historic After Tax Return for Investors



## BASED ON RATES, INFLATION, AND TAXES, SHOULDN'T MULTIPLES BE HIGHER?

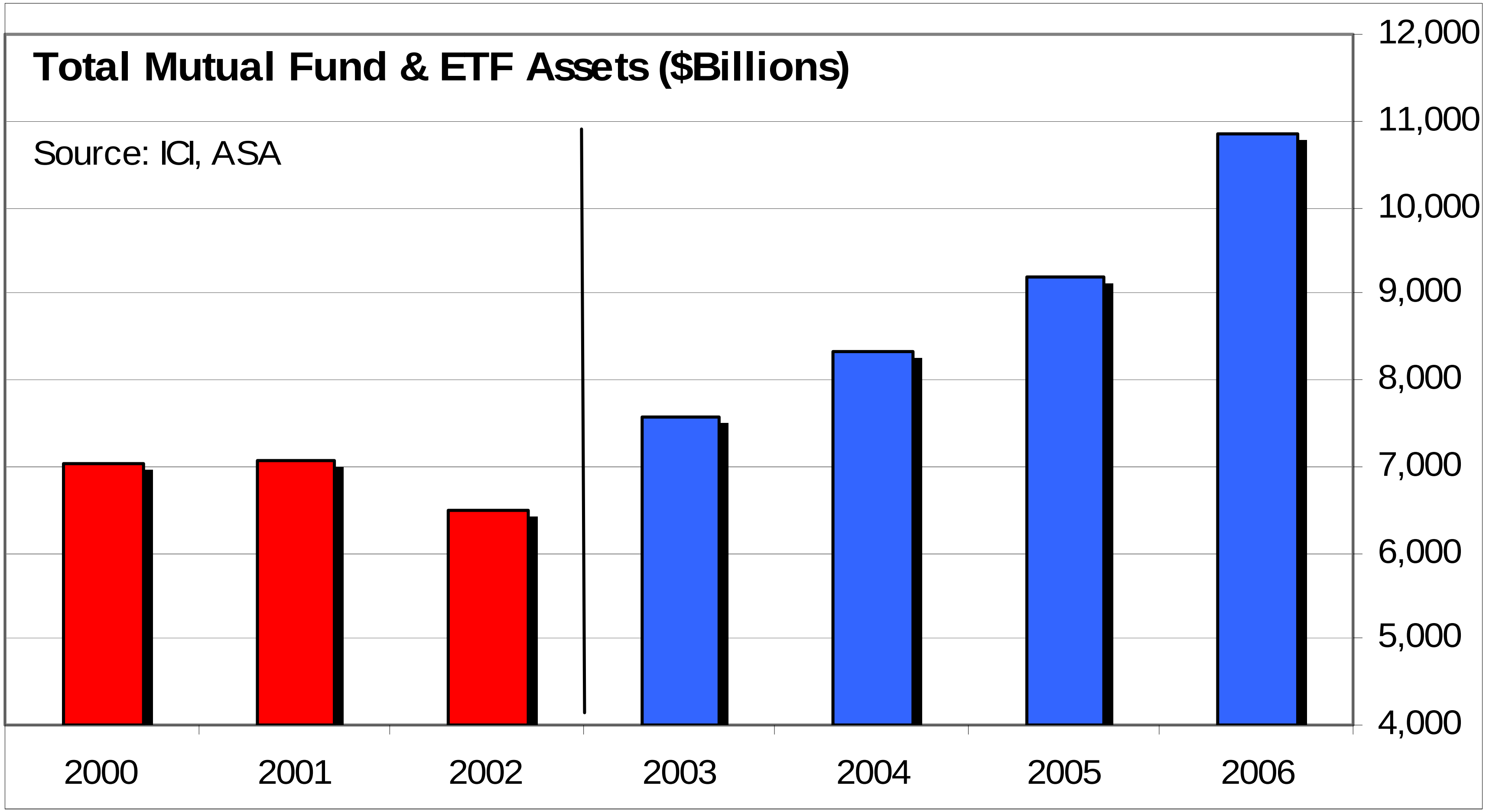
While some market participants might suggest that market multiples are only "average" based on history, a good case can be made that P/Es should be higher than average based on long rates, inflation, and taxes. Over the past 60 years the average 10-year Treasury yield has been 6.3%, the average CPI Q/Q AR has been 3.9%, and the average blended tax rate on dividends and capital gains has been 39.6%. With current levels at 4.9%, 2.0%, and 15% respectively, it seems fair that the market PE should be much higher than average. A simple regression model of these factors suggests that the current multiple should be more like 21x earnings rather than the current 16x.

**Economic Indicators by Decade**

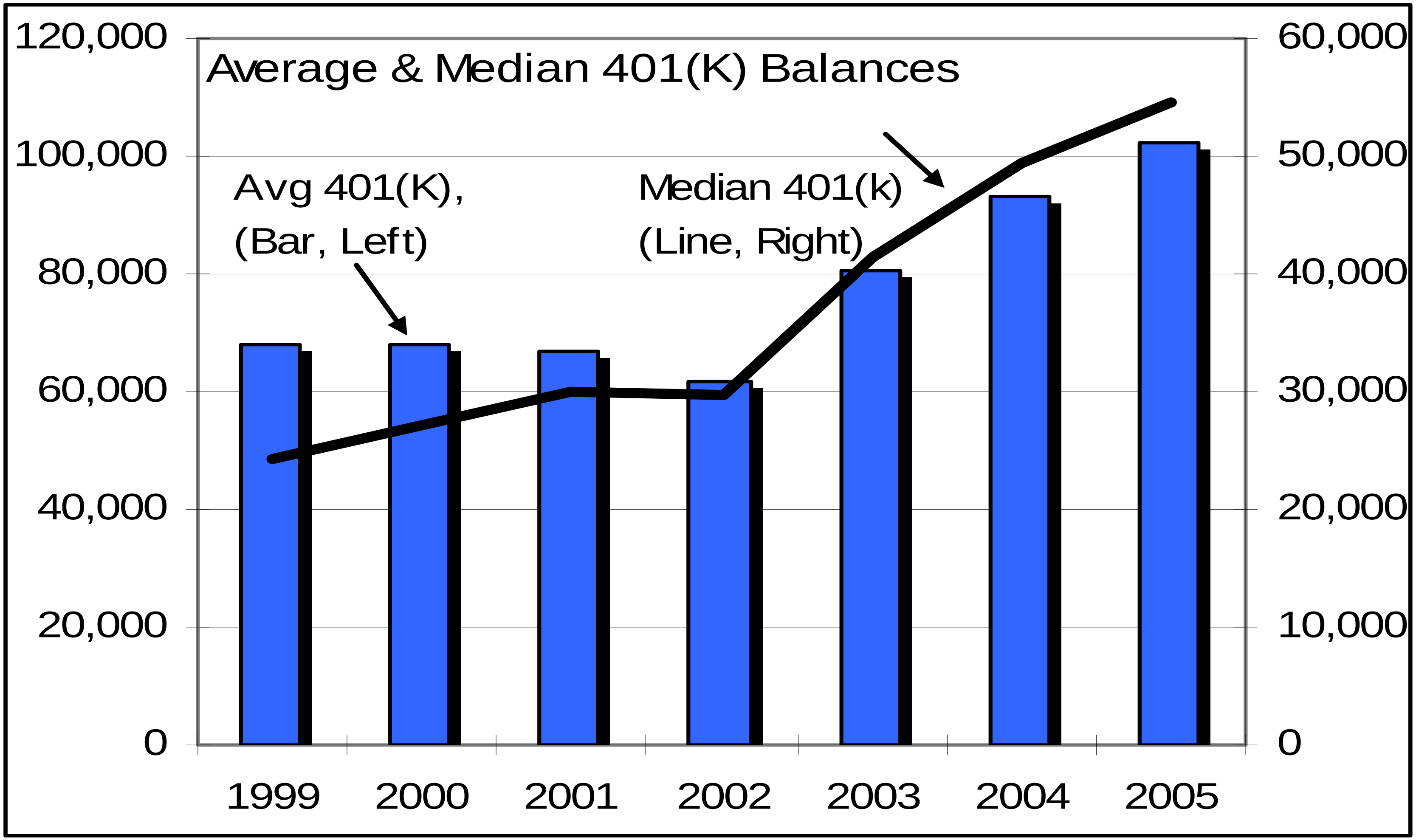
| | S&P 500 LTM P/E | 10-Year Yield | CPI Q/Q % AR | Div & Cap Gains Tax |
|---|---|---|---|---|
| '50 | 12.6 | 3.0% | 2.2% | - |
| '60 | 18.1 | 4.7% | 2.5% | 55.5% |
| '70 | 12.5 | 7.5% | 7.4% | 52.2% |
| '80 | 11.7 | 10.6% | 5.2% | 35.8% |
| '90 | 19.5 | 6.7% | 3.0% | 32.4% |
| '00 | 20.6 | 4.7% | 2.6% | 21.8% |
| Average | 15.6 | 6.3% | 3.9% | 39.6% |
| Current | 16.2x | 4.9% | 2.0%* | 15.0% |

*For inflation "right now" we use the Y/Y % of +2, not the Q/Q % AR of -2 since the point estimate is too noisy.

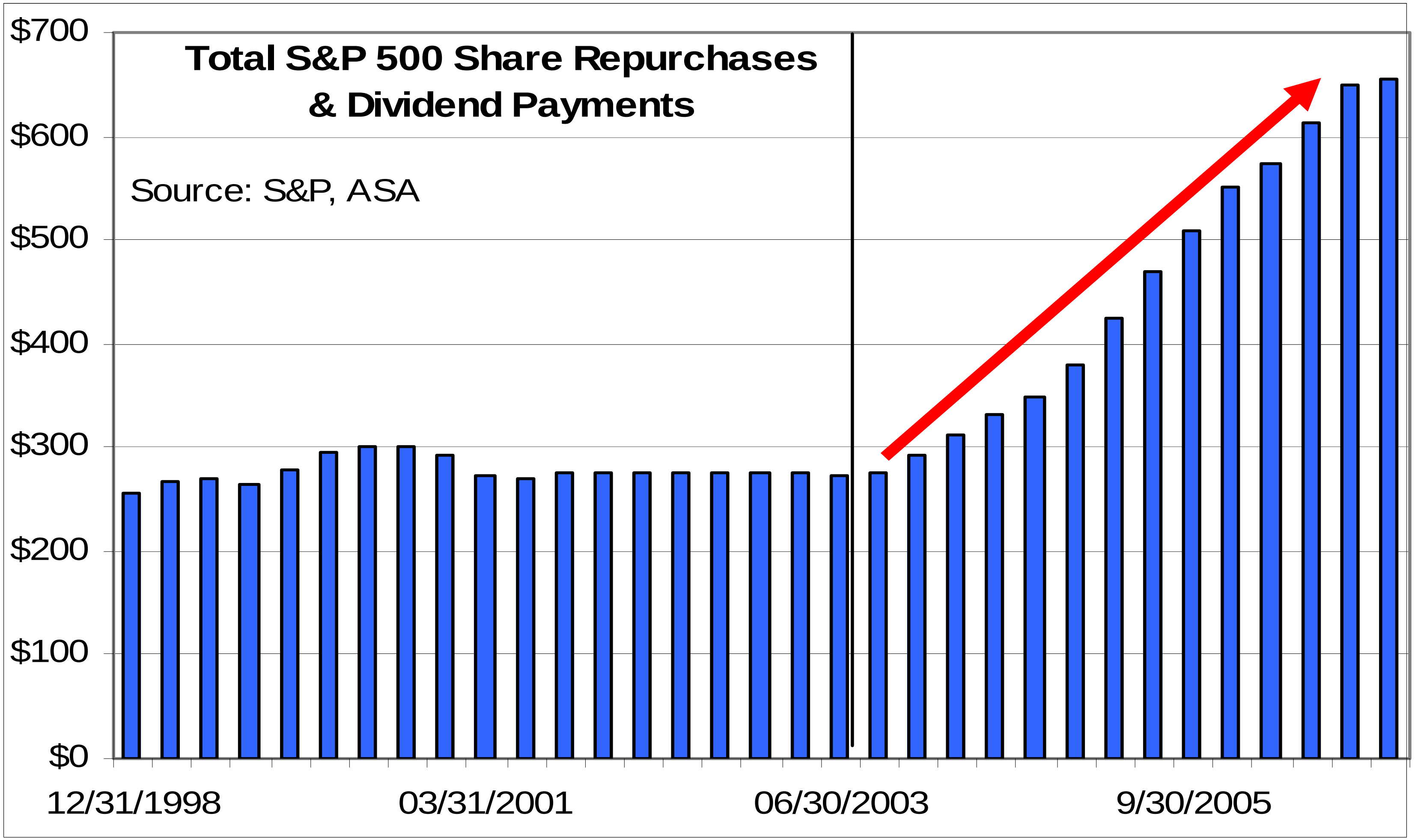
# Mutual Fund/ETF Assets Up $4.3 Trillion, 13.7% Per Year



