

Dueling Visions

By JIM MCTAGUE

John McCain's and Barack Obama's tax plans hold vastly different implications for the U.S. economy. Required reading before you vote.

WITH HOUSING IN A DEPRESSION, FINANCIAL COMPANIES in crisis, stocks slumping and a recession gathering or under way, you'd think that Wall Street would have a strong opinion about whether John McCain or Barack Obama is better-suited to steer the ship of state away from the rocks. But interviews with dozens of money managers, economists and industry analysts over the past few months indicate that, while most would be more comfortable with the Republican candidate, the vast majority don't think that either man would affect the economy much differently than the other.



Scott Pollack

The vast majority, however, is wrong.

In McCain and Obama, the electorate is presented with dueling visions of what shape the economy, and particularly the nation's tax structure, should take. Obama's stated belief is that the best way to revitalize America is by raising taxes on the rich and redistributing wealth to the poor and middle class. McCain, in contrast, would retain all of President Bush's tax cuts, including those for the wealthy, and cut corporate taxes markedly, with the aim of boosting investment in businesses and creating jobs.

Whichever concept prevails will have profound implications for the economy over the next decade.

And, if Obama's plan prevails, it could well be for the worse. While both candidates' proposals have their pros and cons, Obama's appears to have a few too many cons. There's no question about that if you happen to be in the top 1% of income-tax payers. According to the nonpartisan Tax Policy Center, the Obama plan would boost the average tax bill for that group by \$93,709, to \$652,890. McCain's plan would reduce that group's average by \$48,862 to \$510,319.

But far more is at stake than the size of any single fat cat's tax bill. With adjusted gross incomes totaling \$2 trillion, or \$1.6 million per capita, the top 1% of taxpayers account for more than 20% of all adjusted gross income. And these folks tend to plow a lot of their money into businesses -- from family operations to blue-chip stocks -- to say nothing of shopping trips and travel. In other words, cutting their after-tax income could deal another blow to an already-hobbled economy.

The problem would only be compounded by Obama's stand on capital-gains and dividends taxes -- he'd hike them both. He also would institute a more onerous estate tax than McCain would.

It's almost as if Obama wants to repeat the mistakes of Herbert Hoover. During the Great Depression, Hoover raised the top marginal rate to 63% from 25% and hiked corporate taxes, too, says Michael Aronstein, chief investment strategist at Oscar Gruss & Son in New York. The moves siphoned needed investment capital out of the markets and into the hands of bureaucrats, delaying the turnaround.

Of course, taxes aren't the only part of Obama's and McCain's economic programs, and the economy isn't the only issue in the election. *Barron's*, in highlighting the weaknesses of Obama's tax plans, is not taking a position on his entire candidacy, or on McCain's. It is *Barron's* policy not to endorse candidates. We do, however, see taxes as a crucial issue for the economy and markets, and Obama's positions have troubling implications. With the Democratic convention starting this week, it's not too late for him to change.

SO FAR, WALL STREET has reacted to Obama with relative warmth. He's attracted such advisers as Warren Buffett and former Fed chief Paul Volcker. And many seasoned observers maintain that the Democrat's economic policies are quite similar to those of his Republican rival. "There are attempts to make the Obama-McCain difference big; but they are not that big, really," avers Martin Barnes, the managing editor of the *Bank Credit Analyst*.

Because of the budget deficit, now approaching \$500 billion a year, the next president, regardless of party, will have his hands tied, many observers say. He will have little choice but to raise taxes and cut spending.

Obama's tax plans, however, point to a philosophy that historically has worried market pros. Raising taxes on the investor class simply doesn't help investment.

That lesson evidently was lost during the Clinton administration, which promoted tax policies similar to Obama's. Democrats argue that Clinton proved that higher taxes can go hand-in-hand with stronger growth. The U.S. added 2.8 million jobs annually in the Clinton years, and markets soared. The S&P 500 stock index, with reinvested dividends, rose 256% during Clinton's two terms, handily topping the 178% gain for tax-cutting icon Ronald Reagan, according to data from Bianco Research. Better still, the federal budget deficit under Clinton turned into a \$236 billion surplus. Consequently, the total returns on bonds, measured by the Lehman Aggregate Index, rose 73%.

There's a good case to be made, however, that if Clinton had been given a free hand, he would have hurt the economy and the markets. Critics maintain that he was saved from himself by a string of fortuitous events, including the GOP taking control of the House in 1994.

