Report by the Mortgage Bankers Association of America

Estimated Impact of the Major Components of the Bush Administration's Growth and Jobs Plan on Housing and the Economy

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Mortgage Bankers Association of America

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Executive Summary

The halting and weak nature of the current economic recovery and the related lack of job creation have led to the proposal that fiscal policy be used to encourage greater economic growth. February payroll employment declined by over 300,000 jobs affecting all sectors of the economy. Fourth quarter Gross Domestic Product (GDP) increased a paltry 1.4 percent at an annual rate. House price increases are slowing, increasing the likelihood that the strong support provided by the housing sector will moderate somewhat toward a more historically normal role, but raising the risk of slowing consumer spending. While some signs of strengthening can be observed, the Federal Reserve Board has noted that there is still greater risk of weak economic growth than of resurgent inflation.

The Bush Administration has proposed a defined package of policies for the purpose of increasing economic growth and accelerating job creation. In light of the challenges faced by the economy and the importance of job and income growth to both the residential and commercial real estate finance industries, it is prudent for the Mortgage Bankers Association of America (MBA) to evaluate the impact of the proposal on the economy and real estate.

The two main elements of the administration's proposal are the acceleration and making permanent of the previously enacted marginal tax rate cuts and the elimination of the double taxation of corporate dividends. The MBA incorporated the combined package into a simulation of economic activity for purposes of evaluating the capacity of the proposal to increase job formation and income growth in the next two years, a period of time over which the full effects should play out.

Simulation results produced by MBA, and based on conservative assumptions, show that the effects predicted by the administration's economic advisors are supported, with any differences within the tolerances of such models. Our estimates anticipate an annualized increase of 0.9 percent in GDP growth by year-end 2004 and the addition of 1.0 million jobs in that same time frame. The proposal will have a minimal impact on mortgage interest rates and will generate an additional 130,000 housing starts over the simulation time frame.

As a result of the estimated positive effects on the economy and the related benefits for the commercial and residential real estate sectors, MBA is strongly recommending the adoption and implementation of the proposal as soon as possible.

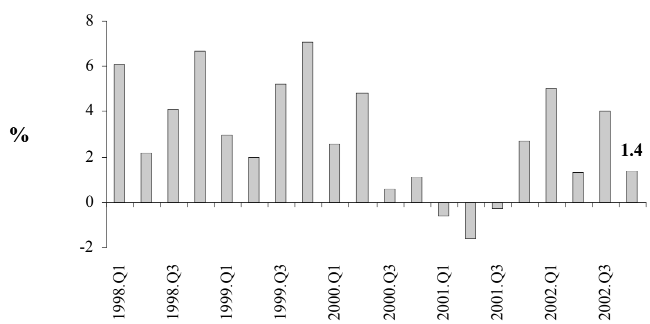
Current Economic Environment

The recovery of the U.S. economy from the recession that began in 2001 has been modest and uneven and has failed to produce a desirable level of job growth. As a result, the Bush Administration has proposed an economic growth package intended to increase both employment and GDP growth.

Growth of Gross Domestic Product (GDP) began decelerating in the second half of 2000 and became negative at the outset of 2001.

Real GDP Growth

(Percent change, Seasonally Adjusted at Annual Rate)



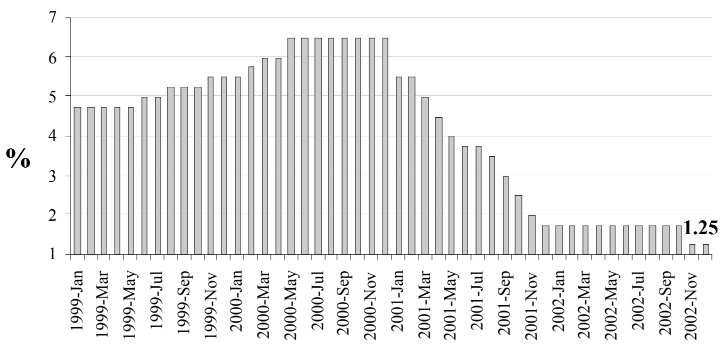
Source: U.S. Department of Commerce

After three consecutive quarters during which the annualized rate of GDP growth was negative, national income growth turned up but at an erratic pace. The preliminary GDP estimates for the fourth quarter of 2002 stand at 1.4 percent, well below the economy's long-run capacity for growth and well under the pace normal for this far beyond what appears to have been the end of a recession and the beginning of an expansion.

Monetary policy has been accommodative since the onset of the recession. The Federal Reserve has lowered the Federal Funds Rate Target both rapidly and to a very low level.