# Average 401(k) Balance Up 64.7%
# Median 401(k) Balance Up 83.4%

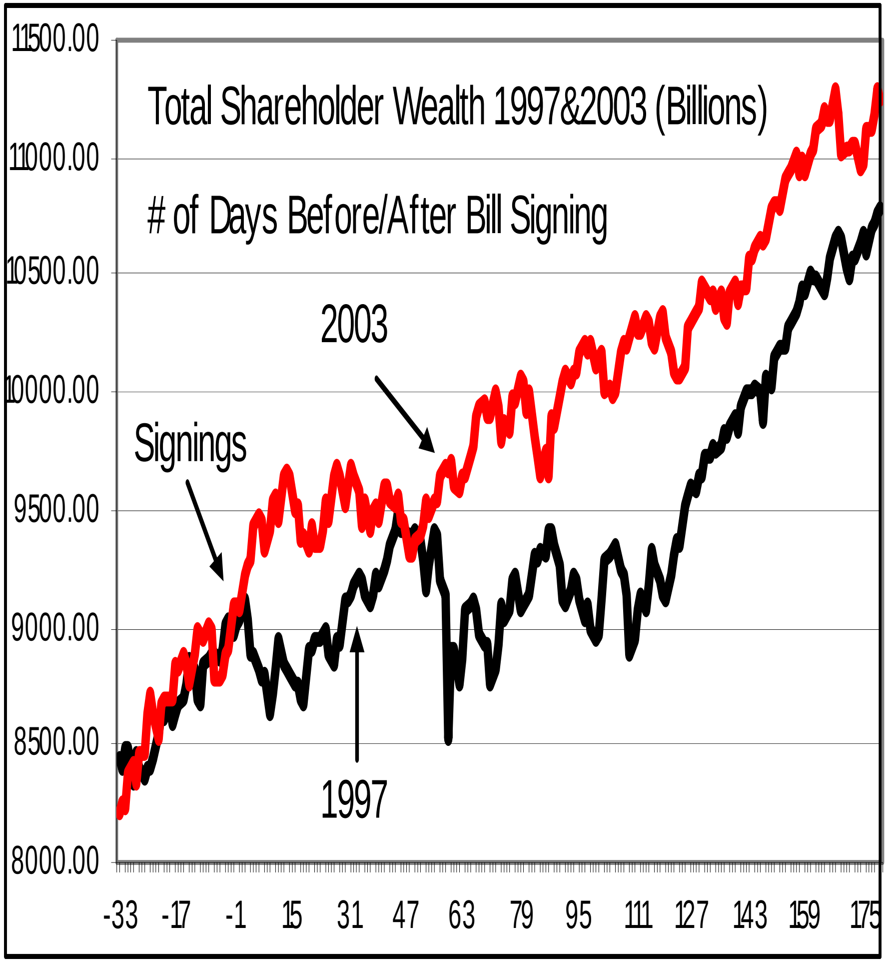


# Dividend/Repurchases Up 140% Since Tax Cut Was Enacted

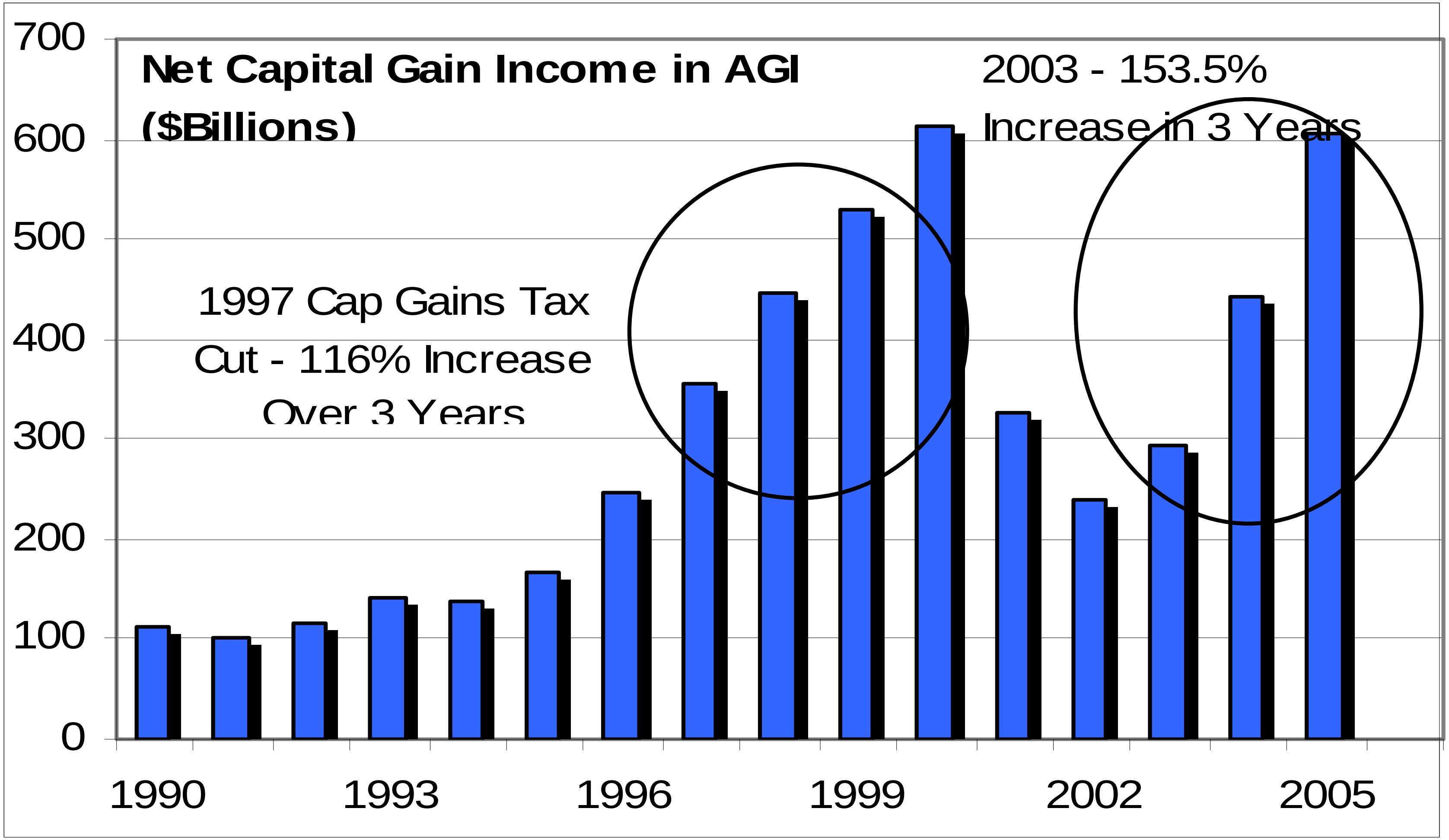


# $6.2 Trillion of New Shareholder Wealth

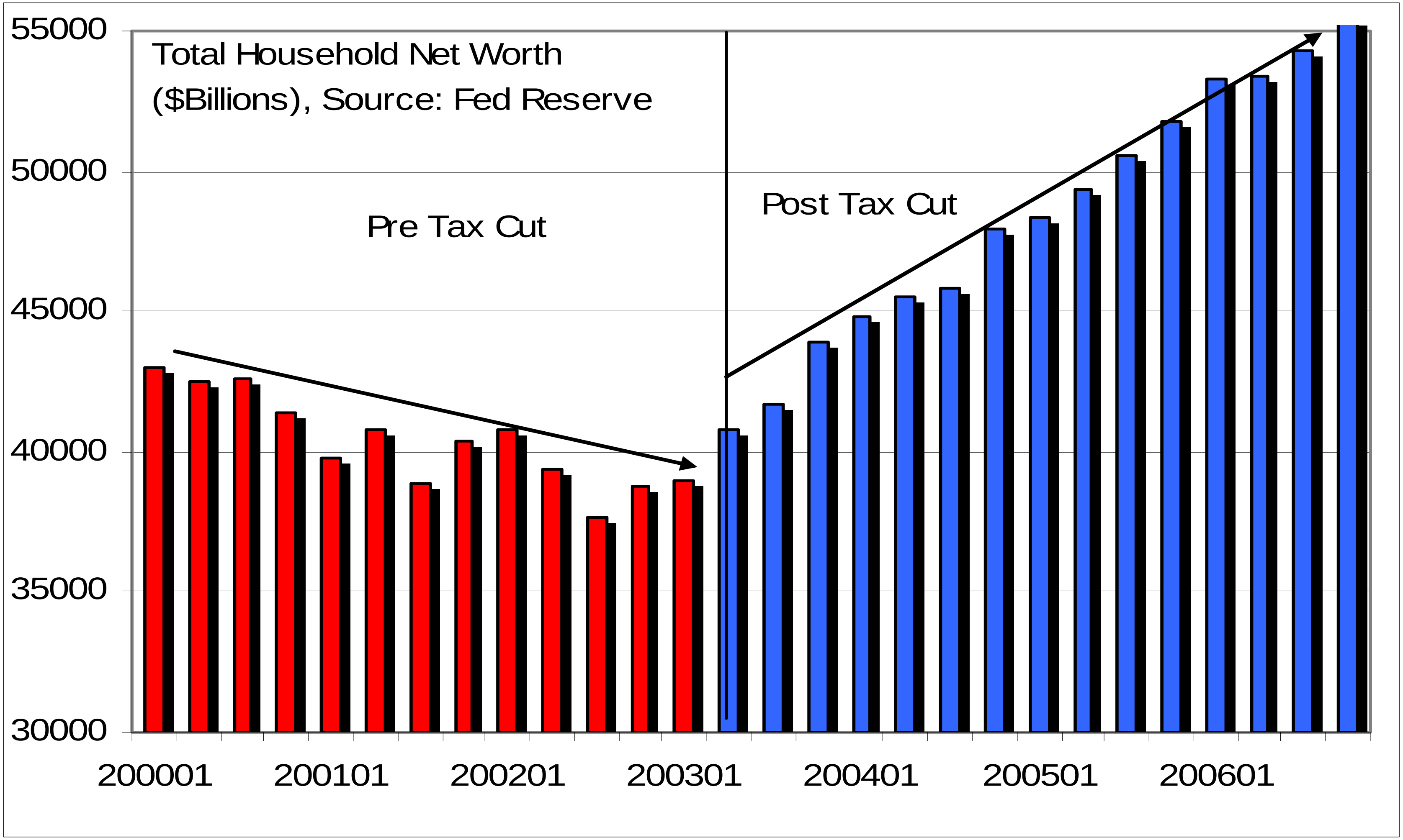
- Capital Gains Tax Reduction increases the after tax return on equities and boost the stock market.
- To date (4/11), $6.2 trillion of new shareholder wealth has been created which is now being taxed.
- Many investors also unlock their gains to take advantage of the lower rate and then reinvest that money back into the market.
- A similar effect occurred in 1997.



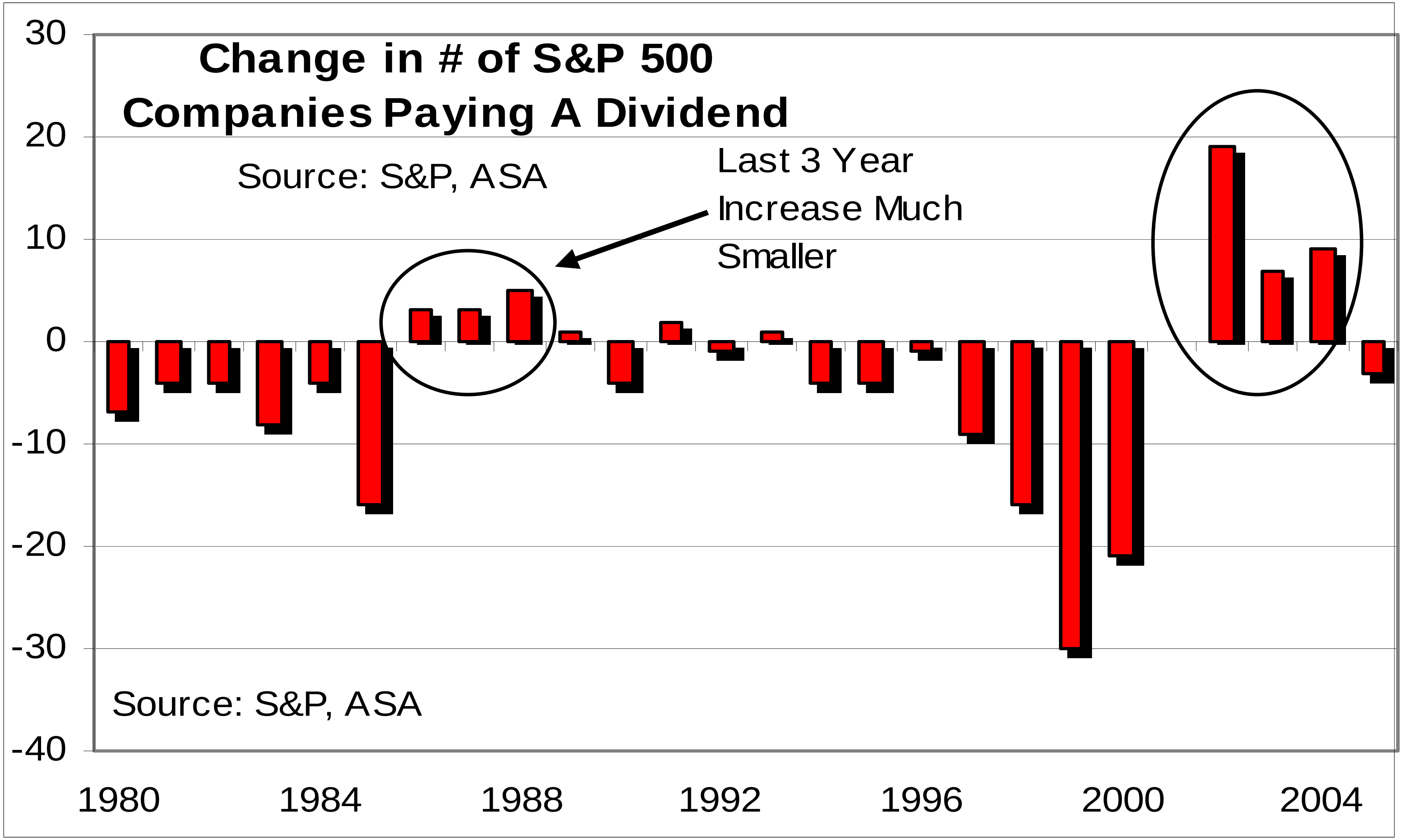
# Capital Gains Income Up 153.5 Percent In 3 Years



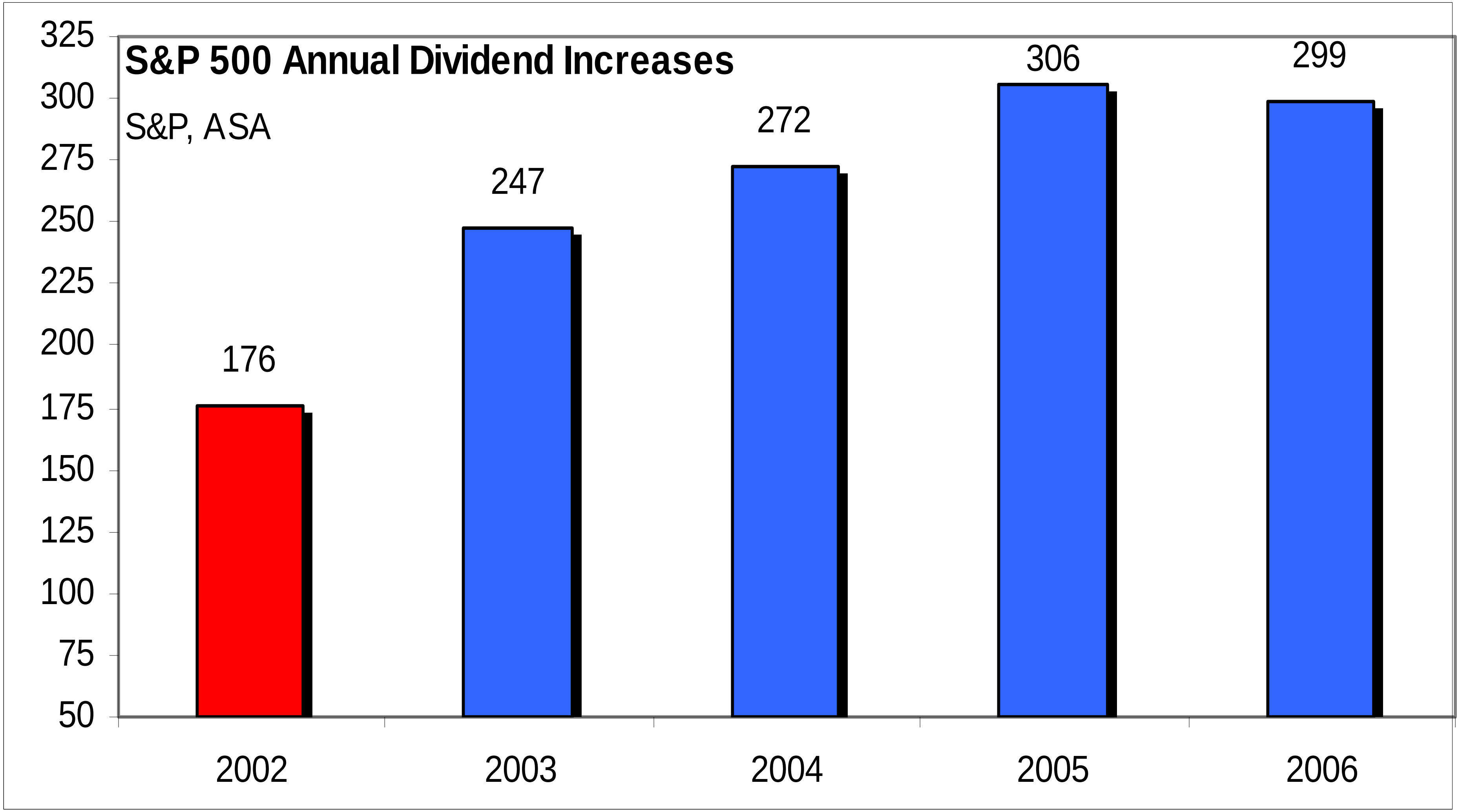
# $16.7 Trillion of New Wealth



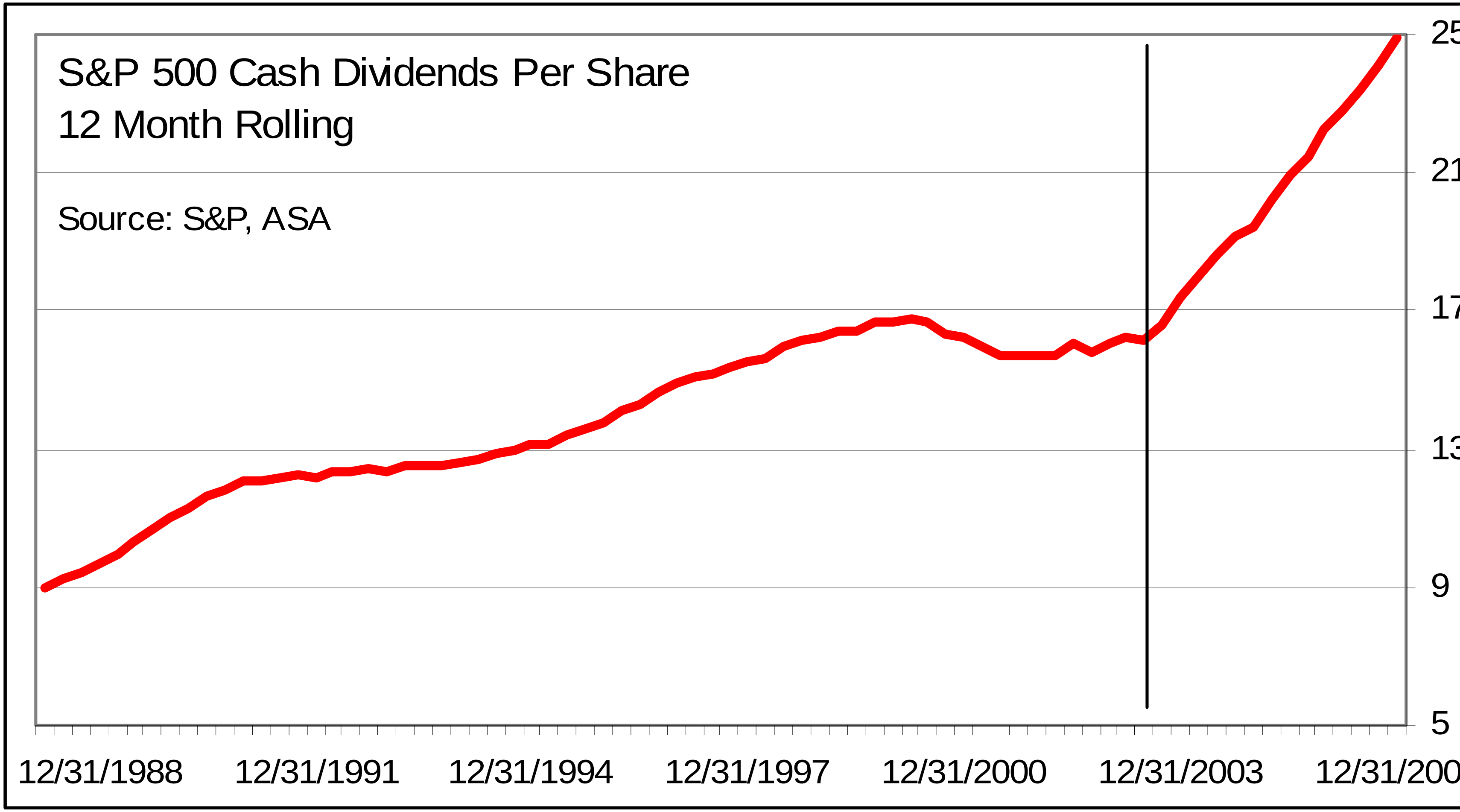
# 25-Year Decline of Dividend Paying Companies Reversed



