

Musings from the Chief Economist

Election 2008: Potential tax policy changes

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Now that the presidential election campaign is in full swing, the political rhetoric is flowing freely, positions are becoming more “flexible”, and promises are being handed out like candy. All this makes it easy to lose track of the underlying tax policy proposals of Barack Obama and John McCain. The tables on the next three pages contrast the two major candidates’ tax policy positions as of July 2008. Table 1 summarizes the two tax policies, Tables 2 and 3 calculate the top marginal tax rates on income and dividends, and Table 4 examines the share of income and tax burdens across income percentiles. The information in these tables comes from the two candidates’ web sites, The Brookings Institute Tax Policy Center and Urban Institute, the Tax Foundation and The Internal Revenue Service.

As the election approaches, investors should consider asking the following questions to help them assess these two very different approaches to tax policy.

- What impact would higher taxes have on capital formation, work effort and long-term economic growth?
- What are the behavioral impacts on economic activity from tax policy changes?
- What impact will policy changes have

upon the federal deficit, the U.S. dollar and U.S. interest rates?

- Will the prospect of a higher capital gains tax trigger stock selling pressure?
- What impact would raising the tax on capital gains and dividends have on equity market valuations? Higher taxes by definition lower the projected after-tax cash flow to taxable investors.
- How much of a potential tax hike on capital is already priced into stocks? Equities are relatively cheap, and some of the potential for higher taxes has likely already been discounted in stock prices.
- Will tax-free investors (i.e. 401(k)’s pensions, retirement funds, etc.) step in and buy stocks if taxable investors start to sell them? Are marginal prices set by tax-free investors or by taxable investors?
- After the election, will economic reality trump political rhetoric? Will the new President’s final tax proposal look different when forced to govern?
- What will the economy look like when and if tax policy is changed? Will the economy be strong enough to absorb a tax hit? Will tax hikes be postponed depending on economic conditions?
- Will tax changes be able to get through the legislative process?

There are a lot of questions worth pondering. Although investors will have many different viewpoints in answering these questions, that’s what makes markets and that’s why we have

elections. Regardless of one’s opinions, any analysis should start with the facts. Moving forward, we will keep our portfolios diversified. We will evaluate relative asset values, economic and market fundamentals, and the relative price action in markets for opportunities to tilt portfolios.

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Table 1: Proposed Tax Policies of Presidential Candidates as of July 2008

Tax Category	Current Law	Obama	McCain
Married Filing Jointly 2007 Taxable income	Marginal Tax Rate	Marginal Tax Rate	
\$0-\$15,650	10%	10%	
\$15,600-\$63,700	15%	15%	Make 2003 tax cuts permanent.
\$63,700-\$128,500	25%	25%	
\$128,500-\$195,850	28%	28%	
\$195,850-\$349,700	33%	36%	
\$349,700 and over	35%	39.6%	
Highest Marginal Tax Rate Family of four, adjusting for phase out of exemptions starting at \$234,600 AGI (not more than 2/3 of \$3,000 exemption) and itemized deductions over \$156,400 AGI	38.5%	Increase phase out level to \$250k for both exemptions and deductions. 43.1%	37.5%
Capital Gain Tax	15%	25%-28%	15%
Maximum Dividend Tax	15%	39.6%	15%
Alternative Minimum Tax (AMT)	28%	28% Extend and index the 2007 AMT patch.	Permanently index exclusion and increase by 5%/year after 2013 until it reaches a joint \$143,000.
Estate Tax	Top rate 45%. 0% 2010/ 55% 2011. Exclusion in 2008 is \$2 million and goes to \$3.5 million in 2009.	Freeze 2009 law at 45%. \$3.5 million exclusion. Not indexed.	15% \$5 million exclusion. Not Indexed.
Personal and Dependent Exemptions	\$3,500 Indexed for inflation.	No Change.	Increase dependent exemption to \$7,000 by 2016 and indexed thereafter. Personal exemption \$3,500 indexed.
Child Tax Credit	\$1,000 Phased out on joint income over \$110,000.	\$500	No Change.
Child and Dependent Care Credit to individuals paying for care while they work or look for work	35% nonrefundable credit up to \$15k of income. Phases out after \$15k at a rate of 1% for each \$2k additional income.	50% refundable credit up to \$30k. Phases out at a 2% rate for each \$2k in additional income.	No Change.
Corporate Income Tax	35%	35%	Reduce to 25% by 2015 to average OECD rate.
Business Depreciation	Depreciation over the life of the asset.	No Change.	Full expensing of equipment with 3-5 year life until 2013
Research and Development Credit	Temporary 20% credit above base amount of expenditures.	Permanent Extension of R&D Credit	Permanent 10% credit on all R&D wages.

