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The 2013 Fiscal Cliff Could Crush Stocks

By Donald L. Luskin

Why doesn't the stock market, that most sensitive of economic barometers, seem to care that the U.S. economy faces a "fiscal cliff" at year-end? On Dec. 31, trillions of dollars in tax cuts will expire, trillions more in new tax hikes under ObamaCare will kick in, and a trillion in automatic spending cuts will begin. Yet stock prices are the highest in four years.

Maybe with the date still far away, the fiscal cliff just doesn't seem real. It's certainly being treated that way on both sides of the political divide. On the left, economists claim with a straight face that even huge tax hikes don't matter—a top tax rate as high as 70%, they claim, would have no chilling effects on top earners' incentives. On the right, they just as solemnly claim even a small rise in the top rate for high earners from today's 35% to the 39.6% scheduled for after year-end will bring about economic ruin.

So perhaps the stock market has been lulled into thinking these issues are merely abstract matters of theory to be hashed out by economists on both sides. What's the big deal, so long as Apple beats consensus earnings expectations again next quarter?

The big deal is that one key element at stake here is not a matter of theory at all—it's simple arithmetic. And it leads to the simple yet alarming conclusion that unless current law is amended before year-end, the stock market has to fall by at least 30%.

It's all about how dividends are taxed—and the reality that we are facing one of the biggest hikes in dividend tax rates in history.

The market sets the price of a dividend-paying stock so that it will pay the after-tax yield required to attract capital. When the tax rate on dividends goes up, the after-tax yield necessarily goes down—to restore the after-tax yield to its required level, the stock price has to fall.

Please bear with us through an explanation that involves a little arithmetic. If you are an investor, this is important.

Consider a stock trading at $100 that pays a $10 dividend every year. Under current law, an investor pays a 15% tax on that dividend, so he gets to keep 85% of it, or $8.50. So the after-tax yield on that stock is 8.5%.

After year-end, under current law, the top dividend tax rate will rise to 43.4% from 15%. That's not only because the temporary low 15% rate granted under the 2001 Bush tax cuts will revert to the prior rate of 39.6%. In addition, a provision of ObamaCare slaps a 3.8% surtax on all forms of investment income, including dividends—the resulting total is 43.4%.

So on Jan. 1, an investor won't keep $8.50 of that dividend—he'll pay a 43.4% tax and keep only $5.66. Suddenly, a stock that yielded him 8.5% now yields only 5.66%.

If 8.5% was the after-tax yield that investors demanded in order to allocate their capital to that particular company, then 5.66% will not be sufficient. That company's stock price will have to fall until it once again offers an 8.5% after-tax yield.

Precisely, the stock price has to fall by the percentage difference between $8.50 and $5.66. It will therefore fall to $66.60 from $100—that's 33.4%. And it's also a good first approximation of how much the overall stock market will fall when dividend taxes rise to 43.4% from 15%.

This 33.4% figure is only an approximation, because investors such as pension funds don't pay taxes on dividends. About a quarter of all dividends are earned by individuals taxed at the top rate. Who's to say that these high-earning individuals aren't the so-called marginal investors who set stock prices?

And perhaps it's unfair to implicitly assume here that stock prices are determined entirely by dividend yields. But who's to say they are not? Even companies that pay no dividends may well be priced by markets in the expectation that dividends will be paid in the future.

To be sure, we can quibble about the exact amount—but not the direction. It's pretty much axiomatic: after-tax yields lower, stock prices lower.

All the same logic would apply to the increase in capital gains tax rates scheduled for year-end. With the expiration of the Bush tax cuts and the advent of the ObamaCare surcharge, the top capital gains rate will rise to 23.8% from 15%.

The arithmetic for how much stocks will drop as a result is more complicated, because capital gains taxes are only paid when assets are eventually sold. But the effect on stock prices is the same—it's down.

The same logic also applies here to bonds, because at year-end the top tax rate on interest income will rise to 43.4% from 35%. According to our simple arithmetic, if the yield on a 10-year Treasury is 2% today, it would rise to 2.3% with next year's tax rates. That's a whole new version of the Laffer Curve, one in which higher taxes drive higher government debt service costs.

So just by the numbers, the fiscal cliff matters. Investors are wrong to blithely assume that the boys in Washington will somehow do the right thing and it will all work out in the end.

All these tax issues will have to get negotiated in the lame duck session of Congress after what is likely to be an unusually bitter election season. And it's highly likely that an increase in the statutory debt ceiling will have to be negotiated at the same time, in order to avoid a Treasury default—investors would be wise to remember what a near-death experience that was last August.

If there's a bargaining failure and the scheduled tax hikes on dividends aren't stopped, we'll be sorry we're spending so much political energy now debating about the "1%" and their supposed privileges. It's the 30% down in the stock market we ought be worrying about.

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