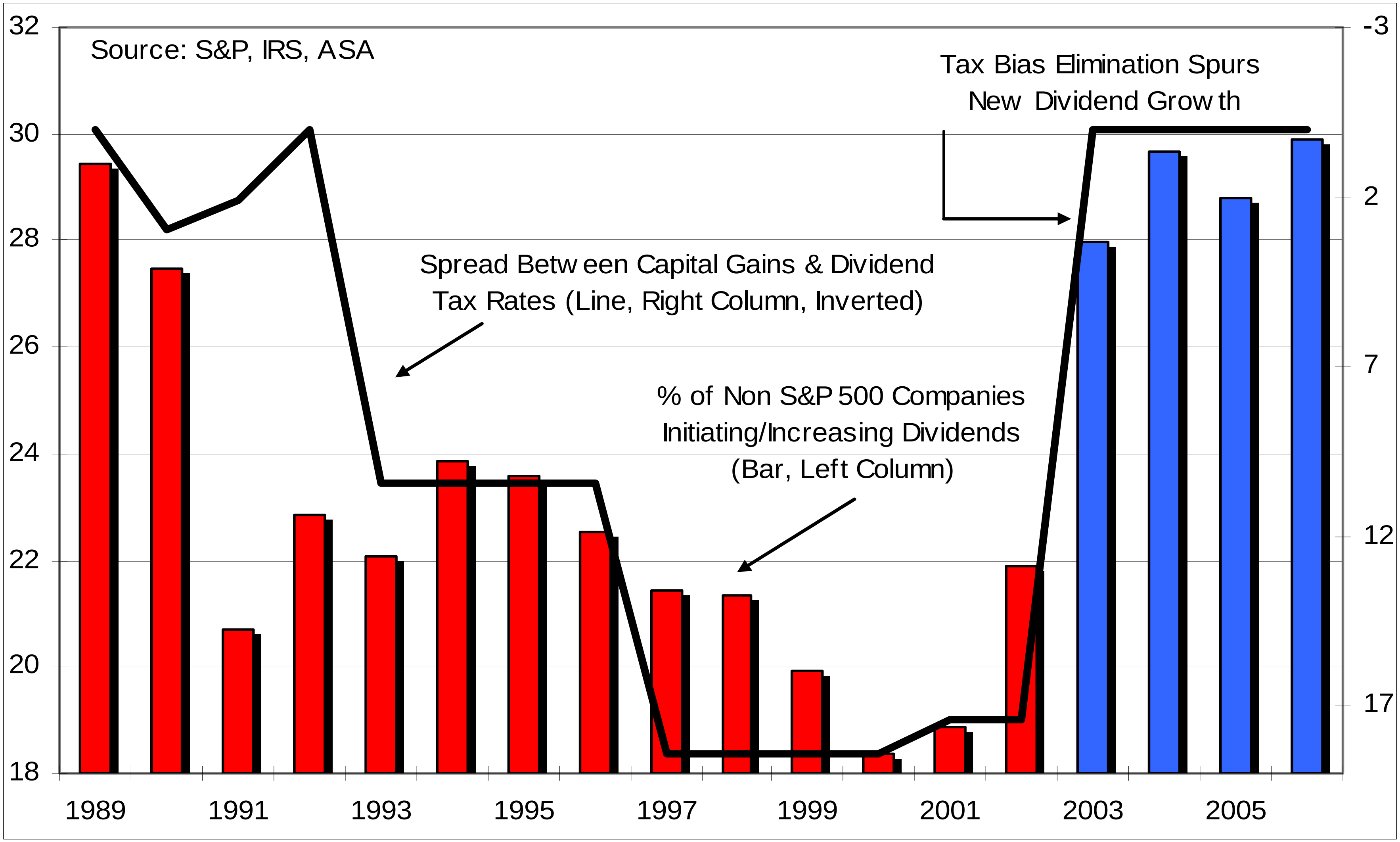
# Dividend Increases Up 70%



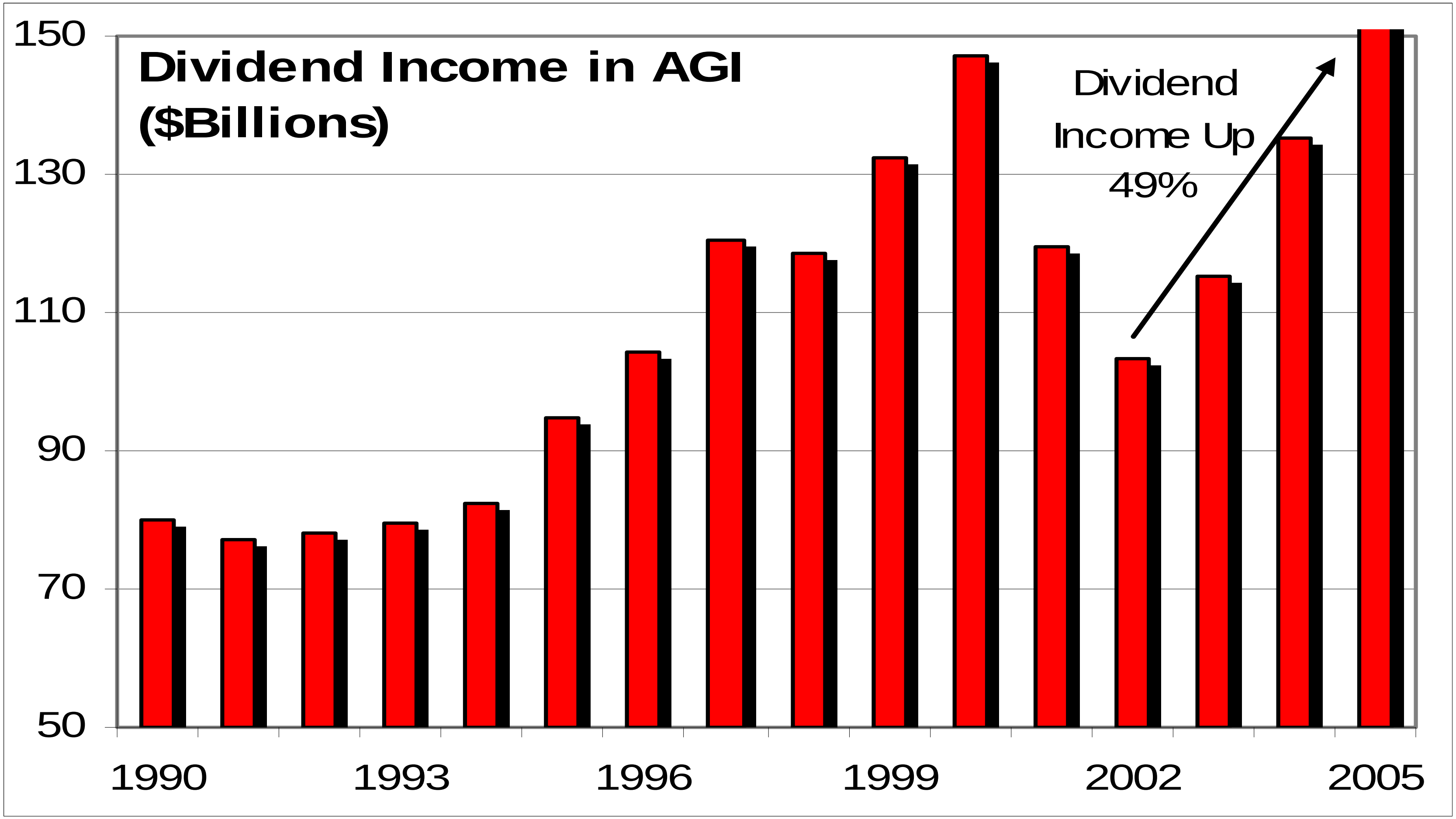
# Dividends Per Share
# Up 54% Since Tax Cut



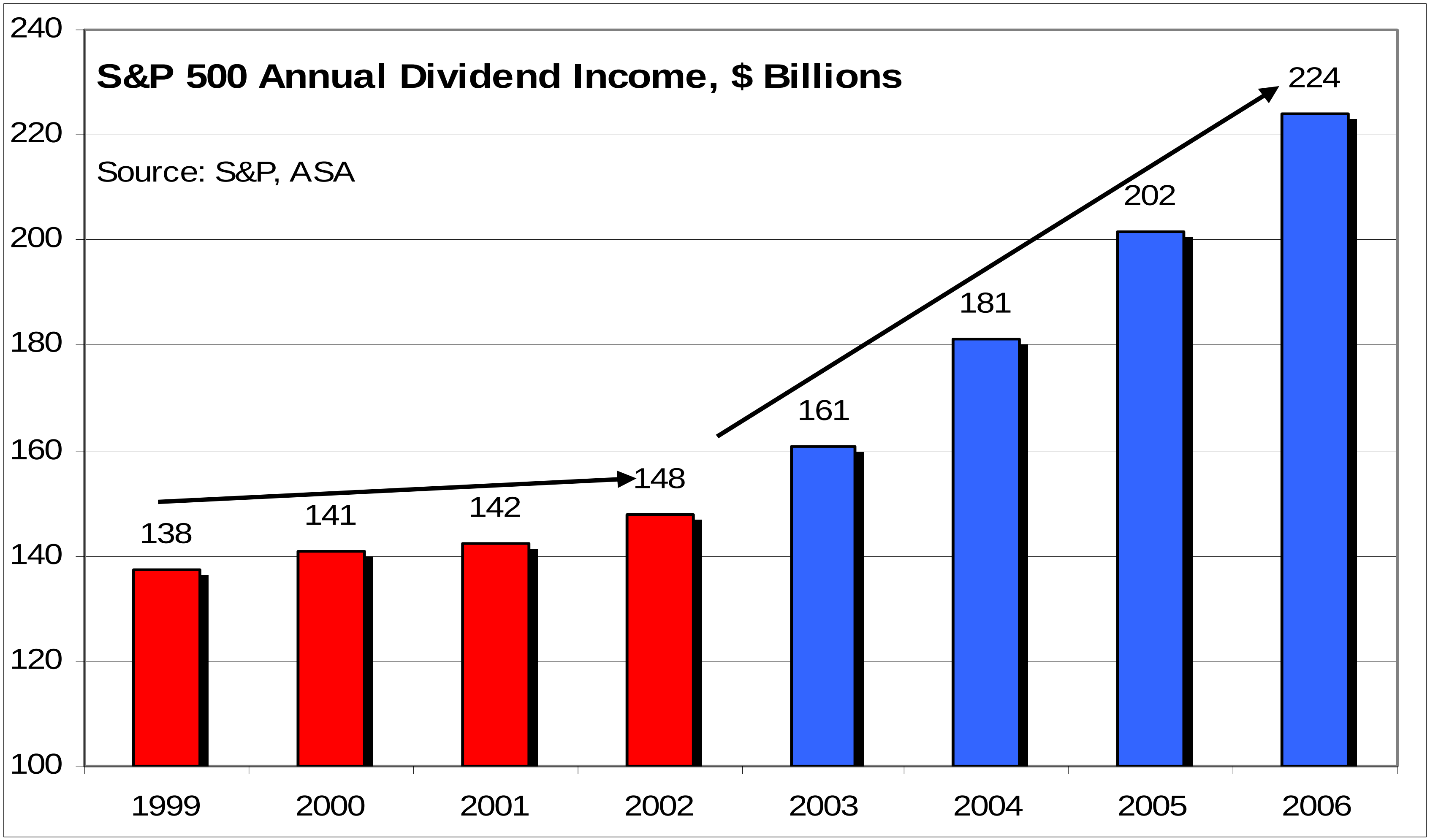
# Tax Bias Elimination Spurs New Dividend Growth



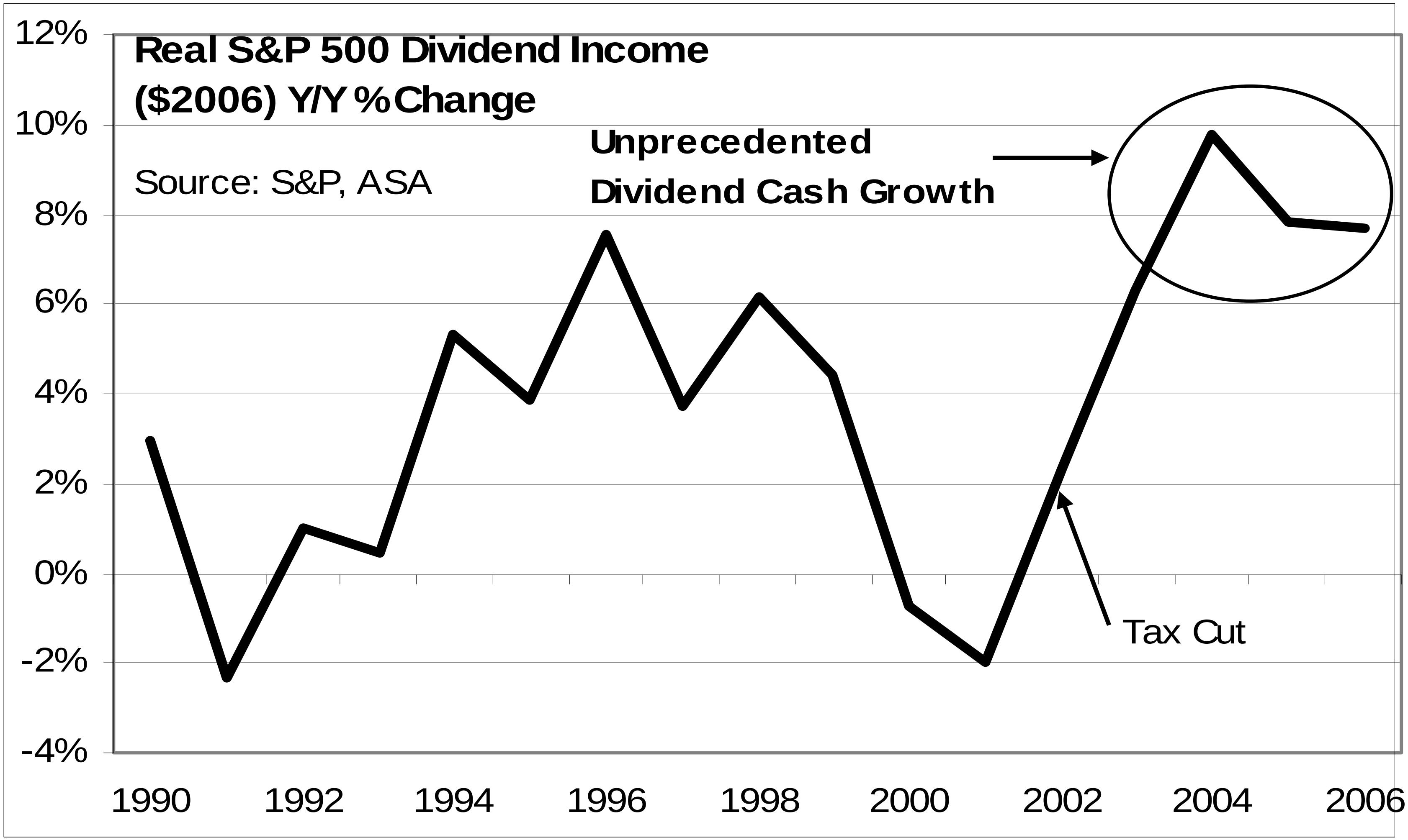
# Total Dividend Income Up 49% In Three Years



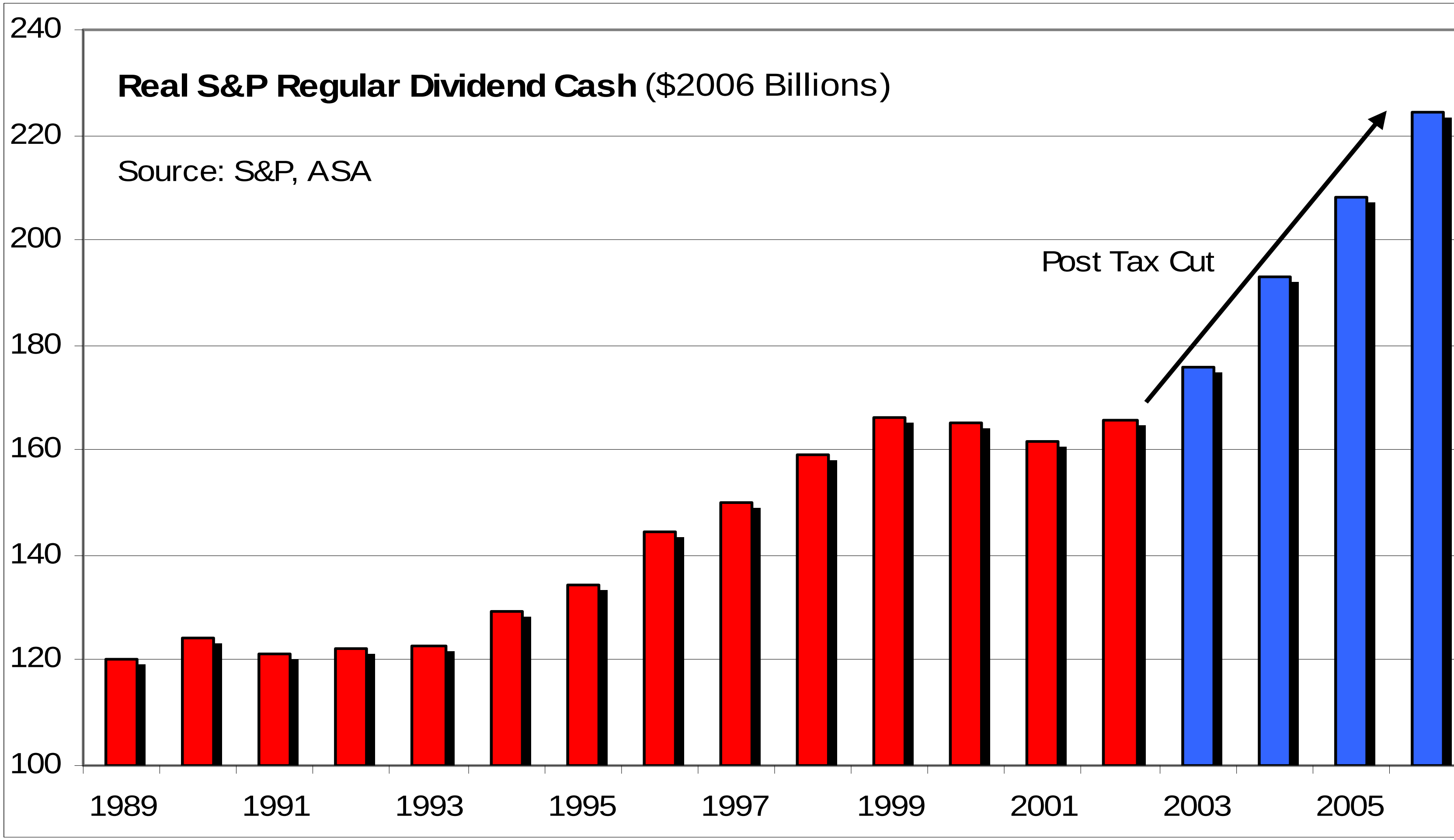
# S&P 500 Dividend Income Growing 11% Per Year