Federal Funds Rate Target

(Percent, End of Period)



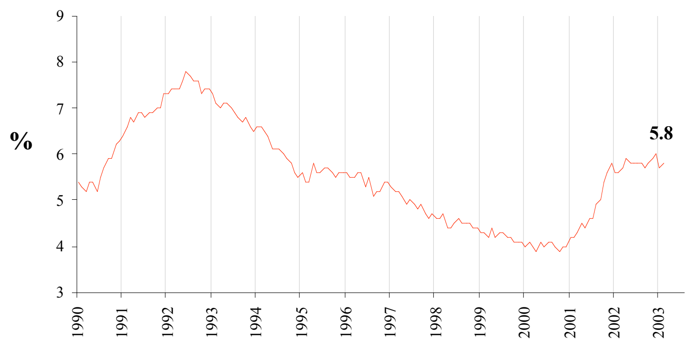
Source: Federal Reserve Board

The most recent cut in the Fed Funds target, November 2002, to 1.25 percent was accompanied by commentary indicating that the observed softening of activity in the manufacturing sector indicated that the risks to the recovery of the economy remained significant and growth-oriented rather than inflationary. The Federal Reserve Board has been very clear that it will retain an accommodative policy stance until such time as it sees a solid footing established under the recovery; something that it does not yet see.

Unemployment, which began to rise in late 2000, has remained stubbornly high, most recently reported in February 2003 at 5.8 percent.

Unemployment Rate

(Percent, Monthly Average)

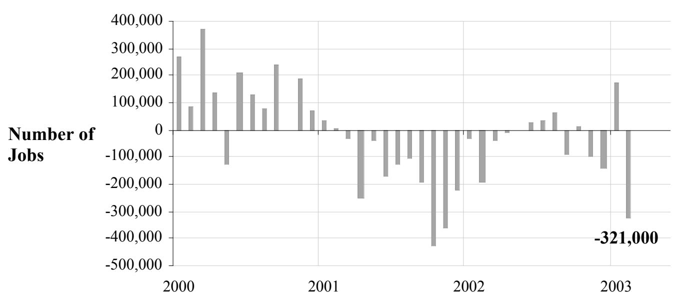


Source: BLS Household Survey

The February report indicated private nonfarm payroll job losses of 321,000.

Employment Growth

(Monthly Change in Private Nonfarm Employment, Number of Jobs)

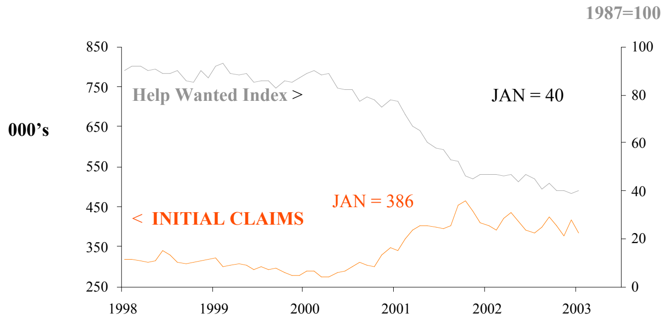


Source: BLS Establishment Survey

These losses were not concentrated but rather were reflected in all broad categories of employment with retail trade and services suffering the largest losses. Manufacturing continued to register job losses. Additionally, the rate of initial unemployment claims have remained relatively high and the Help Wanted Index gives no indication of a trend shift toward improved employment conditions.

Unemployment Insurance Claims and Help Wanted Index

(Seasonally Adjusted)



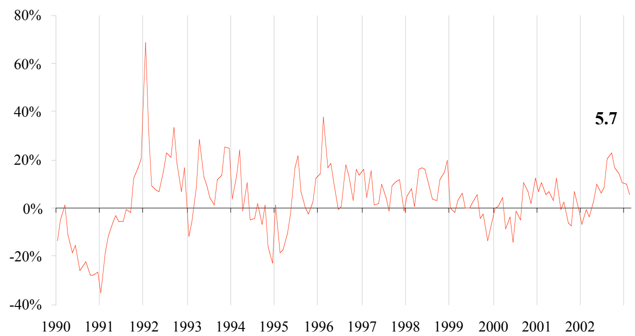
Source: U.S. Department of Labor and The Conference Board

One of the few sectors of the economy that has been adding jobs has been the residential housing real estate finance sector. Mortgage bankers and brokers have added over 120,000 jobs since January of 2001 during which time the U.S. economy has suffered a net loss of 2,531,000 private nonfarm jobs. Record low interest rates have provided an impetus that has allowed the housing sector to stand as one of the most important supports for the overall economy, softening the recession and serving as an engine to support the modest recovery to this point.

Home sales have set records each of the last two years at 6.19 million new and existing homes sold in 2001 and 6.58 million in 2002.