If Obama wins, there will be no credible opposition to his tax plans. In fact, he might well enjoy the largest Democratic majority in Congress since 1937, with his party likely to pick up seats in the House and Senate as the Republicans suffer from a "throw the bums out" backlash against the Bush years.

Obama's team, for its part, insists that the tax proposals would be a boon to the economy. Obama adviser Lawrence Summers, who was Clinton's Treasury secretary, argues: "At a time when the 10-year interest rate is in the threes, at a time when it is clearly lack of demand for products rather than the cost of capital that is inhibiting investment, the idea that a return to the tax policies of the

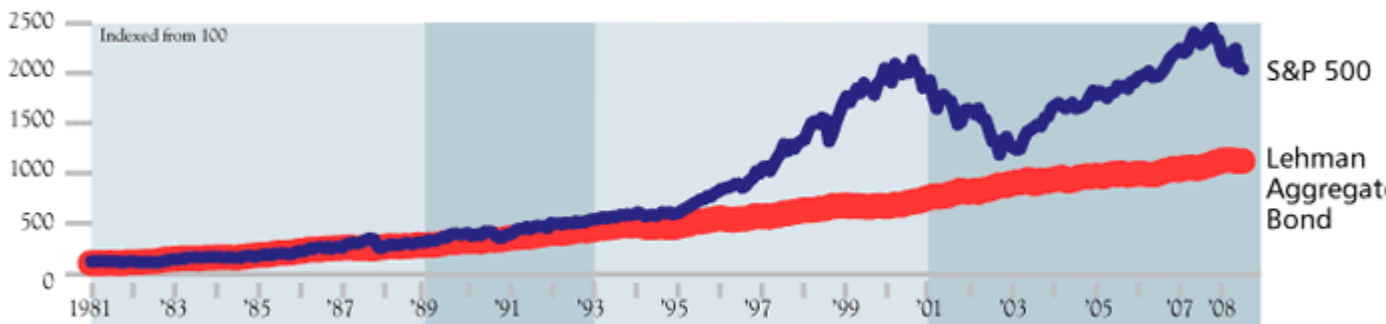
1990s would somehow damage the economy in a substantial way seems to me supported by neither theory nor evidence nor the longer-term history."

But leverage is dead for the moment, so those low rates are not as alluring as they once were. And Summers assumes that raising someone's tax bill by multiple thousands will not curb their investment activities. That assumption is dubious at best.

Who Moved My Market?

Democrats say the Clinton years proved that higher taxes can go hand in hand with economic growth. And, indeed, the stock-market surge under Bill Clinton topped the one under tax-cutting icon Ronald Reagan. Could Democrat Barack Obama repeat Clinton's market performance? Observers differ sharply on that.

Indexes of total returns, stocks and bonds



Source: Bianco Research

The reductions of tax bills under President Bush certainly helped the economy. They spurred consumption, investment and entrepreneurial activity. Without the cuts, GDP growth would have been 0.7% less each year from 2001 through 2006, and the unemployment rate would have been 1.2 percentage points higher over the period, according to an analysis prepared for the American Council for Capital Formation by independent economist Allen Sinai.

IT'S HARD TO PIN down the details of Obama's tax proposal because they keep changing. Follow the bouncing tax rates. Until this month, he said he would raise taxes on only those making \$250,000 or more, hiking the marginal rate from 35% to 39.6%, exactly where it was when Clinton was president. He said that he'd raise capital gains and dividend taxes, now 15%, to 20%, where they stood before 2003, and possibly as high as 28%, where they were when Ronald Reagan was president. Obama also promises to apply a Social Security tax on this cohort of 2% to 4%.

This month, however, Jason Furman and Austan Goolsbee, his top economic advisers, wrote in a Wall Street Journal op-ed piece that Obama would raise taxes on individuals making \$200,000 or more. Their top marginal rate would go from 33% to 36%. Asked about this apparent change, the Obama campaign declined to provide an explanation.

Obama's tax plan, at least in the original version, would generate \$131 billion a year in new revenue for the government, according to the Tax Policy Center, a joint operation of the Brookings Institution and the Urban Institute in Washington. His proposal to make the wealthiest taxpayers

pay higher Social Security taxes than everyone else could net Uncle Sam another \$40 billion a year. He's recently had second thoughts about this proposal and said that he might delay its implementation to 2018, way beyond his term.