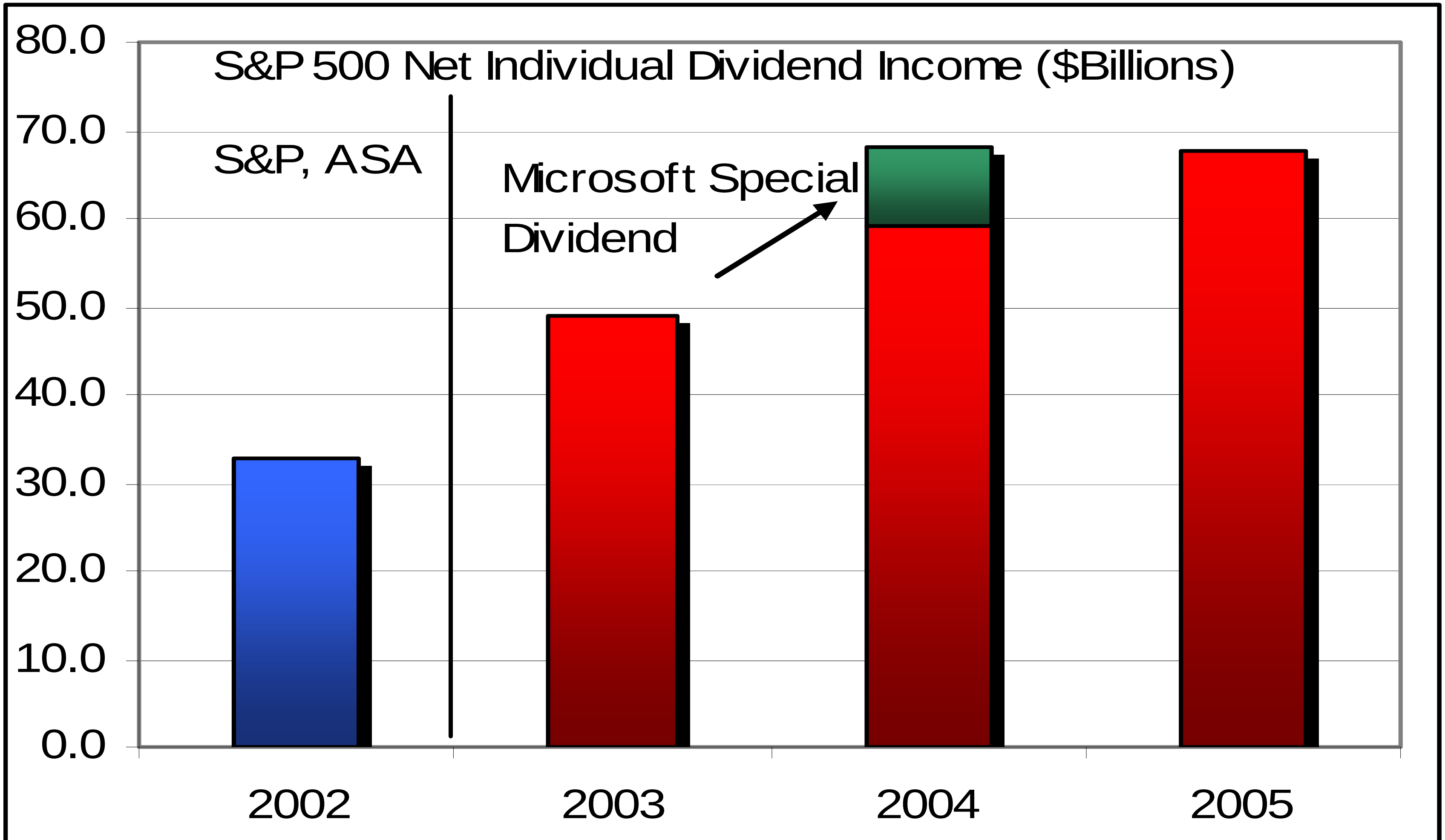
# Real Dividend Cash Payment Growth At Record Levels



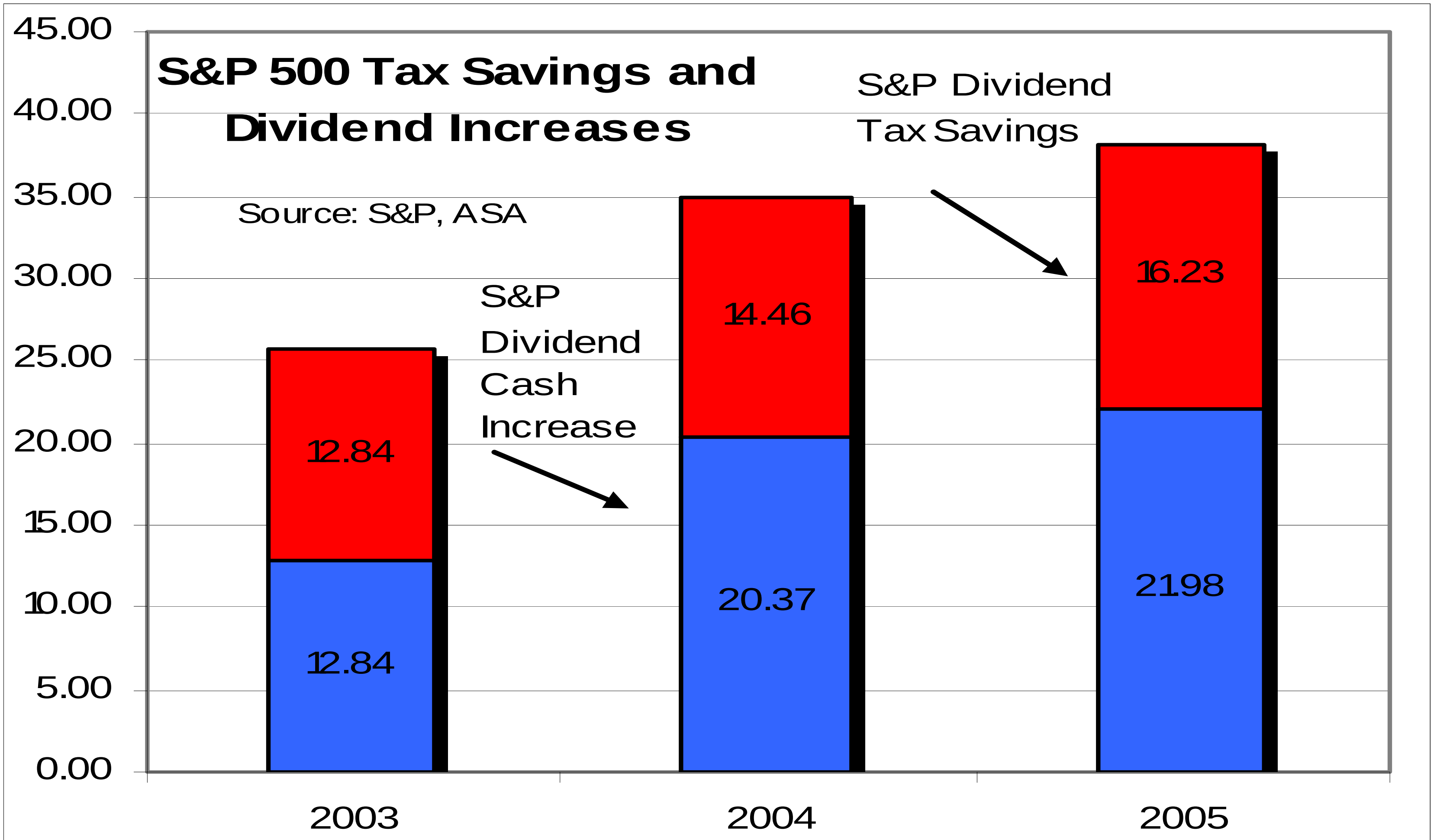
# Dividend Cash Increasing 3X Faster Than Previous Average



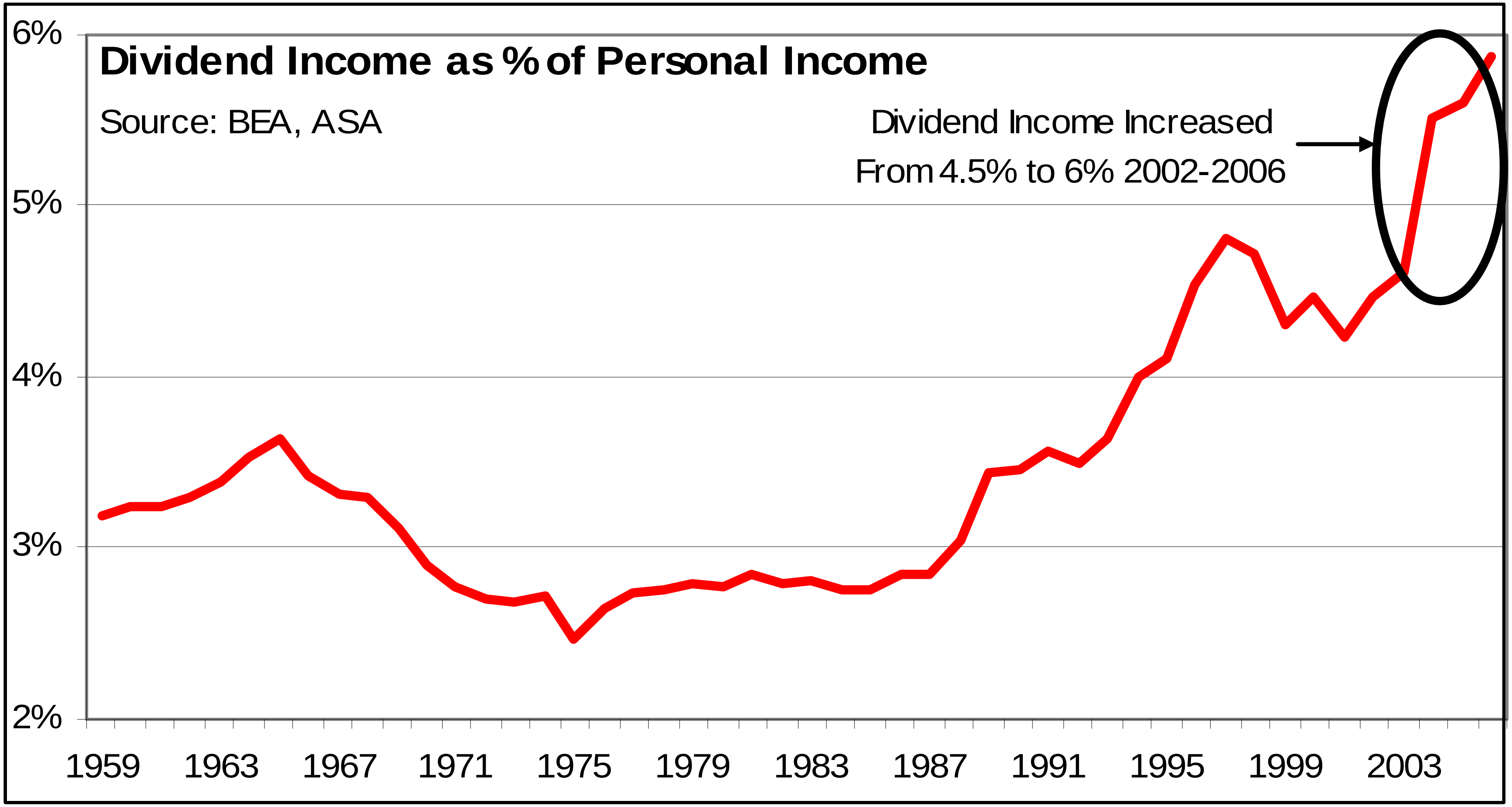
# Individual Dividend Income Doubled In Just Two Years



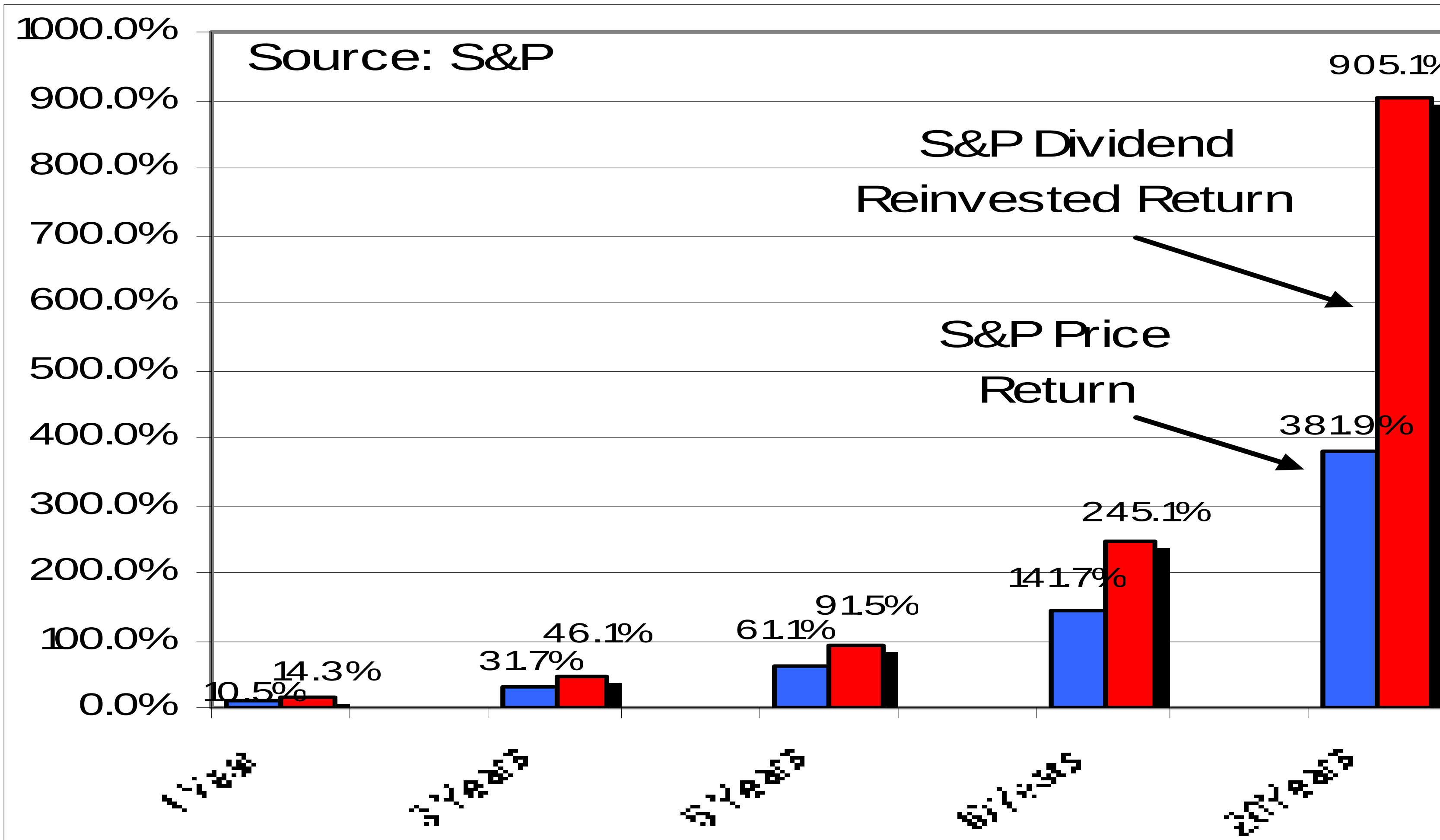
# $100 Billion of Dividend Cash/Tax Savings



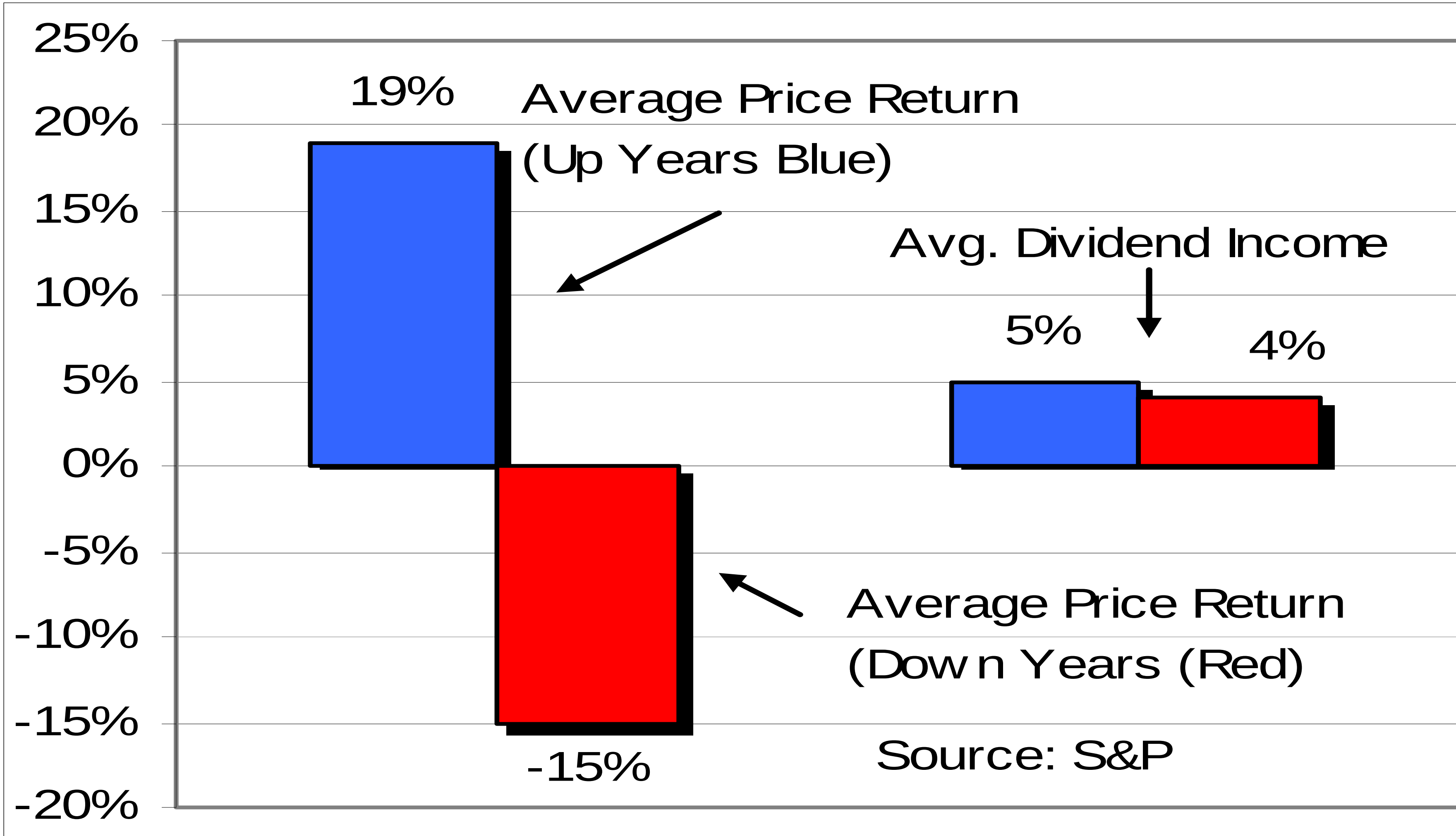
# Dividend Income Becoming More Important For Aging Population