New Home Sales

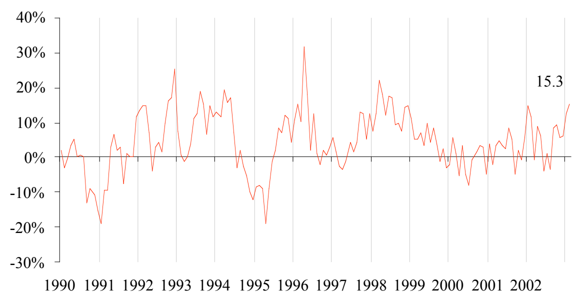
(Year/Year, Percent Change by Month)



Source: Census Bureau

Existing Home Sales

(Year/Year, Percent Change by Month)

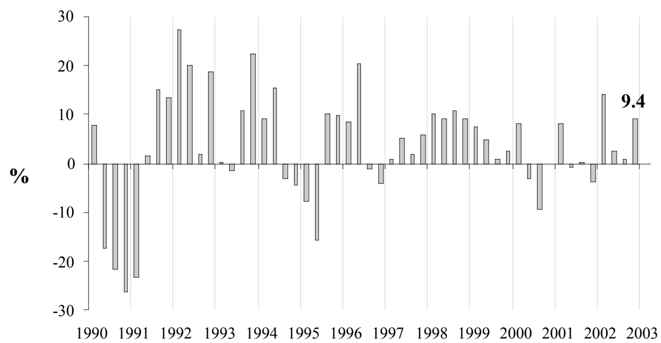


Source: National Associations of Realtors

Real residential fixed investment has remained strong throughout the current recessionary period, in contrast to the 1990-91 recession, providing valuable support to economic activity through sustained employment and materials demand in the residential construction sector as well.

Real Residential Fixed Investment

(Percent change, Seasonally Adjusted at Annual Rate)

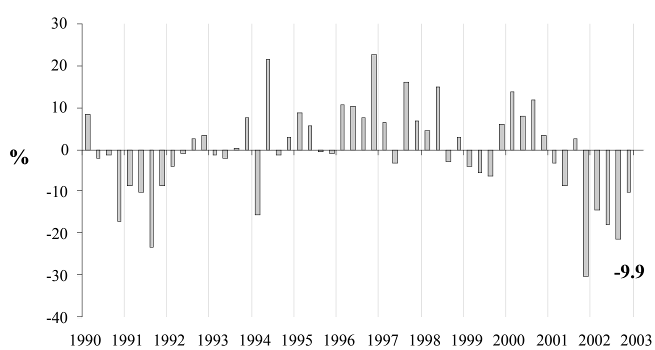


Source: U.S. Department of Commerce

Unfortunately, the economic downturn and its effects on business fixed investment and employment have devastated the real nonresidential or commercial structures sector.

Real Nonresidential Structures

(Percent change, Seasonally Adjusted at Annual Rate)



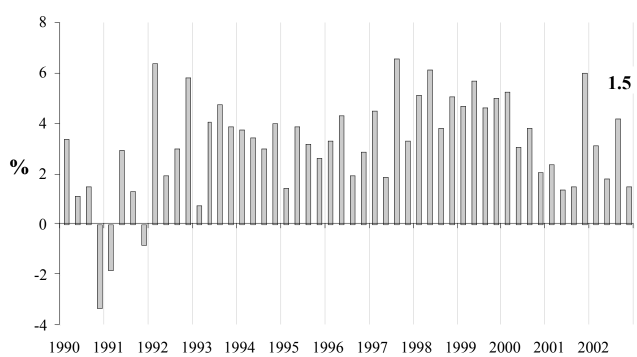
Source: U.S. Department of Commerce

This sector will not return to health until such time as economic growth resumes at a higher level and employment picks up.

Concurrent with home sales increases, residential mortgage originations registered $2.03 trillion in 2001 and $2.46 trillion in 2002, both record levels. A significant part of the origination dollar amount was the removal of equity built up by increases in home values. The Federal Reserve estimates that roughly $200 billion of equity was extracted through “cash-out” refinancing in 2002, slightly higher than that of 2001. Of this cash, a substantial portion was applied to the reduction of other forms of debt but the remainder, perhaps as much as $75 billion each year was used for consumption of various kinds by households. Once again the housing sector provided support for the economy at a level well above that of the 1990-91 recession.

Real Personal Consumption Expenditures

(Percent change, Seasonally Adjusted at Annual Rate)



Source: U.S. Department of Commerce

The role of residential housing as a support for the economy through both the cash-out refinancing supporting consumer spending and through the consumption boost generated by the sale and financing of new and existing homes is expected to wane slightly in 2003. Refinancings, in particular, will recede from the historic levels of the last few years as the number of households for which there is an economic benefit declines. The housing sector will still be a strong leg for the economy but more in its traditional role of providing between 12 and 20 percent of GDP depending on how it is measured. However, as interest rates rise modestly and refinancing activity declines and provides somewhat less support for consumer spending and the economy, there will need to be an increase in income growth and employment to offset it.

The MBA's forecast for economic growth, employment and housing activity without the implementation of any sort of growth plan is for continued growth below capacity and little recovery in jobs until late 2004. Without a growth plan, we expect GDP growth in the neighborhood of 2.8 percent from fourth quarter to fourth quarter 2003 and 3.4 percent the following year. Furthermore, unemployment is expected to rise to a level of 6.1 percent and remain there through most of 2004. The housing sector is expected to begin a slow decline of modest proportions.

