PAGE 29
FRIDAY, FEBRUARY 13, 1987

THE WALL STREET JOURNAL.

© 1987 Dow Jones & Company, Inc. All Rights Reserved.

Lower Tax Rates Feed Stock-Market Boom

By Alvin Rabushka

On Dec. 31, 1986, the Dow Jones Industrial Average stood at 1895.95. Nearly six trading weeks into the new year, by Feb. 11, 1987, it rose 276.01 points to reach 2171.96, for a gain of 14.56%. Similarly, the New York Stock Exchange Composite Index rose 14.35%, the S&P 500 Index gained 14.61%, the Nasdaq OTC Composite tacked on 17.03%, and the Amex added 14.63%. These are phenomenal increases and appear to have taken analysts by surprise. Many warn of the inevitable correction that lurks over the horizon.

One explanation for the stock-market boom is no mystery or puzzle, but is a straightforward consequence of the Tax Reform Act of 1986. Everyone seems to have overlooked how after-tax returns to equity sharply increased on Jan. 1, 1987.

In the U.S. tax code, corporate and personal income taxes are not integrated, which effectively taxes business income twice. The Internal Revenue Service first taxes corporate profits at the corporate tax rate and then taxes corporate income a second time—in the form of dividends at the individual stockholder's personal income-tax rate.

In 1986, the combined maximum tax rate on corporate income was 73% (46% on corporate profits plus up to 50% on the remaining 54% received by individuals). If no dividends were paid from after-tax profits, but shareholders realized their returns in the form of capital gains from rising share values, the combined top rate was 56.8% (46% plus 10.8%, which is 20% of the remaining 54%).

Since Jan. 1, 1987, however, corporate income is taxed at sharply lower rates. The corporate rate fell to 34% from 46% and the top individual rate to 38.5% from 50%. The combined potential maximum rate on corporate income declined to 59.4% from 73% (34% plus 38.5% on the remaining 66%). The new combined rate of 59.4% reduced the top tax rate 18.6% compared with 1986. If no dividends are paid, but all returns are taken in capital gains, the combined rate still fell to 52.5% from 56.8% (a decline in overall taxation of 7.6%), despite an increase in the top capital-gains tax rate to 28% from 20%.

When couched in terms of the percentage increase in after-tax returns to equity investments, the numbers look still better. A 73% tax rate on corporate income in 1986 left high-bracket taxpayers with a 27% after-tax rate of return. In 1987, the after-tax rate of return to the same high-bracket taxpayer increases to 40.6%—a phenomenal gain of 50.4% in the investor's return. Spinning the dial ahead to 1988 dramatizes the new benefits to owning equity from lower tax rates. In 1988 the top combined rate on corporate income will drop to 52.5%, which will give investors an increase of 75.9% in their after-tax returns compared with pre-reform 1986.

In effect, the stock market has been rapidly capitalizing the lower tax rates that took effect Jan. 1, 1987. Tax capitalization occurs whenever taxes are changed on any asset. In real estate, for example, a decrease in property taxes on a house would increase the market value of that house by some multiple of the reciprocal of the mortgage rate. At mortgage rates of 10%, every dollar in lower property taxes raises the value of the property by about $10.

Similarly, every dollar in lower taxes on equity investment creates several dollars in new market value. In addition, if efficiency improves, which was the objective in lowering marginal tax rates, business will become more profitable. In that case, greater returns to equity investment will show up in still higher stock prices.

What happened in the U.S. is reflected in world stock markets. Between Jan. 1 and Feb. 11, the Canadian, British and Japanese markets put on double-digit percentage gains while the German market declined 16%. Japan's ruling party plans to cut its top personal-income tax rate from 70% to 50% this year and Canada is scheduled to debate tax reform in the spring. On Jan. 1, Britain's corporate rate declined from 40% to 35%. Conversely, Germany has yet to show serious interest in reducing its current high-rate corporate and personal income-tax schedule.

Higher after-tax returns on equity investment suggest two additional measures. The first is to integrate fully the corporate and personal income taxes, thereby reducing the maximum tax rate on business income to 34%. The second is to lower the top corporate and personal rates. Even without integrating the tax code, a top rate of 20% would mean an overall combined rate on business income of 36%. Either measure would propel equity prices upward, thus stimulating investment. Wouldn't this be a better way to improve "competitiveness?"

Mr. Rabushka is a senior fellow at Stanford's Hoover Institution.