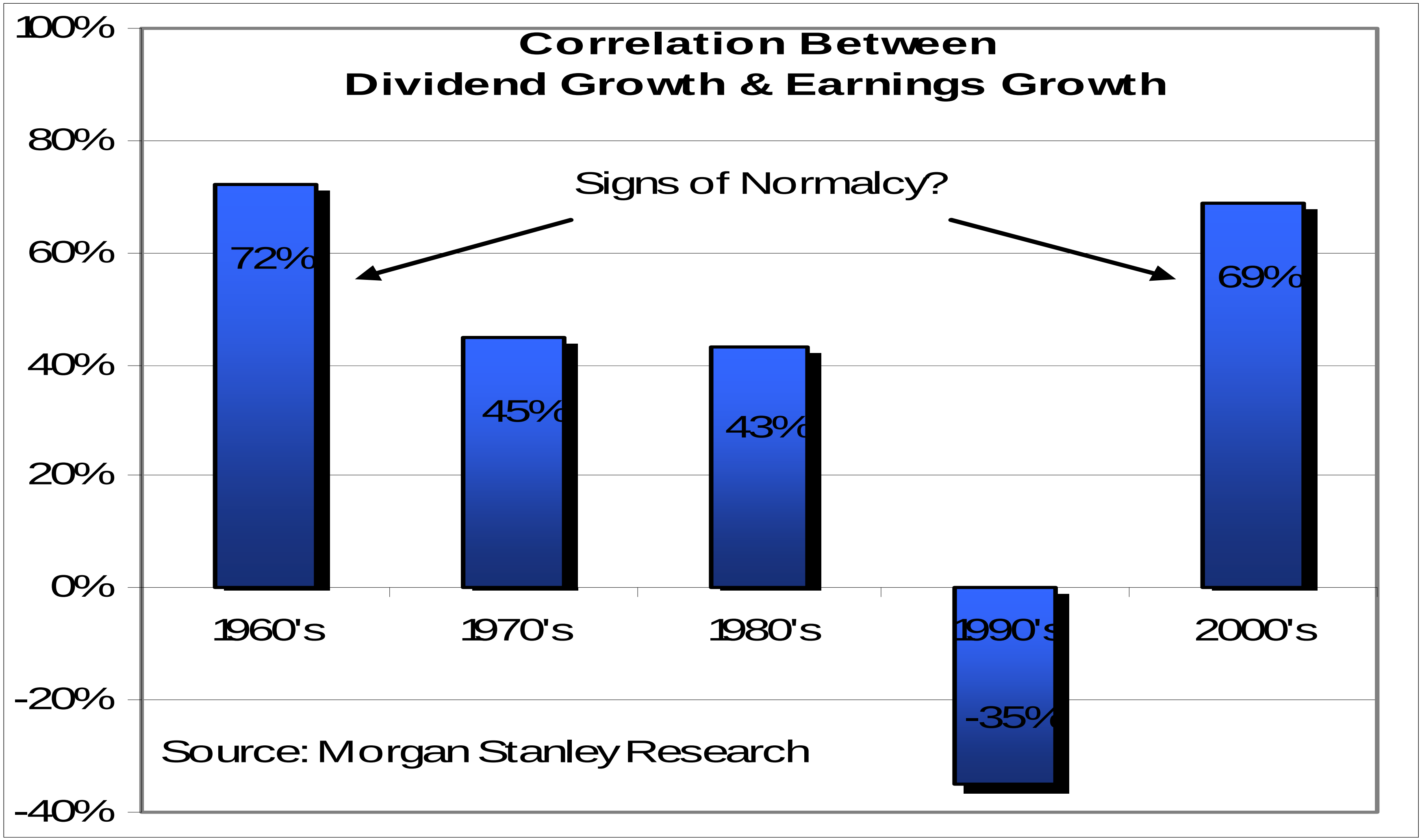
# Reinvesting Dividends Boost Returns by 523 Percent



# More Dividends Will Cushion Market Downturns



# Dividends Signaling True Health of Companies



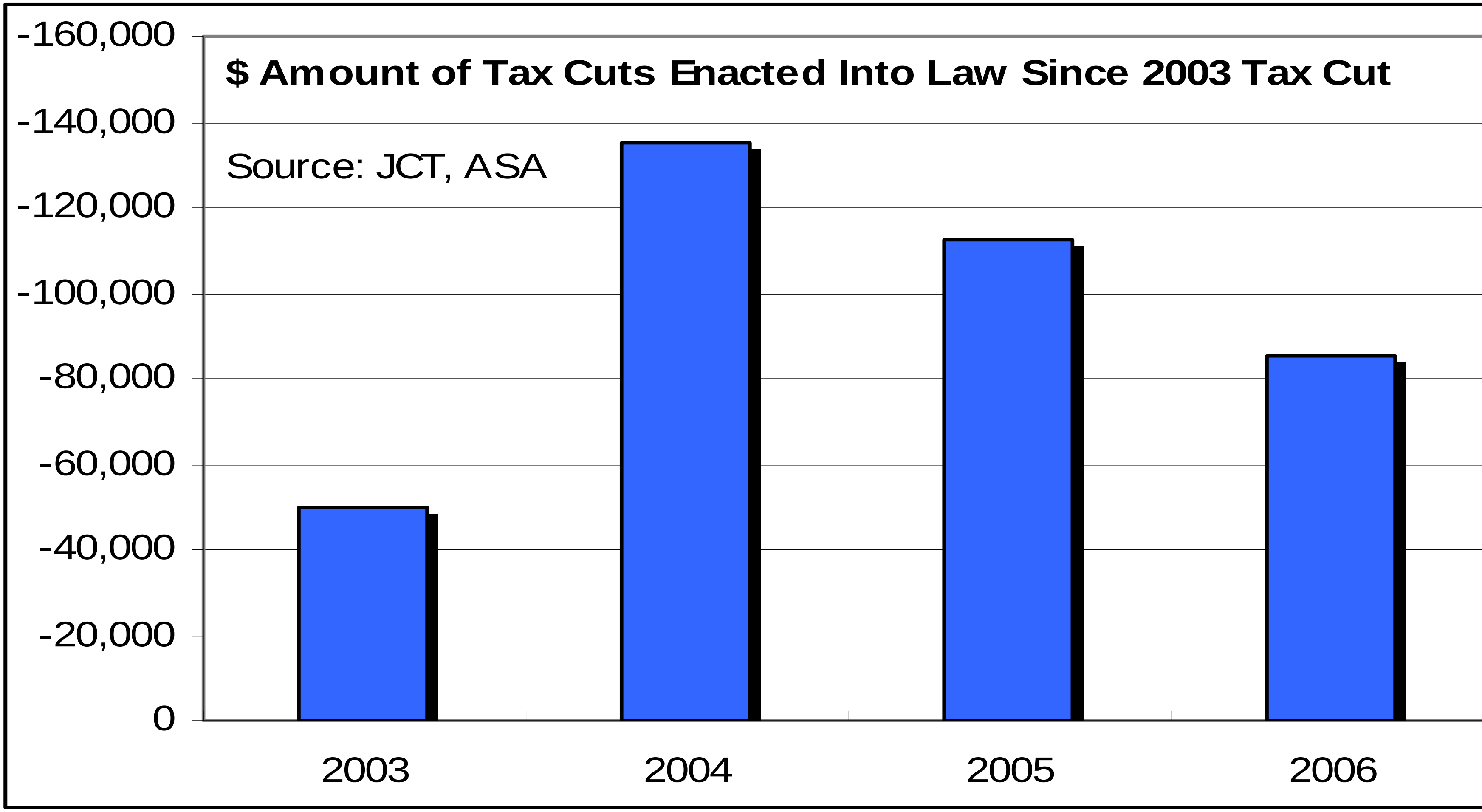
# FISCAL EFFECTS

*STATIC SCORING MISSED IMPORTANT ECONOMIC & STOCK MARKET EFFECTS WHICH BOOSTED TAX REVENUE*

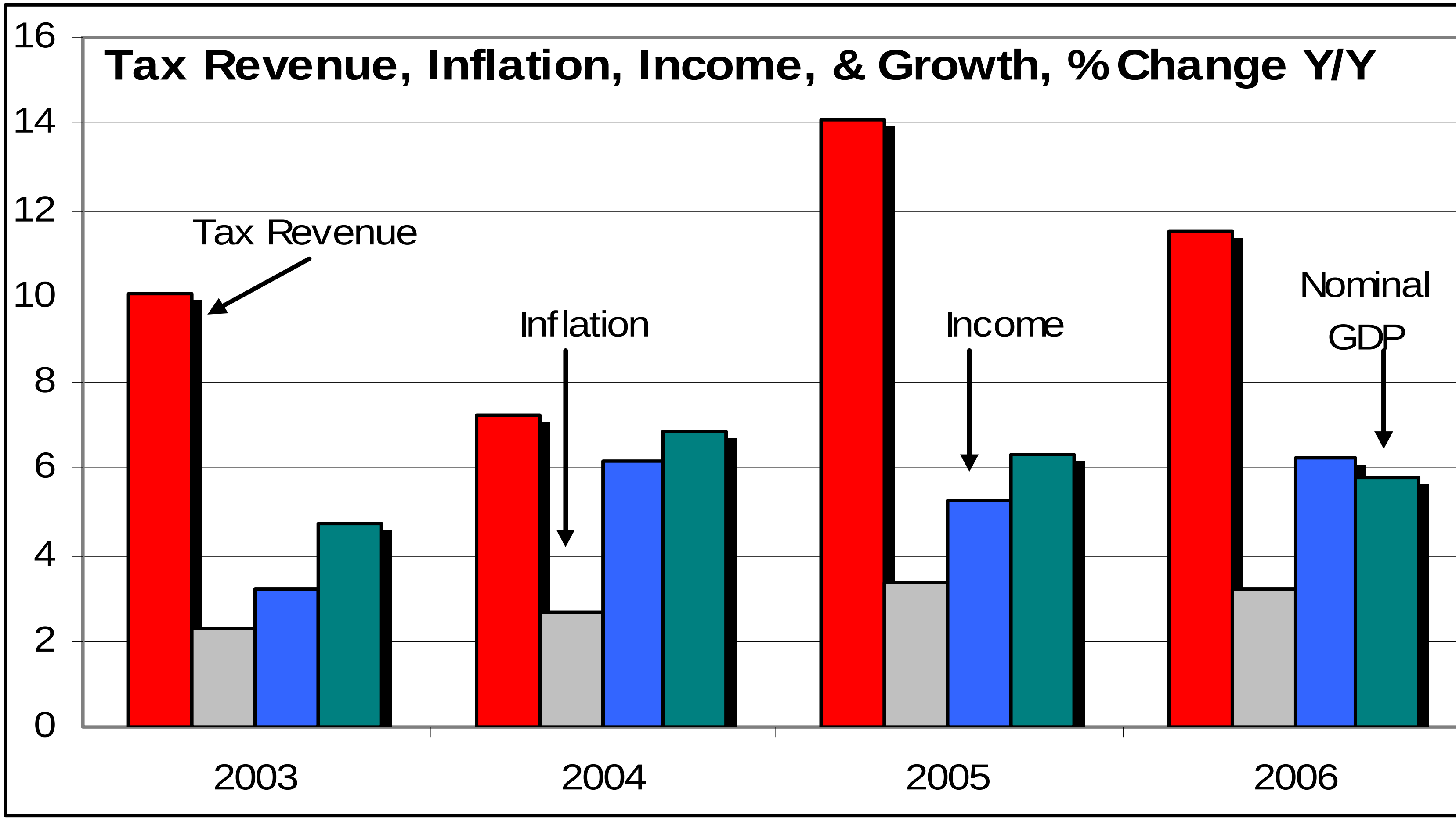
# JCT Overestimated Cost of the 2003 Tax Cut

- Despite the third largest tax cut in American history, tax revenue growth is exceeding historical levels.
- JCT/CBO revenue numbers failed to take into account economic and behavioral effects from the 2003 tax cut.
- As such, 51 percent of the total tax cost "cost" has been recouped and the deficit is closing much faster than expected

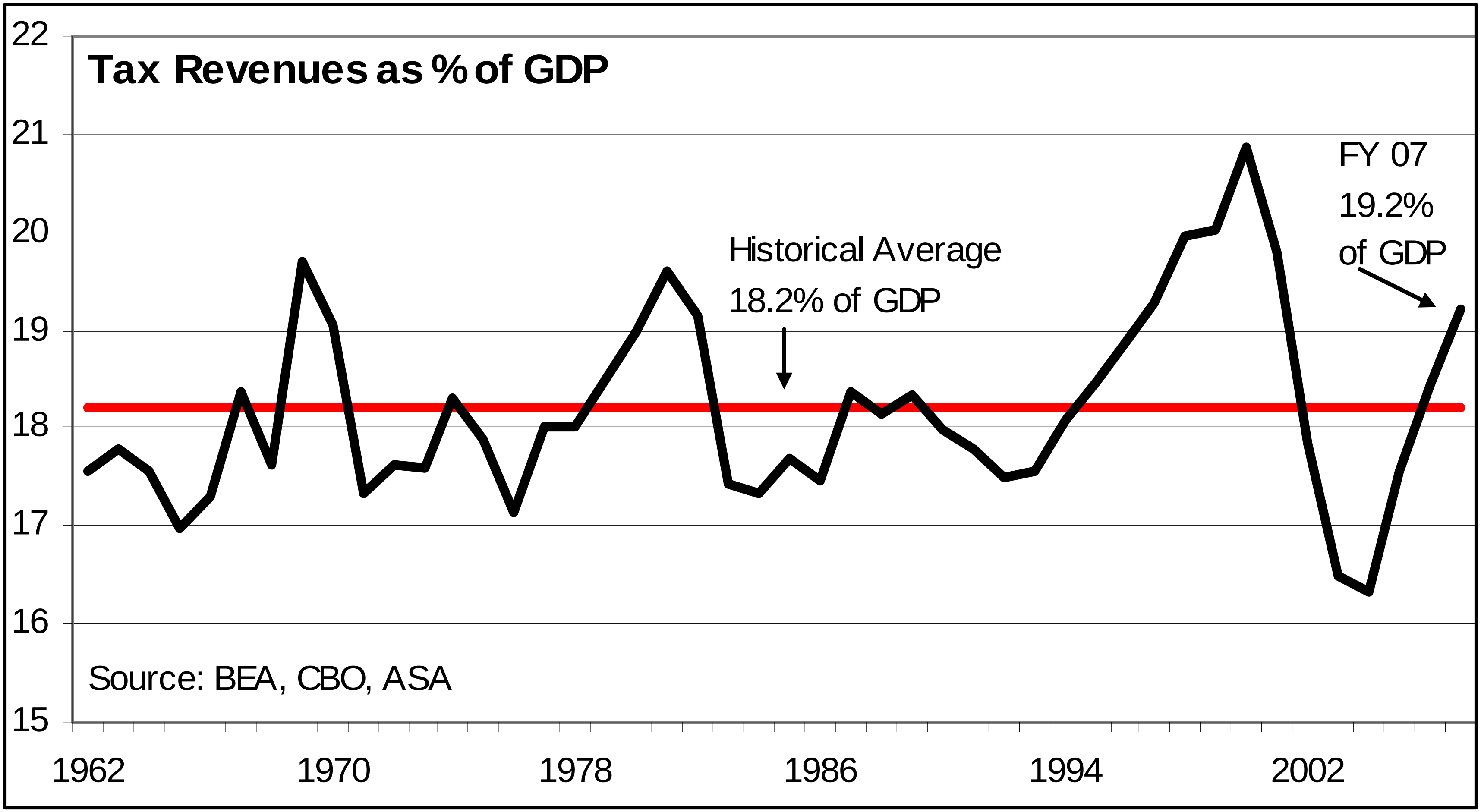
# $383 Billion Of Tax Cuts Enacted Into Law Since JGTRRA…