The Bush Administration has introduced a plan intended to boost employment and economic growth to provide the offset to the slowing housing sector. This will potentially be important to the housing industry as the three most important factors for a growing housing industry in the longer term are jobs growth, income growth, and demographic factors. Since the Bush Administration's plan is intended to increase both jobs and economic growth, it is incumbent on the Mortgage Bankers Association of America (MBA) to assess the plan's expected impact on the residential and commercial real estate and real estate finance industries. What follows is a description of the administration's proposal's major elements and their estimated impacts on the economy and real estate finance.

MBA Analysis of the Bush Administration's Growth and Jobs Plan

The MBA has undertaken an analysis of the economic effect of the Bush Administration's proposed economic growth package. The MBA has determined that if the package were passed by the middle of 2003, 1.0 million new jobs would be created by the end of 2004, or within 18 months of the passage of the plan. The MBA estimates that if the plan were passed in its entirety, Gross Domestic Product (GDP) would increase by an additional 0.5 percent during 2003 and by an additional 0.9 percent during 2004. As a result of this analysis, the MBA strongly recommends passage of the plan.

<u>Key Points of the Bush Administration's Plan</u>

The Bush Administration's plan has two key components, the acceleration to January 1, 2003 of the tax cuts passed in 2001 that are now being phased-in over several years, and an elimination of the double taxation of dividends. The proposed accelerated tax cuts include:

- The expansion of the 10 percent tax bracket.
- The reduction in the 27%, 30%, 35% and 38.6% income tax rates to 25%, 28%, 33% and 35% respectively.
- The reduction in the marriage penalty.
- An increase in the child tax credit from $600 to $1,000. In addition, the 2003 increase would be paid to qualifying taxpayers with advance payment checks in July 2003.

In addition to the elimination of the double taxation of dividends, the administration proposes increasing from $25,000 to $75,000 the amount of investment that small businesses can expense immediately and increasing the Alternative Minimum Tax exemption by $8,000 for married taxpayers ($4,000 for single taxpayers) between 2003 and 2005.

Assumptions in Estimating the Effect of the Plan

Estimates of the effects of tax changes on economic growth are always challenging, particularly when we are looking at reversing the effects that the double taxation of dividends has created over many years. For example, the MBA estimates that the removal of the double taxation of dividends would add roughly $30 billion annually to after-tax incomes. Since there is little historical precedent on how much of this will result in additional spending, the MBA made the very conservative assumption that the amount of new spending would be small, and that the principal stimulative effect of the proposal would come from the resulting increase in equity prices. There appears to be little argument that some increase in stock prices would occur; the question is how large it would be. Estimates of private economists put the probable increase in the 5 to10 percent range. The MBA is assuming an increase of 7.5percent in its model.

The experience of the late 1990s clearly indicates that increased wealth in the form of higher equity prices does encourage consumers to spend more and save less, as would be expected. Higher equity prices also reduce the cost of equity capital to businesses, potentially increasing business spending for capital equipment. There is thus good reason to expect positive benefits to economic growth from eliminating taxes on dividends. Indeed, since the weak and erratic nature of the economic recovery that began a year ago probably traces in good measure to the legacy of the bear market in equities, an upturn in stock prices should clearly help strengthen the economy.

The acceleration of the tax cuts should have a major, direct impact on consumer spending. Tax cuts that are permanent have a much larger impact on consumer spending than those that are temporary, such as rebates. Estimates from previous tax cuts are that individuals spend only about one-fifth of any funds received via temporary tax cuts or rebates. On the other hand, spending out of permanent tax cuts, such as those proposed in the administration's plan, runs closer to two-thirds of the increase in disposable income.

One additional but minor point is whether the acceleration of previously scheduled tax cuts might have a slightly different impact on personal consumption than newly scheduled tax reductions. The issue with the accelerated tax cuts in the administration's proposal is whether or not individuals have already increased their spending in anticipation of future tax cuts already enacted into law. While it is theoretically possible that consumers have already begun to spend part of expected future tax cuts, the MBA believes this is highly unlikely and that most consumers have not made the careful calculations that would be necessary to estimate how future tax changes would affect their after-tax income. Even if they had done so, they would probably still be uncertain as to whether future tax cuts would actually be realized, given the desires of some in

Congress to cancel some or all of scheduled future tax cuts. In the estimates of the economic effects of the stimulus package discussed below, the accelerated tax cuts announced in the administration's proposal are treated the same as if they were newly enacted tax reductions.

To estimate the impact on economic growth, simulations were done with the econometric model that the MBA uses for creating its economic forecasts, a model created by Macroeconomic Advisers of St. Louis. The MBA used the following assumptions:

- The new tax proposals are assumed to be passed in their proposed form by mid-year 2003 and go into effect during the third quarter.
- Stock prices are assumed to increase 7-1/2 percent in response to the elimination of taxes on dividends.
- The tax cuts result in a $70 billion increase in income to taxpayers.