Over all, he would raise \$800 billion more over 10 years than the government would if the Bush tax cuts were made permanent, according to the Tax Policy Center. McCain's plan, which keeps all the Bush cuts and trims corporate taxes to 25% from 35%, would cut revenue by \$600 billion.

Obama would use the money he takes from the wealthy to keep rates low for everyone else and to fund universal health care (estimated cost: \$55 billion a year when up and running). For the nation's poorest households, there also would be benefits for child care, mortgage interest and education. He wants to make amends for a Bush expansion that saw incomes rise at the top while real incomes slid for the middle and lower classes, owing to higher fuel and food costs.

Cognizant that his tax hikes might retard job growth, Obama plans a zero capital-gains rate for small businesses and start-ups -- details to come later. But that might not be broad enough to offset the damage of his tax hikes.

Wachovia's chief economist, John Silvia, says corporate and capital-gains tax hikes would crimp the flow of foreign capital to the U.S. and slow growth and job creation relative to the rest of the world: "If foreign investors perceive that our tax rates are going to go up over time, they are not going to invest as much in this country as they otherwise would. And this is bad not only for Wall Street but for Main Street."

MCCAIN'S TAX PLAN is more growth-oriented than Obama's because it punishes no one group and, by lowering corporate tax rates, makes U.S. businesses more attractive to American and foreign investors. Workers with corporate health benefits would be pinched by McCain's proposal to end tax exclusions for that coverage and replace it with a tax credit of \$2,500 for individuals and \$5,000 for families. If you wanted a more expensive policy, then you would have to shell out additional dollars for it. But that's part of a health-care reform proposal aimed at bringing down medical costs by making consumers more savvy shoppers, not a revenue-raising scheme.

McCain's tax plan, which includes a reduction in the alternative minimum tax, is lacking in progressivity and thus, like the Bush cuts, would benefit the top brackets the most. According to the Tax Policy Center, McCain would cut taxes for 60% of households -- but less than one in five households in the bottom fifth and less than half of those in the next-to-last fifth would see a reduction in their IRS bills.

McCain promises that his fiscal plan will lower deficits, not raise them, because he will be austere on the spending side of the ledger. Whether he'd succeed at that is open to question, but he does have a lengthy track record of opposing pork-barrel projects and has been known to take on special interests. It's as if he's been paying penance these past 20 years for his association with S&L rogue Charles Keating back in the 1980s. McCain was one of the Keating Five -- five senators accused of improperly helping Keating fight regulators.

His mantra on the campaign trail is that he will veto wasteful spending and make the authors of such bills "famous," meaning infamous. And since he is a Republican -- though more in the vein of

centrist Nelson Rockefeller than conservative Reagan -- he would have an easier time than would Obama in bucking a Democratic Congress.

An Investor's Guide to Taxes

Barack Obama would boost taxes on the rich and redistribute wealth to the poor and middle-class. John McCain would keep all the Bush cuts, including those for the wealthy, and cut corporate taxes.

Tax	McCain	Obama
Individual Income	Make Bush tax cuts permanent, with the highest rate at 35%.	Raise taxes on those with incomes above \$250,000, with the highest rate at 39.6%. Cut taxes for low-and middle-income households.
Capital Gains and Dividends	Retain at 15%, the level set in 2003.	Raise taxes on capital gains and dividends to 20%, and possibly 28%.
Corporate	Reduce maximum corporate income tax rate to 25% from 35%.	No changes in tax rate.
Estate	\$10 million exemption, 15% rate.	\$3.5 million exemption, 45% rate.

Nevertheless, plenty of Wall Streeters see no threat to the economy from Obama. Investors like unconventional economic approaches when conventional ones seem to be failing, says Tom Gallagher, an analyst with ISI Group in Washington. Gallagher also notes that in three previous contests where a Democrat won a close contest, there was a selloff after Labor Day, followed by a pre-election rally. He expects this pattern to be repeated if Obama is the frontrunner going into the fall.

The last of those Democrats to win, Bill Clinton, went on to defy the tax-hike worrywarts -- with some help from Lady Luck. Not only did a GOP Congress hold his tax and spending plans in check, but a loose-fisted Fed also brought interest rates to rock-bottom levels and pumped \$40 billion into the economy on the eve of Y2K.

Obama could get lucky, just like Clinton. Oil prices could fall to \$50 a barrel, or a Tom Edison might turn crab grass into jet fuel. Better yet, Obama, who's no dummy, might think twice about raising taxes during the worst financial crisis in 78 years.