# …And Revenues Growing Faster Than Inflation, Income, & GDP

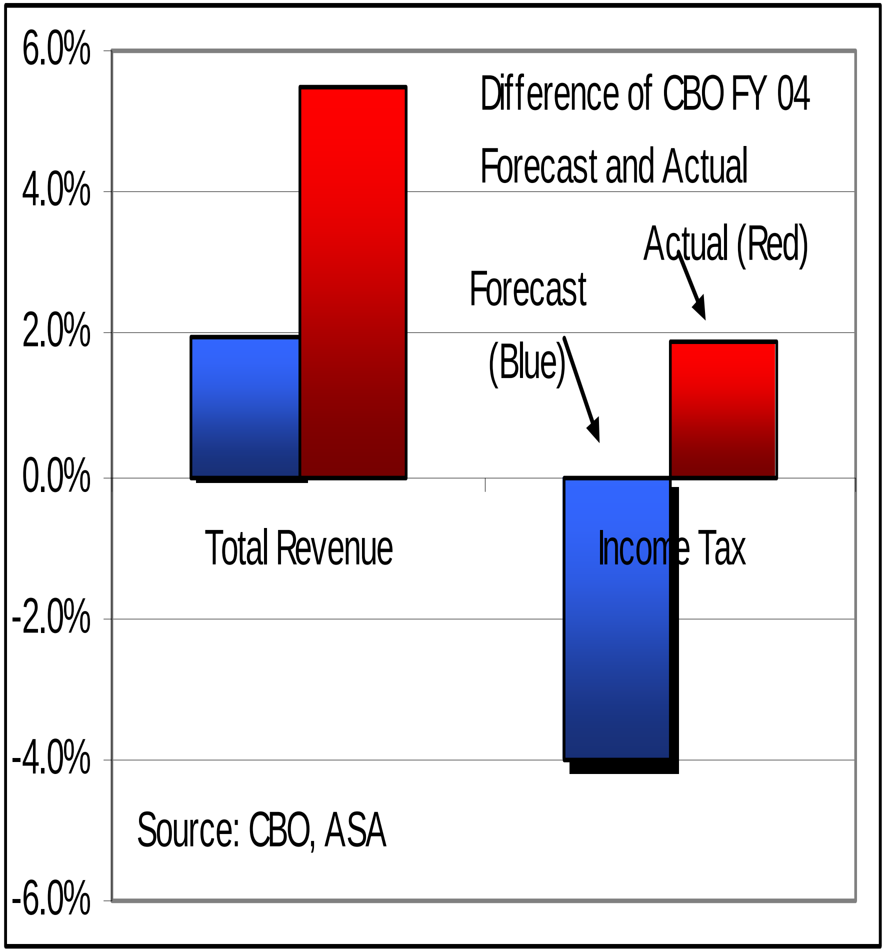


# Tax Revenues as % of GDP: 1% Higher Than Historical Average

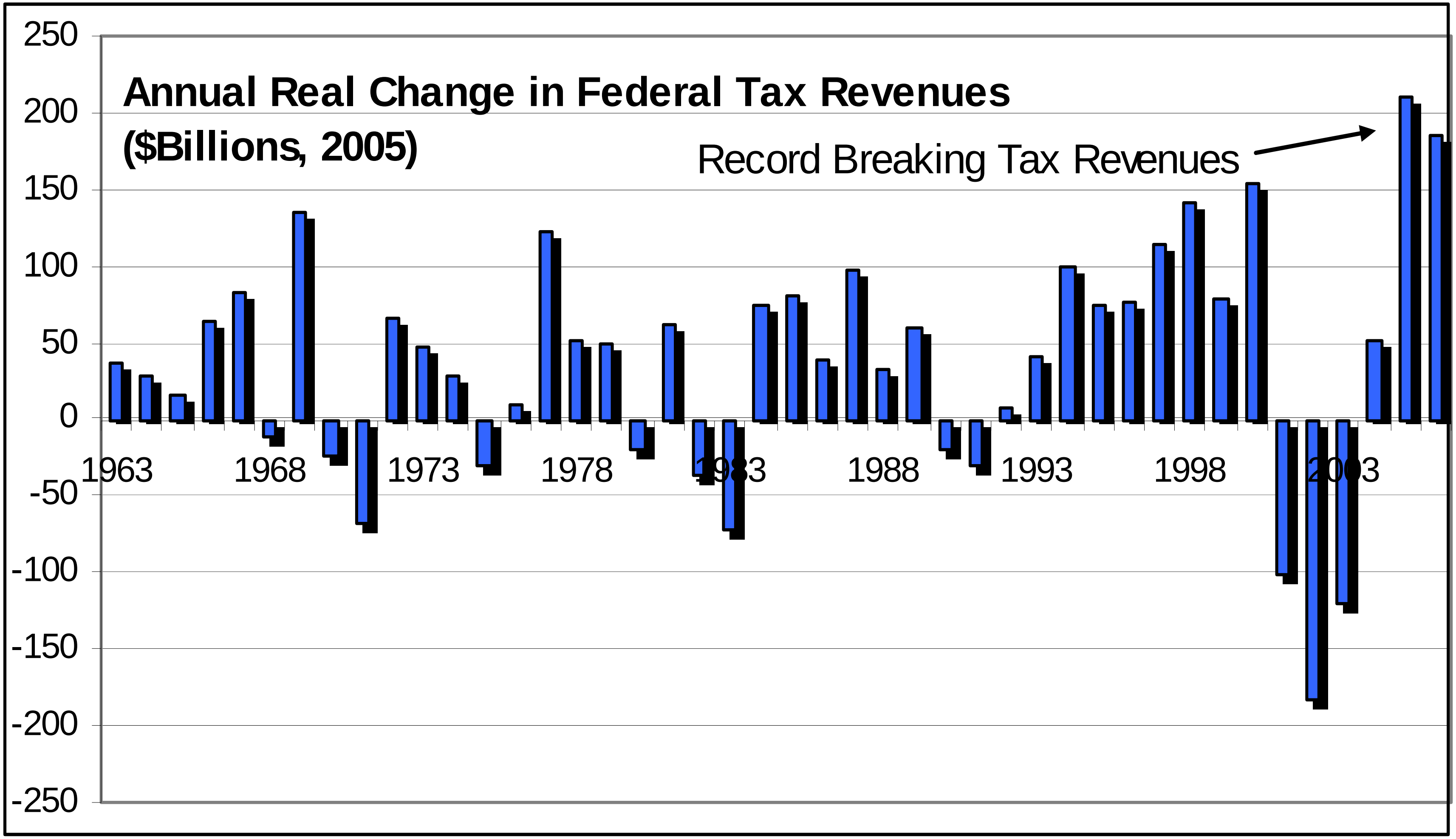


# Tax Revenue Effects

- New growth has spurred tax revenues.
- The CBO/JCT forecast suggested federal revenues would increase a paltry 2 percent in FY 2004.
- However, revenues increased nearly 3 times that rate and federal revenues increased $100 billion in the fiscal year. Income tax revenues were forecasted to *decline* by $32 billion.
- Instead income tax revenues *increased* by $16 billion, a 6 percent swing from the forecast.

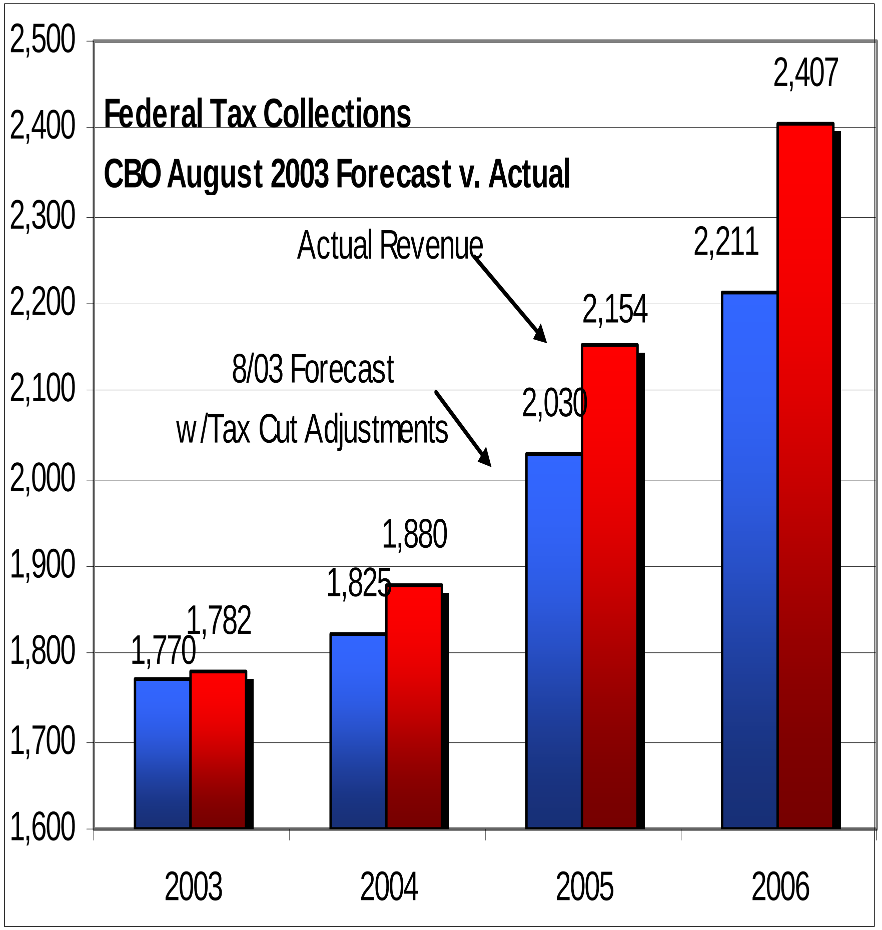


# FY 05/06 Two Largest Increases of Tax Revenues Ever



# Tax Revenue Baseline Adjusting Upwards…

- In each of the three fiscal years since the tax cut was implemented, revenue has exceeded the forecast and the numbers are growing larger each year.
- Clearly, this new revenue growth is effectively wiping out a large portion of the “revenue loss” estimated by the Joint Committee on Taxation.



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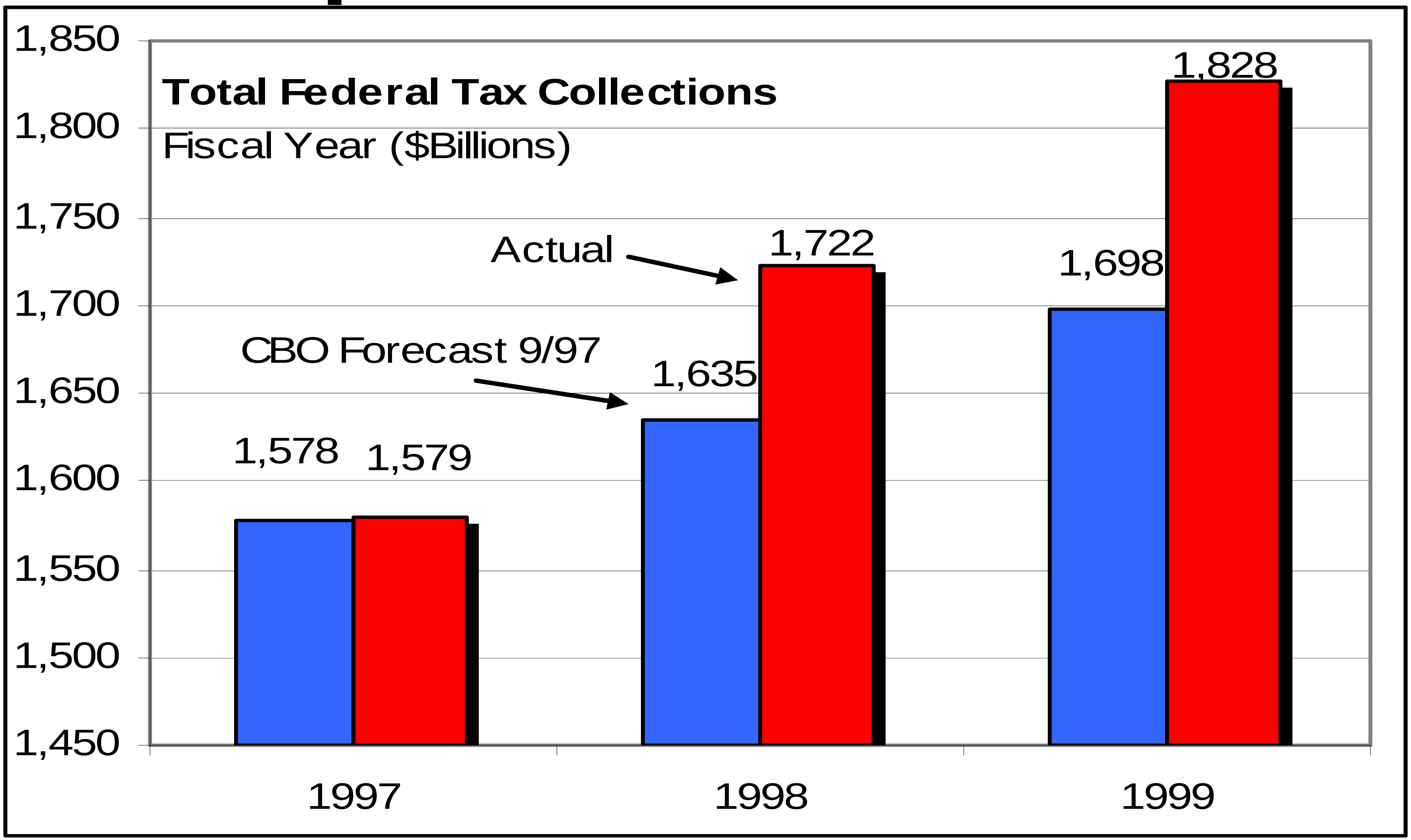
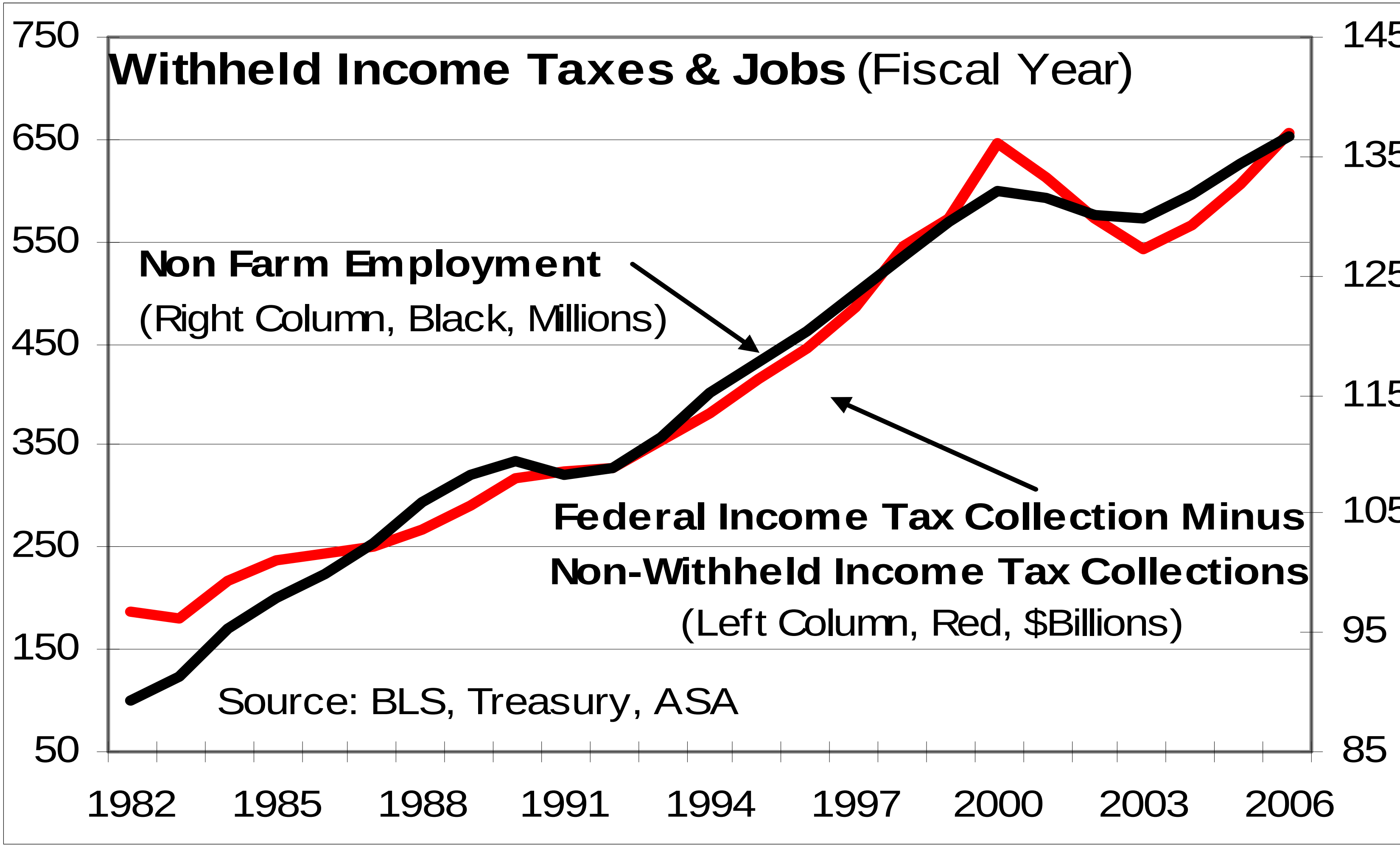
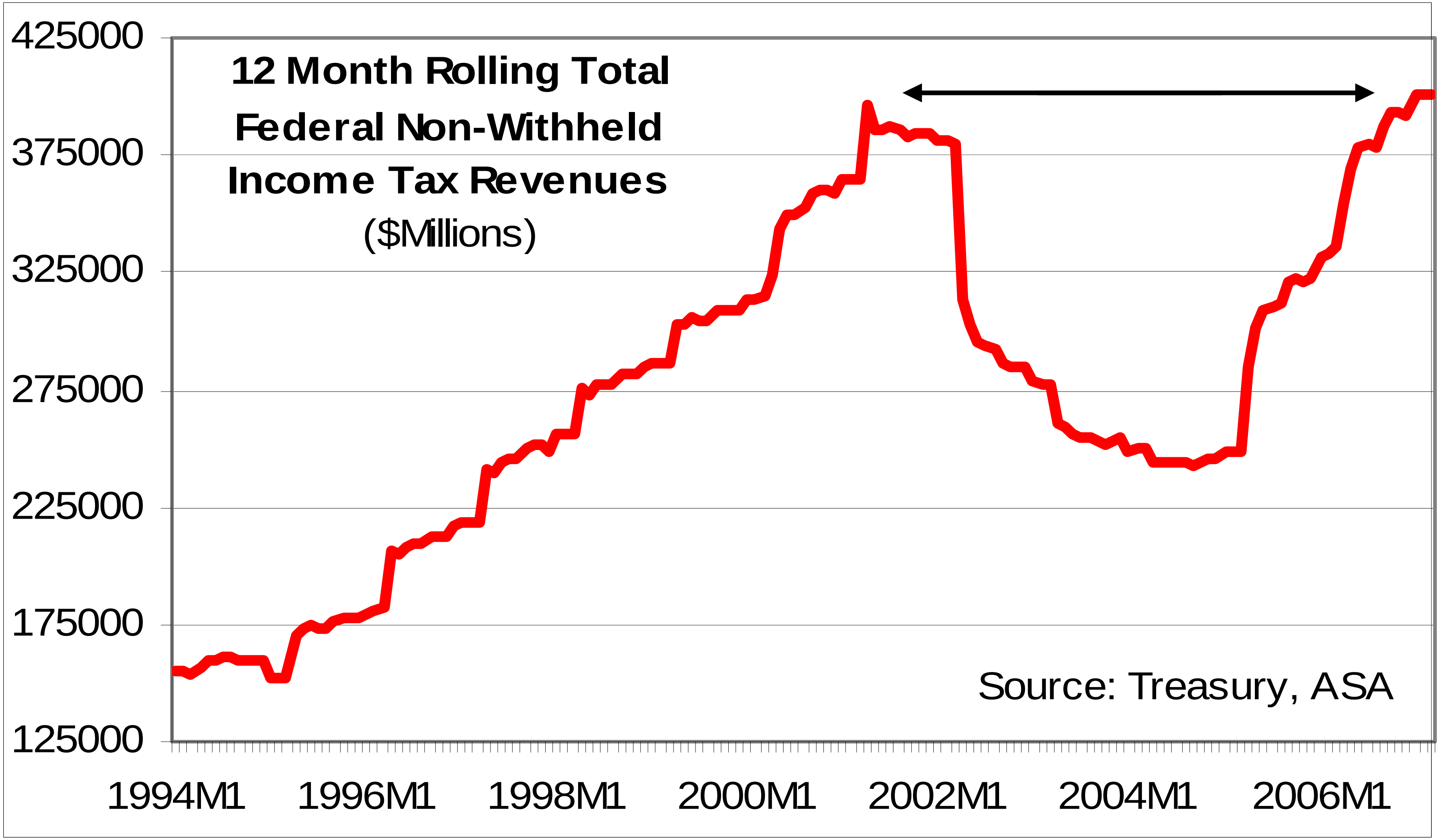