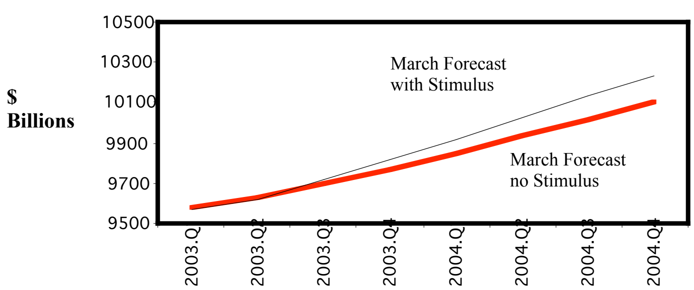
MBA Simulation Results

Impact on GDP and Employment

The results provide general confirmation of the administration's estimates of the near term impact on economic growth. Regarding GDP growth and employment, the simulations suggest the following.

The simulations suggest that 0.5 percent would be added to GDP growth in the last two quarters of 2003, measured year-over-year, and 0.9 percent added to year-over-year growth in 2004.

Real GDP
(Billions, Annual Rate)

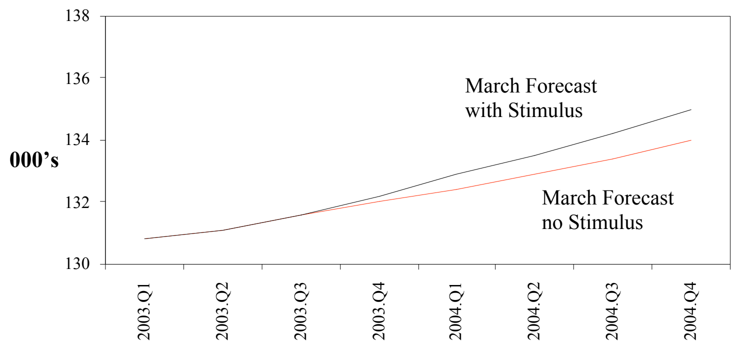


Source: MBA

By the fourth quarter of 2004, the number of payroll jobs would be boosted by 1.0 million.

Payroll Employment

(Number of Jobs)



Source: MBA

The MBA's current forecast for annualized growth in the latter half of this year is in the 3 to 3-1/4 percent range. The simulations suggest that annualized growth during the third and fourth quarters might be boosted by as much as a full percentage point, raising the growth rate during that period to 4 to 4-1/4 percent.

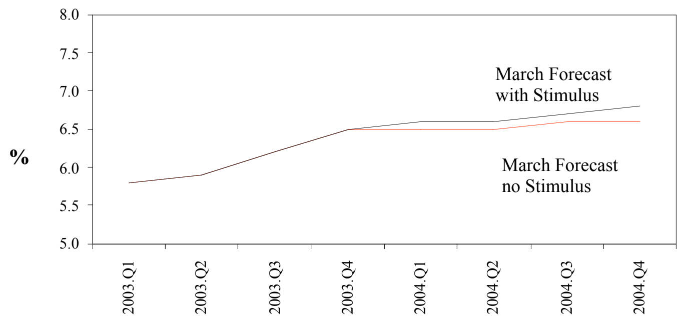
Impact on Interest Rates

The MBA's estimate of the impact of the administration's growth package suggests a bit less growth coming from the stimulus package than what the administration estimates—though the difference is quite small. One possible reason for the difference could be differences in the allowances made for the impact of the stimulus package on interest rates.

Several factors would likely increase interest rates with any stimulus package. First, the demand for funds is likely to increase with any economic recovery, putting upward pressure on rates. Second, if equity prices are boosted, a substantial part of the money flowing into equities might come from investments in fixed income securities, pushing up their yields. Both of these effects would be offset somewhat if the result of elimination of the double taxation of dividends is to make equity funding less expensive and reduce somewhat the corporate demand for debt funding.

How large an effect on interest rates would occur depends importantly on how the Federal Reserve reacts to the impact of the stimulus package on the economy. Given the currently very low rate of inflation, it is MBA's judgement that the Fed would not rush to raise interest rates at the first sign of improved economic growth. From the middle of this year onward, however, the economy could well be growing at a pace that reduces unemployment significantly. The real federal funds rate is now below zero (meaning that the rate is below the rate of inflation), implying a posture of monetary policy that cannot be sustained indefinitely. Solid economic growth would give the Fed the opportunity to move gradually back toward a neutral posture. The simulations allow for this, but suggest that the increase in interest rates would be quite moderate, in the neighborhood of 20 basis points above what they otherwise would have been on the 30-year fixed rate mortgage rate by year-end 2004.