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Table 1: Proposed Tax Policies of Presidential Candidates as of July 2008 (continued)

Tax Category	Current Law	Obama	McCain
Oil Companies		Eliminate oil and gas loopholes. Impose a windfall profit tax on oil and gas companies.	Eliminate oil and gas loopholes, specifically the expensing of exploration and development costs, repeal the 15% credit for recovery costs from tertiary wells and eliminate exceptions to uniform capitalization rules for intangible drilling costs.
Health Care		Provide refundable tax credits to low-income families without employer or public health insurance. Insurance must be purchased from a newly created insurance exchange. Employers who fail to provide health insurance would be penalized. Health insurance for children would be mandated, requiring families to provide coverage for children up to age 25. Expand the state children's health insurance program (CHIP) to cover children up to age 25 and increase family income cap to \$82,600.	Eliminate exclusion from personal income of health care benefits provided by employers and provide an indexed refundable tax credit of \$2,500 for individuals and \$5,000 for family coverage for both privately purchased and employer provided insurance. Create a subsidized high risk pool for those who cannot secure insurance. Allow insurance companies to compete across state lines.
Other		<p>"Make Work Pay Credit" offsets payroll taxes (6.2%) on the first \$8,100 of earnings on incomes less than \$55k, generating a credit up to \$500/person or \$1,000/family.</p> <p>"American Opportunity Tax Credit" replaces the Hope Credit of \$1,800 for college education and increases it to \$4,000. Income caps would apply. Students claiming the credit would have to provide 100 hours of community service (military service excluded).</p> <p>"Patriot Employer Act" gives tax breaks to certain businesses that meet certain hiring, wage and other government requirements.</p> <p>"Senior Tax Exemption" Eliminates income taxes for seniors (65+ years old) making less than \$50,000.</p> <p>"Universal Mortgage Credit" would provide a 10% mortgage credit for non-itemizers, up to \$800.</p> <p>"Minimum Wage Earner Credit" would increase the earned income caps in calculating credit for childless workers, with a maximum credit of \$555. If workers are "responsibly" providing child support, the credit would go to a maximum of \$1,110.</p> <p>Mandate that employers offering 401(k) plans automatically fund employee accounts through payroll deductions. Employees would have to opt out, not opt in. If employers do not have 401(k) plans, they must provide automatic IRAs'.</p>	

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Table 2: Marginal Tax Rate on Income

	Current	Obama	McCain
Top Federal Marginal Rate	35.0%	39.6%	35.0%
Phase-out of Deductions and Exemptions	3.5%	3.5%	3.5%
Top California State Tax Rate	10.3%	10.3%	10.3%
Unlimited Social Security Tax on household income above \$250k	0%	12.4%	0%
Medicare	2.9%	2.9%	2.9%
Total Top Marginal Tax	51.7%	68.7%	51.7%

Sources: Bailard Research, BarackObama.com, JohnMcCain.com, The Brookings Institute Tax Policy Center and Urban Institute, Tax Foundation, Internal Revenue Service

Table 3: Top Marginal Tax Rate on Dividends

Tax	Current	Obama	McCain
Dividend Tax Rate	15.0%	39.6%	15.0%
Phase out of Deductions and Exemptions	3.5%	3.5%	3.5%
California Tax Rate	10.3%	10.3%	10.3%
Corporate Tax Rate	35.0%	35.0%	25.0%
Total Top Marginal Dividend Tax	63.8%	88.4%	53.8%

Sources: Bailard Research, BarackObama.com, JohnMcCain.com, The Brookings Institute Tax Policy Center and Urban Institute, Tax Foundation, Internal Revenue Service

Table 4: Progressivity of Tax Code

Income Bracket	Taxpayer Shares of Adjusted Gross Income and Taxes *3								
	1990			2000			2006		
	Share of AGI*	Share of Taxes	Extra Tax Burden *2	Share of AGI*	Share of Taxes	Extra Tax Burden *2	Share of AGI*	Share of Taxes	Extra Tax Burden *2
Top 1%	14.0%	25.1%	+11.1%	20.8%	37.4%	+16.6%	22.1%	39.9%	+17.8%
Top 5%	27.6%	43.6%	+16.0%	35.3%	56.5%	+21.2%	36.7%	60.1%	+23.4%
Top 25%	62.1%	78.5%	+16.4%	67.1%	84.0%	+16.9%	68.7%	86.3%	+17.6%
Top 50%	85.0%	95.0%	+10.0%	87.0%	96.9%	+9.9%	87.5%	97.1%	+9.6%

*AGI=Adjusted Gross Income

*2 Extra Tax Burden is the difference between the share of taxes and the share of income.

*3 Income distribution shifts with tax policy, and there are many nuances to consider:

A. Income numbers do not adjust for transfer payments, which boost lower income levels.

B. Sub-S corporate tax filings increased when personal income tax rates fell relative to corporate tax rates, boosting income in the top brackets. What was previously counted as corporate income now shows up as personal income.

C. 401(k) contributions are not included in AGI and are capped. The expansion of 401(k)'s has reduced AGI for middle income tax payers relative to higher income earners.

D. The expansion of the underground economy reduces reported income.

E. Percentiles are not static. Earners move up and down the income spectrum, and most people start at the bottom.

Sources: Internal Revenue Service "Summary of Latest Federal Individual Income Tax Data", July 18, 2008; Bailard Research

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