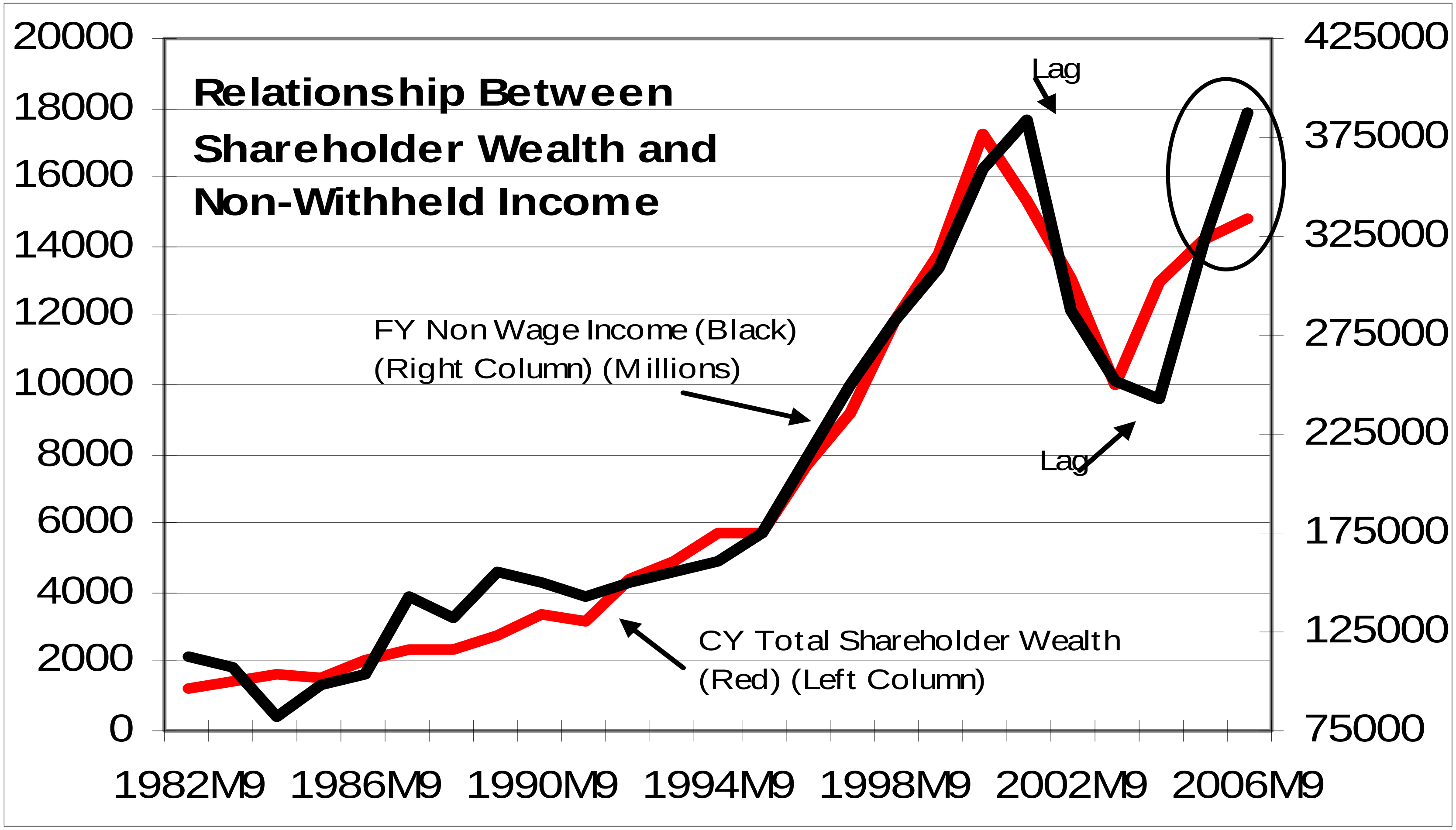
# More Jobs = More Income Taxes



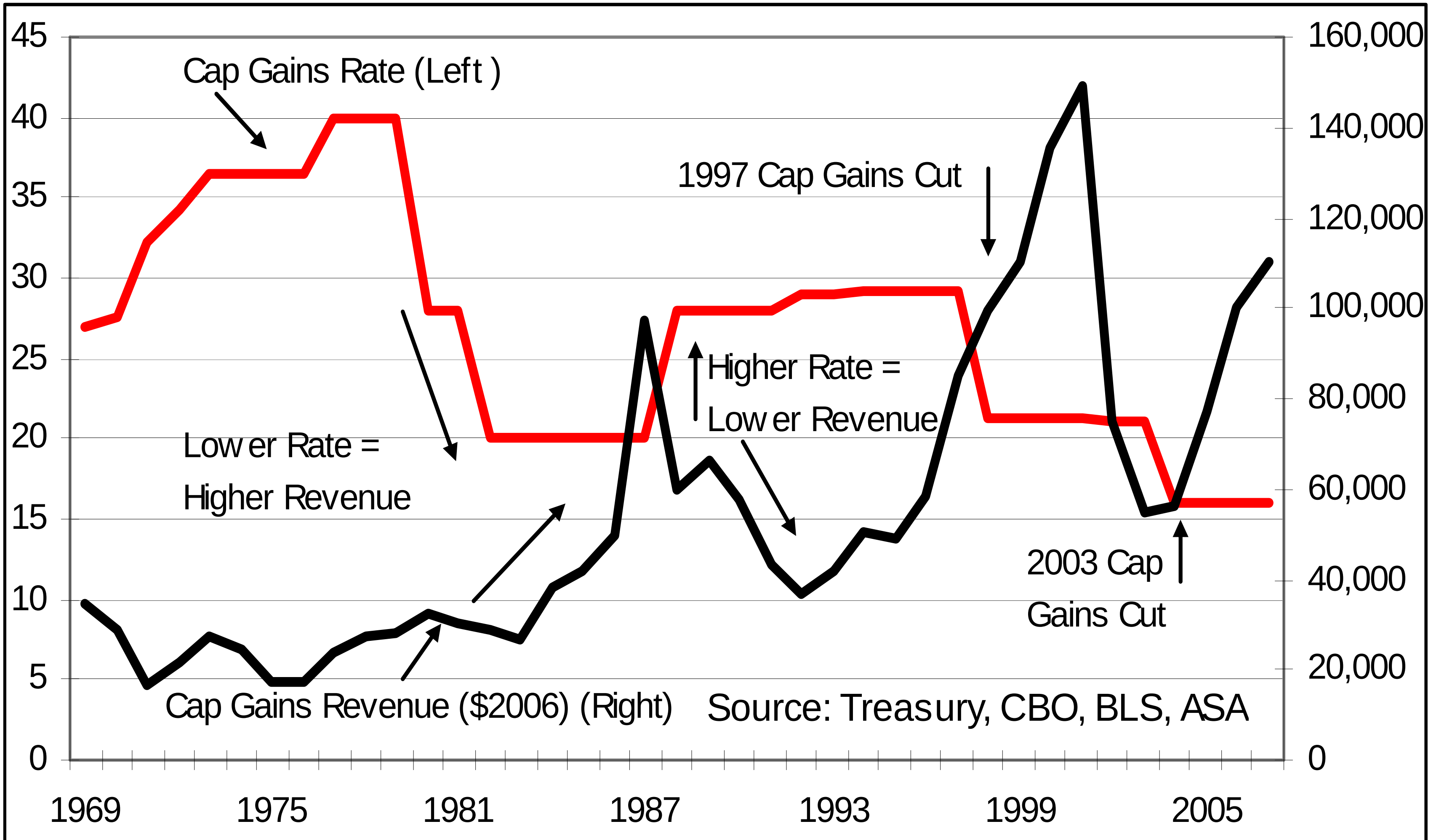
# Non-Withheld Income Tax Collections At Record Levels



# Higher Stock Market Boosts Cap Gains & Dividend Tax Revenues



# Lower Capital Gains Rate = Higher Tax Revenue



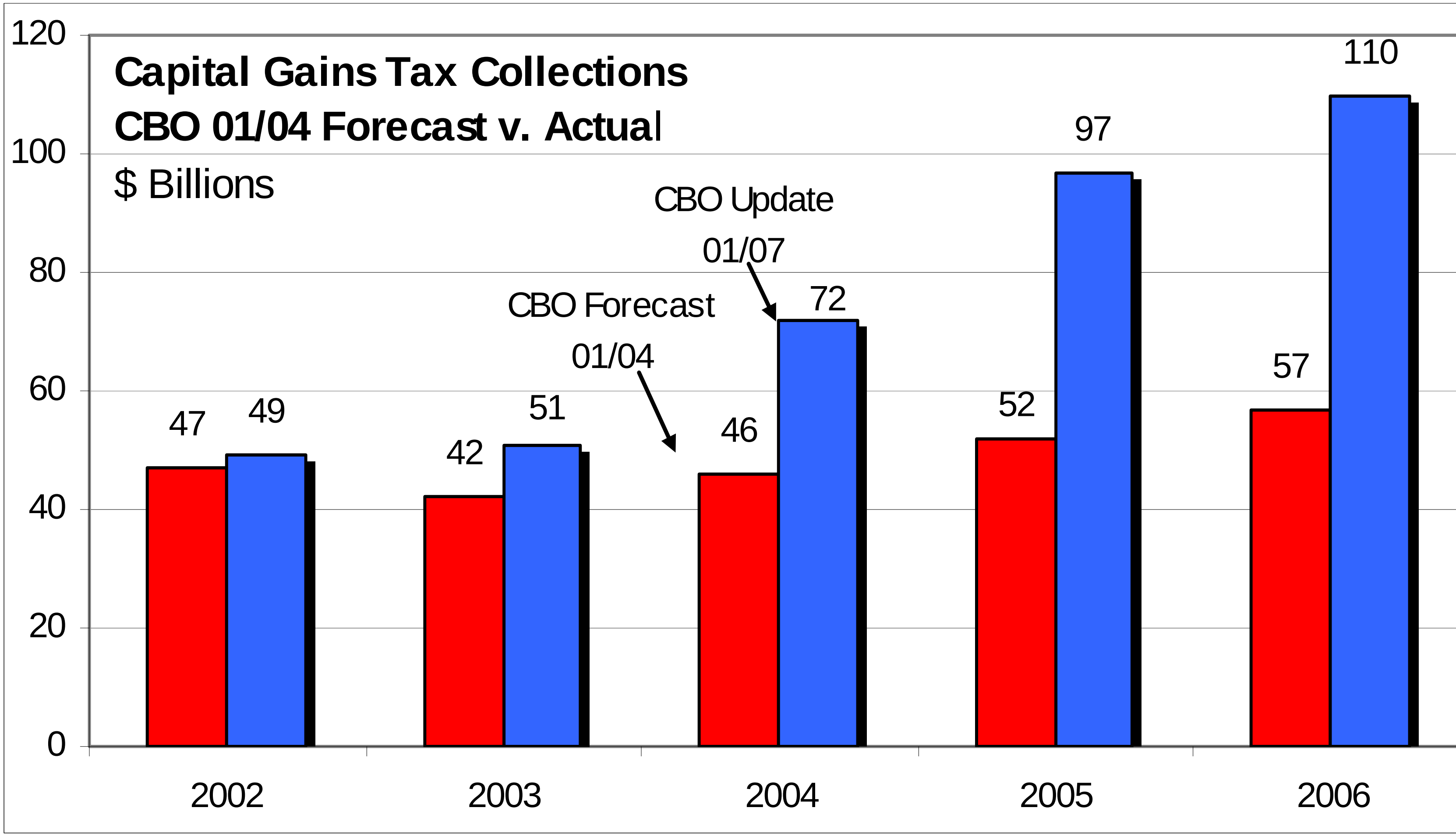
# Tax Revenue Effects

- The same effect is now occurring with the capital gains tax following the 2003 tax cut and is driving the strong growth of tax revenues.
- Government revenue estimators forecasted the capital gains tax reduction would lose $5.4 billion from FY 03- FY 06.
- Congressional Budget Office forecast after the tax cut was passed was for the government to collect $42 billion, $46 billion, $52 billion, and $57 billion in calendar years 2003, 2004, 2005, and 2006 respectively.

# Tax Revenue Effects

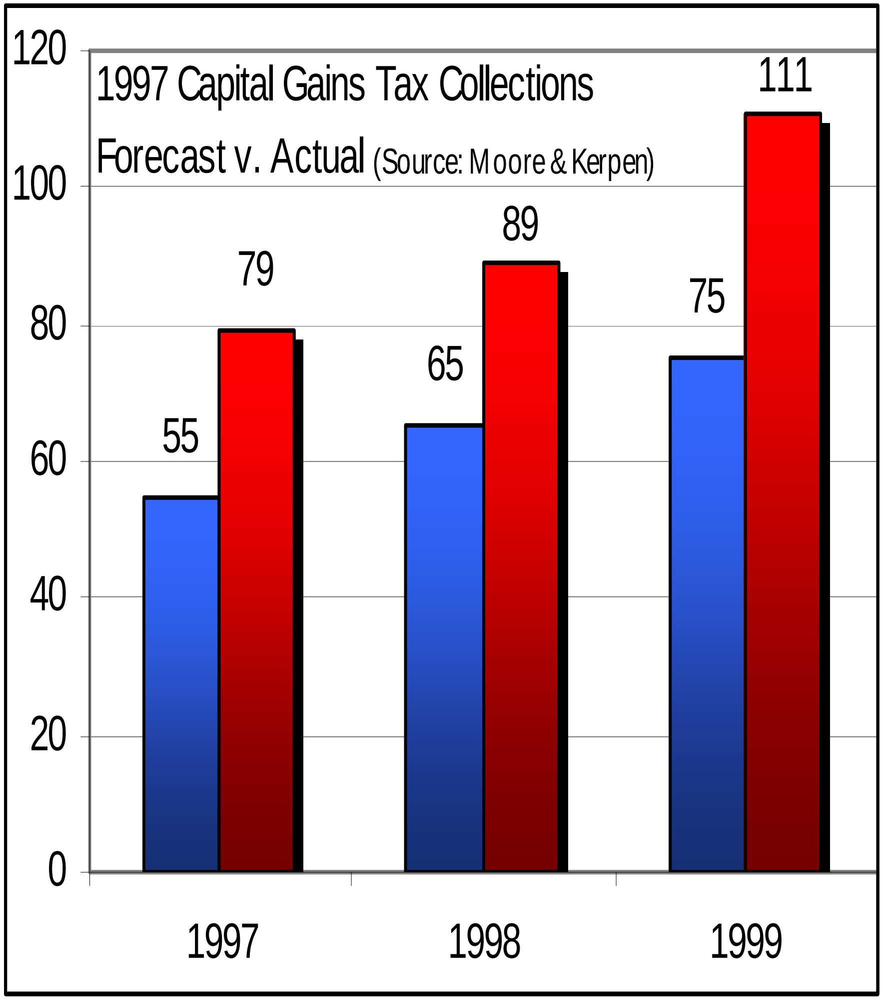
- Yet, the new data shows the government collected $51 billion, $72 billion, $97 billion, and $110 in calendar years 2003, 2004, 2005, and 2006
- Capital gains tax revenue doubled in from the end of CY 03 through CY 05 despite a 25 percent tax reduction.
- As a result, the government collected $133 billion more than was originally forecasted following the tax cut.

# Cap Gains Revenue Doubles:$133 Billion "Unexpected" Windfall…



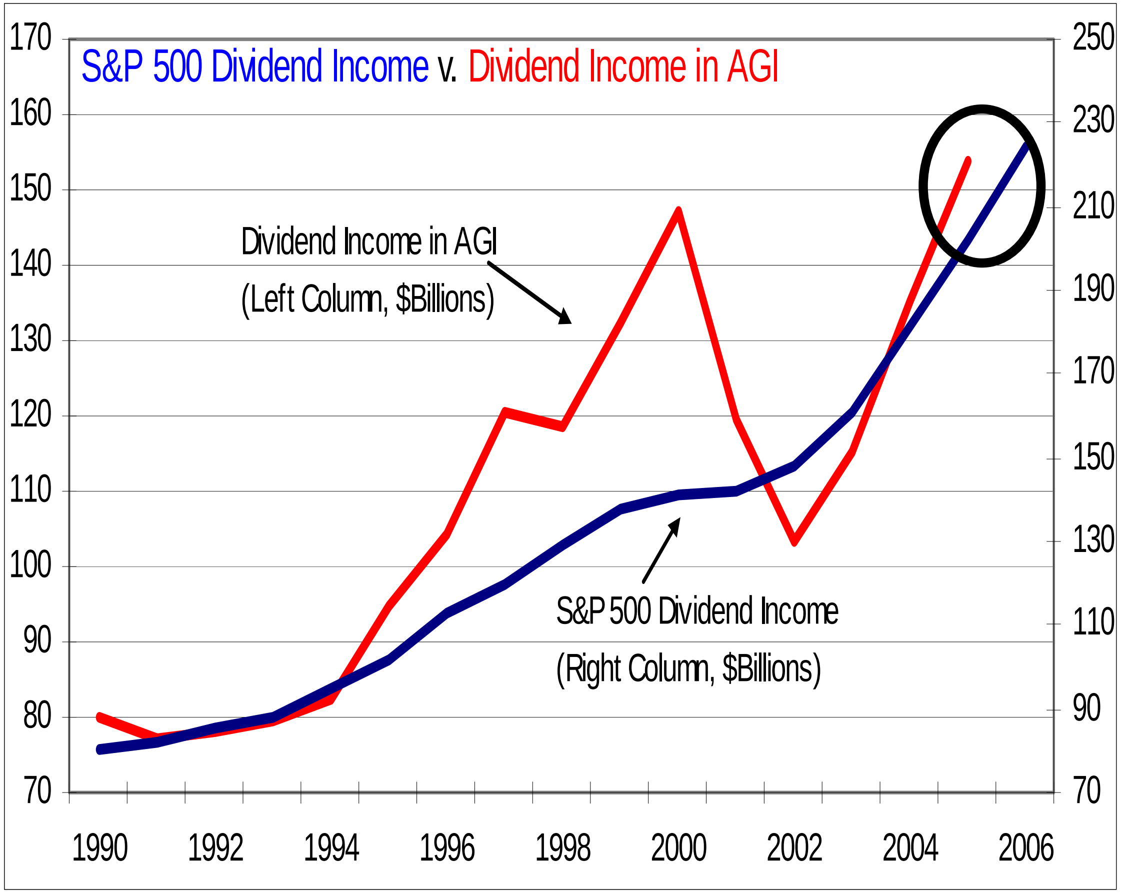
# …Just Like 1997 Capital Gains Tax Cut

- Cutting the capital gains tax in 1997 resulted in more revenue, not less as would be expected.
- JCT missed the forecast by $24 billion in ‘97 and ‘98 and $36 billion in ‘99. The static models cannot account for the unlocking, dynamic, and asset value effects.
- Because of this, tax cuts are being scored as having a larger effect on the deficit than what is occurring in reality.