Conventional 30-Year Mortgage Rate

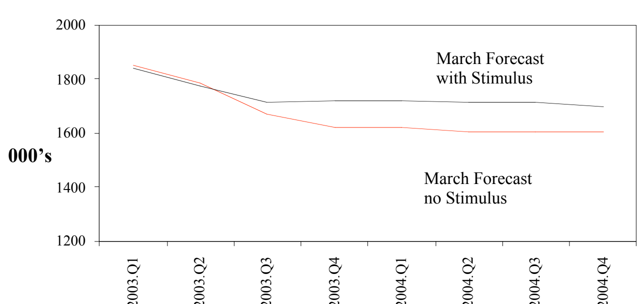


Source: MBA

<u>Impact on Housing Starts</u>

The effect of the administration's proposal on housing starts is to increase them. The increase in employment (which is significant but not so large as to put upward pressure on the price level) and disposable income overrides the minor increase in interest rates. The result is that housing starts are increased by 30,000 units in 2003 and by 100,000 units in 2004 through implementation of the full plan.

Housing Starts
(Thousands, Annual Rate)



Source: MBA

Were the dividends exclusion component of the plan not enacted, the impact on 2003 starts would be a smaller increase of 25,000 units and starts in 2004 would be 60,000 higher rather than 100,000 with the full plan.

Conclusion

The halting and weak nature of the current economic recovery and the related lack of job creation have led to the proposal that fiscal policy be used to encourage greater economic growth. The Bush Administration has proposed a defined package of policies for the purpose of increasing economic growth and accelerating job creation. The two main elements of the administration's plan are the acceleration and making permanent of the previously enacted marginal tax rate cuts and the elimination of the double taxation of corporate dividends.

The MBA incorporated the combined package into a simulation of economic activity for purposes of evaluating the capacity of the proposal to increase job formation and income growth in the next two years, a period of time over which the full effects should play out. Simulation results produced by MBA, and based on conservative assumptions, show that the effects predicted by the Bush Administration's economic advisors are supported, with any differences within the tolerances of such models. Our estimates anticipate an annualized increase of 0.9 percent in GDP growth by year-end 2004 and the addition of 1.0 million additional jobs in that same time frame. The plan will have a minimal impact on mortgage interest rates and will generate an additional 130,000 housing starts over the simulation time frame.

As a result of the estimated positive effects on the economy and the related benefits for the commercial and residential real estate sectors, MBA is strongly recommending the adoption and implementation of the plan as soon as possible.

Appendix 1

Other Benefits of the Bush Administration's Proposal for the Elimination of the Double Taxation on Dividends

In addition to the direct economic benefits of the administration's growth plan discussed in the report, the MBA sees a number of other advantages to improved corporate governance and operations that will ultimately inure to the benefit of the economy by increasing investor confidence and increasing capital market efficiencies.

1) Greater corporate transparency. By removing the tax disincentive not to pay dividends, corporations will be under greater pressure to justify their levels of retained earnings. The justification for retaining funds in a corporation is that the firm has better growth and investment prospects than the individual investor, particularly on an after-tax basis. Once the double taxation of dividends is removed, firms will have to be more open about their investment prospects that justify not paying out dividends.

2) Dividends will be a greater reality check on earnings. Some of the largest corporate collapses in the last two years came as a result of inflated earnings and cash needs supported by increasing levels of debt. Putting a greater emphasis on cash payouts in the form of dividends will serve as a reality check on reported earnings.

3) Lower leverage levels will tend to make corporate balance sheets less fragile. Removing the double taxation of dividends should make equity

financing relatively cheaper to debt financing than is currently the case. By encouraging corporations to have less debt financing, aggregate corporate balance sheets would become less fragile.

4) Reduce the need to sell stocks for current income. The double taxation of dividends has discouraged firms from paying dividends to shareholders. While individuals in need of regular cash income from their stocks have generally concentrated their purchases on higher dividend-paying stocks, others are placed in the position of having to sell their stocks and buy replacements in order to capture the same income in the form of capital gains but at a lower tax rate. The administration's proposal to reduce the volume of stock sales that occur solely to generate regular income at capital gains rates.

Appendix 2

Analysis of the Impact of the Bush Administration's Economic Growth Plan on Low Income Housing Tax Credits

The MBA fully supports the Bush Administration's economic proposal. Some concerns have been raised, however, about the potential impact of the plan on one of the important and successful methods of promoting the development of rental apartments for lower income individuals, the Low Income Housing Tax Credit (LIHTC) program. The reason for the concern is inherent in the mathematics of the calculation of the Excludable Dividend Amount, or the amount of dividends that can be paid tax free to shareholders. The excludable amount is based on the amount of taxes paid by the corporation in the following fashion:

Excludable Dividend Amount = (Federal Tax Paid $\div$ .35) – Federal Tax Paid

This can be restated as:

Excludable Dividend Amount = 1.85 x Federal Tax Paid

The result is a situation where the amount of tax-free dividends that a corporation can pay is reduced by $1.85 for every dollar reduction in federal tax paid. The issue for LIHTCs then is whether the benefits of LIHTC investing at the corporate level are sufficient to offset any potential negative effects at the shareholder level, given that savings at the corporate level come at the corporate tax rate whereas the potential additional tax exposure is at generally lower individual income and capital gains rates. The MBA's analysis is that, under a range of reasonable assumptions regarding tax rates and dividend payout rates, marginal returns to shareholders from corporate investments in LIHTCs remain positive under the administration's plan. While the marginal shareholder returns from LIHTCs are somewhat lower under the Bush Administration's plan than current law, the differences are driven entirely by assumptions regarding the tax effects of relative changes in capital gains tax basis. Since neither corporate yields nor the amount of tax-free dividends that can be paid are affected by LIHTC investments, under reasonable dividend payout assumptions, it is difficult to predict the degree of any negative pricing impacts. Based on all of the various and sometimes offsetting factors at work, it appears unlikely, that any negative price changes resulting directly from the administration's plan would be significant. Indeed, it can be argued that a failure to pass the administration's growth plan would negatively impact LIHTC prices. A danger to LIHTC pricing is a continued softness in current corporate earnings, combined with a negative outlook for the future. This could result in a reduced appetite for new LIHTC investments and increased secondary market sales of existing credits, both of which would depress LIHTC prices.

In its analysis of the impact of the administration's economic growth proposal on the LIHTC program, the MBA attempted to answer three questions. First, will LIHTCs remain viable investments, that is, will the tax costs to shareholders outweigh the benefits at the corporate level? Second, will prices be affected and to what degree? Third, if any adverse effects of the tax plan are large enough that they need to be mitigated, what form should changes to the plan take?

Will LIHTCs remain viable under the Bush Administration's jobs and growth plan?

The LIHTC program provides benefits at the corporate and shareholder level. While the exact returns will differ based on a broad continuum of corporate and individual income and capital gains tax rates, attached Exhibit 1 shows the marginal benefit of a LIHTC priced to yield 8 percent in the form of tax credits under current law. The assumptions in the model assume that the effective corporate tax rate is 28 percent, the dividend payout rate is 48 percent of after-tax earnings, the marginal individual income tax rate on dividends is 35 percent, and the individual capital gains tax rate is 10 percent. These average tax and dividend payout rate assumptions are reasonable averages of average rates and were used in a recent study on this issue by Ernst & Young. In this particular example, the marginal benefit at the corporate level is $367 and the benefit passed through to shareholders is $287. It is important to note that this benefit is highly dependent on effective tax rates. For example, were it assumed that the effective corporate tax rate is 35 percent, the benefit would jump by 19 percent to $437, of which $341 would be passed on to shareholders. It is reasonable to assume that corporations with higher effective tax rates would be willing to pay more for LIHTCs than those in lower tax brackets. Therefore, any assumptions regarding the pricing impact of the administration's tax proposal must take into consideration the effective tax rates of the purchasers of LIHTCs, not the average of all corporations.

Exhibit 2 uses an identical set of tax rate and dividend assumptions to show the marginal benefit of investing in LIHTCs under the administration's growth package. What is important is that the benefit remains positive overall to shareholders, and, assuming a constant dividend payout ratio, the LIHTC investment increases the amount of tax-free dividends they receive. In addition, the marginal return to shareholders increases by 65 percent if it assumed that companies investing in LIHTCs are those with effective federal tax rates of 35 percent. While the size of the marginal benefit is lower under the administration's proposal, that reduction is entirely in the change in capital gains basis where the applicable rate assumptions are the most open to question.

The purpose of Exhibit 3 is to put the LIHTC issue into some sort of context with the total impact on shareholder returns. While the relative magnitude of the change in returns is based on the relative size of the LIHTC investment, here it is assumed, as in the previous exhibits, that LIHTC investments are 1 percent of a corporation's pre-tax net income. The overall benefits to shareholders from the administration's package dwarf the marginal shareholder effects from LIHTC investments, increasing returns by 24 percent both with and without LIHTCs.

What will be the impact on LIHTC prices?

Absent a detailed analysis of the price elasticities of the demand and supply in the LIHTC market, it is impossible to develop a firm analysis of the impact a change in the relative value of LIHTCs under the administration's plan would have on LIHTC pricing. It would be clearly incorrect simply to establish some baseline hurdle rate and estimate how much LIHTC prices would have to adjust to meet that particular hurdle rate for a set of investors with a particular set of tax and dividend expectations. Given the various reasons for investing in LIHTCs, including CRA considerations, it may be sufficient for some investors to know only that returns do not turn negative for them to continue their investments.

There are a number of factors that influence LIHTC pricing. First, given the long duration of the LIHTC investment commitment, between 10 and 15 years, prices are driven by changes in discount rates, which in turn are driven by changes in underlying interest rates and changes in relative risk. The extent to which interest rates have fallen over the last 18 months has helped support LIHTC prices.