# Dividend Tax Cut "Cost" Way Overestimated

- According to CBO, "Total revenue reductions from the new tax return data and new estimates of the effects of asset accumulation are partially offset through 2009 by **reductions in the estimated loss in revenues from the reduced rates of taxation on dividends.**"



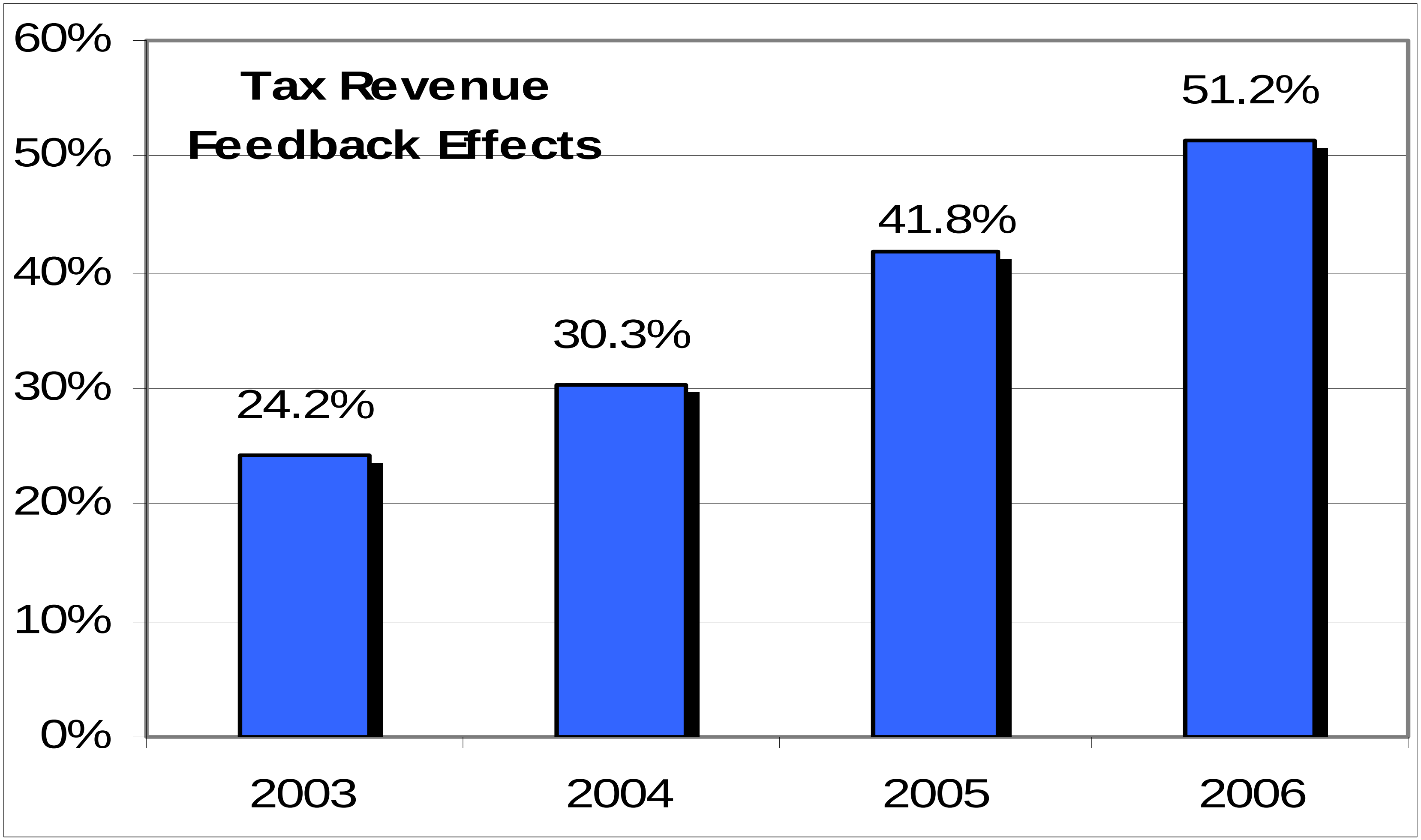

Source:

*Congressional Budget Office "Budget and Economic Outlook 2006-2015." January 2005*

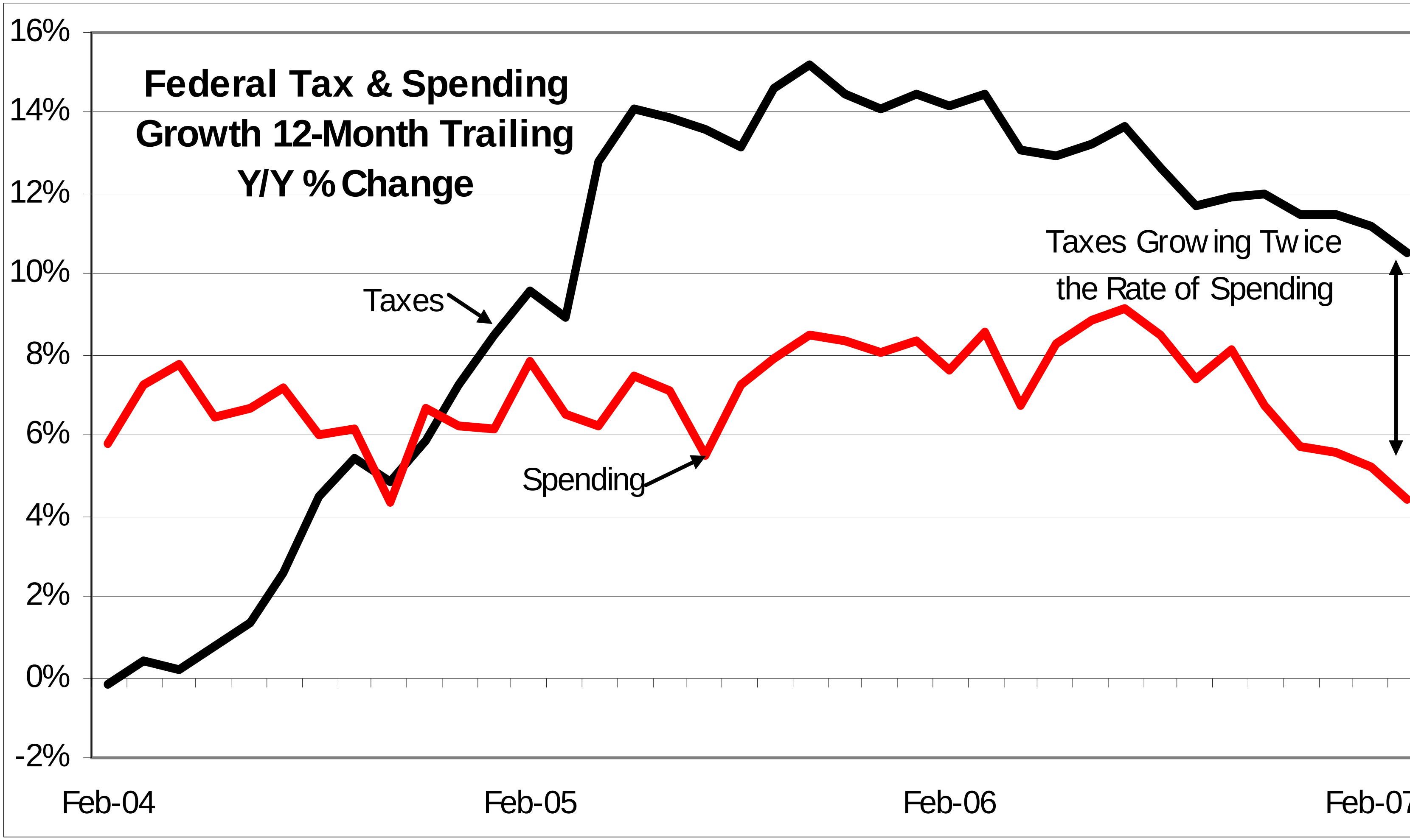
# Tax Revenue Effects

- Over the course of FY03 – FY06, 51.2 percent of the total tax cut cost has been recouped from higher levels of income and economic growth.
- This gap will further narrow over time as the economy continues to grow.
- FY 05 is the first year in which tax revenues exceeded the pre tax cut baseline and has continued into 2006.
- Revenues are now $196 billion above the adjusted baseline, despite $383 billion of tax cuts.
- As such, 51.2 percent of the tax cut has been recouped through higher levels of growth.

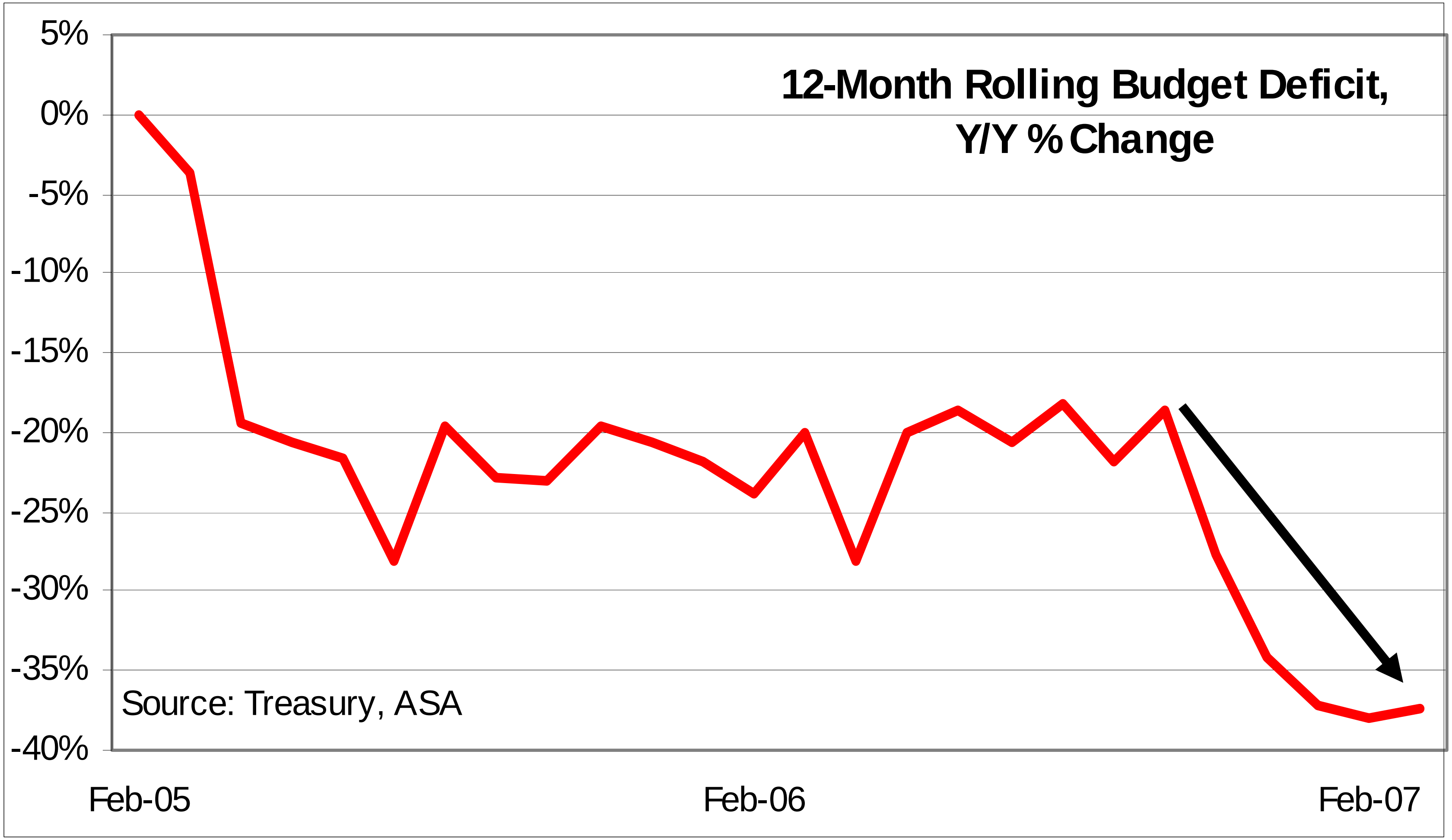
# 51.2% of Entire Tax Cut Package "Cost" Has Been Recouped



# Tax Revenues Growing Twice As Fast As Spending

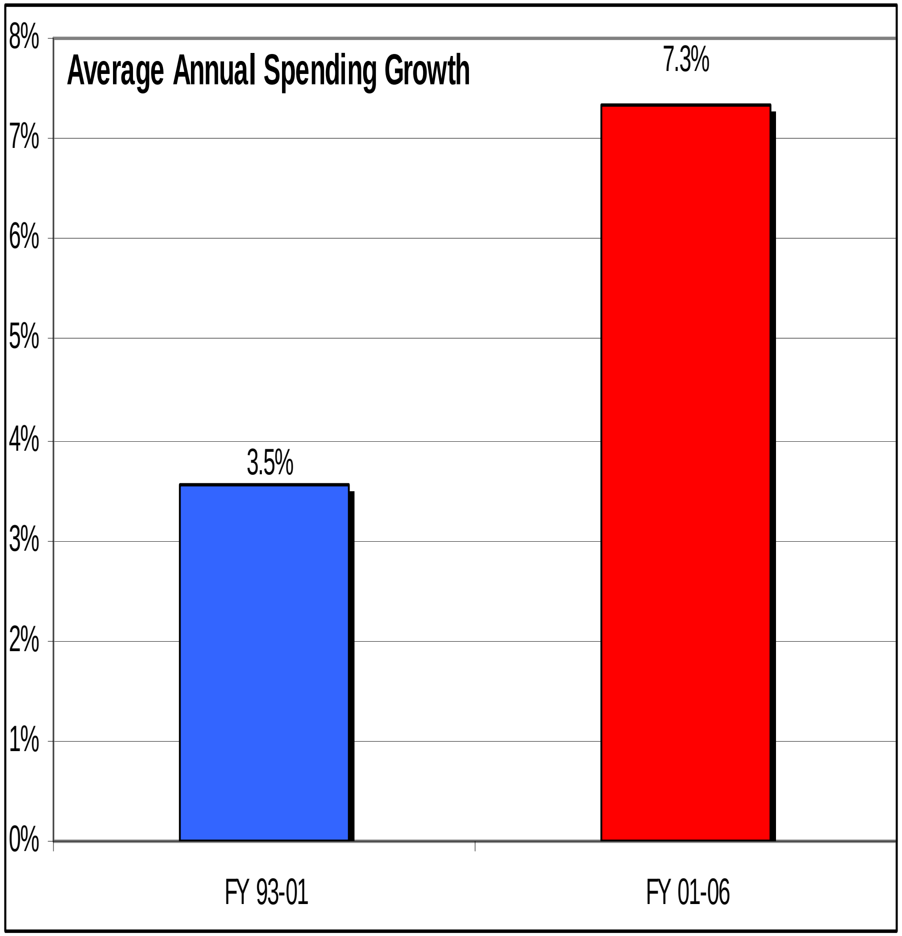


# Budget Deficit Down 37.4 Percent Year Over Year



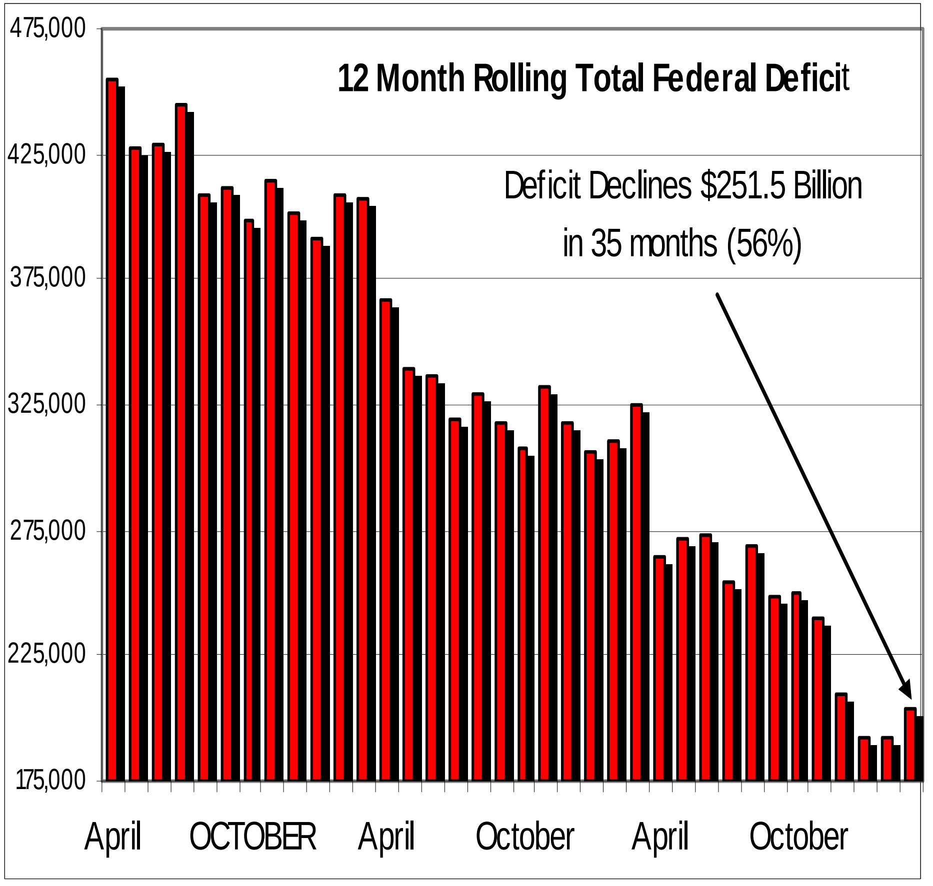
# Deficit Would Be Further Reduced if Not For Spending

- FY 2001-FY 2006 federal spending increased $791 billion from $1.86 trillion to $2.65 trillion
- This is an annual average increase rate of 7.3 percent per year
- From FY 1993- FY 2001, federal spending increased $453.5 billion at an average annual rate of 3.5 percent.
- As such, federal spending growth under Bush has more than doubled Clinton Administration spending growth on annual percentage basis.



# Deficit Dropping Faster Than Expected

- Even more important is the direction of the deficit.
- Including the release of January data, the deficit has dropped $251.9 billion (56%) in the past 35 months.
- The past 12 month total deficit is now at $203 billion – $101.5 billion lower then when the 2003 tax cut was passed.



# Deficit Down 33.3 Percent Since 2003 Tax Cut Signed