Second, it is not clear the extent to which any corporation can base an investment decision on the tax situation of a particular class of investors. For example, corporations have long paid dividends despite the fact that, for some investors, dividends are taxed at a higher rate than capital gains. If after-tax returns to shareholders in the examples used to discuss the potential impact of the administration's plan on LIHTCs are really a primary motivator, one would have to question why any corporations ever pay any dividends. It should be noted that for shares held in pension funds or 401k accounts where the applicable dividend and capital gains rates are zero, there is no reduction in the marginal shareholder return from LIHTCs.

Third, LIHTC prices are fundamentally driven by supply and demand. In a report for the Millennial Housing Commission, Recapitalization Advisors, Inc. gave a history of LIHTC prices since the inception of the program, and demonstrated how prices improved as the program matured:

Years	Average prices (per dollar)
1987 – 1989	.45
1989 – 1993	.52
1993 - 1997	.65
1998 - 2000	.74
2001 -	.77

In addition to noting the steady increase in LIHTC prices, Recapitalization Advisors notes that at one point in early 2001, LIHTC prices dropped by 10 percent in as little as three months as a result of an apparent 40 percent increase in the supply of LIHTCs hitting the market at one time. Other negative impacts on prices mentioned in the Recapitalization Advisors report include whether the strongest properties have already been financed and the potential overhang of the now sizable secondary market for trading these tax credits.

The point is that LIHTC prices can be volatile absent changes in tax laws, and that any and all effects on supply and demand resulting from the passage of the administration's growth plan must be taken into consideration. It can be argued, for example, that if the economy did not improve, the profits and therefore the tax credit appetites of traditional LIHTC investors would go down. Not only would these firms drop out of the primary market for LIHTCs, they would likely seek to sell their existing credits in the secondary market, further depressing prices. Thus depressed corporate earnings from a sluggish economy could pose the greater risk to LIHTC pricing, particularly since LIHTC shareholder returns remain positive under the proposal and firms will thus not have an incentive to dump their credits on the secondary market.

<u>If any adverse effects on the LIHTC program need to be mitigated, what form should changes in the Bush Administration's growth proposal take?</u>

If it becomes clear that the Administration's growth proposal will have significant negative effects on LIHTC prices due to the relative change in shareholder returns, what form should any change take? Since dividend returns to shareholders are not negatively affected under any reasonable assumptions of dividend payout ratios, there appears to be no need to change the fundamental calculation of Excludable Dividend Account. Instead, because it appears that any potential negative effects would be due solely to the change in capital gains basis and potential additional capital gains taxes, any remedy should be aimed at that issue. The problem would be largely ameliorated by allowing the capital gains tax basis to be increased either by the amount of the LIHTC tax credit or the amount of the LIHTC investment expensed by the investor, or lowering capital gains tax rates.

Conclusion

While it appears that the relative benefits of LIHTC investments may decline for some investors under the administration's proposal, it is unclear what the effect on LIHTC prices might be. Given that the effect of the proposal on shareholder returns is limited to the changes in capital gains basis, the proposal may have limited effect. Indeed, not enacting the plan may have a greater effect on LIHTC pricing if the demand for LIHTC investments declines with lower corporate profits.

In any event, any potential impact on LIHTCs is not a reason to oppose the growth plan but, if necessary, to seek changes to limit any negative effects. It appears that adjusting the capital gains basis to reflect LIHTC investments would be sufficient to offset the capital gains impacts on relative shareholder returns.

EXHIBIT 1

LIHTC Benefits Under Current Law

	Without LIHTC investment	With LIHTC investment	Marginal Benefit of LIHTC
At Corporate Level:			
Net Income	100,000	100,000	0
LIHTC cost	0	1,000	1,000
Taxable Income	100,000	99,000	(1,000)
Corp Inc. Tax before LIHTC	28,000	27,720	(280)
LIHTC Credit	0	1,087	1,087
Corp. Inc. Tax After LIHTC	28,000	26,633	(1,367)
Net after tax earnings	72,000	72,367	367
At Shareholder Level:			
memo: Excludable Dividend Amount	0	0	0
Dividends received:	34,200	34,374	174
Shareholder taxable dividends	34,200	34,374	174
Shareholder dividend tax	11,970	12,031	61
Shareholder after-tax dividends	22,230	22,343	113
Capital gains change from retained earnings	37,800	37,993	193
Retained earnings benefit adjustment	0	0	0
Taxable capital gains	37,800	37,993	193
Future capital gains tax	3,780	3,799	19
Shareholder after-tax capital gains	34,020	34,193	173
After-tax return to shareholders	56,250	56,537	287

Assumptions:	
Corporate Marginal Tax Rate:	35%
Corporate Effective Tax rate:	28%
LIHTC Annual Yield	8%
Dividend payout ratio	48%
Individual income tax rate	35%
Individual capital gains tax rate:	10%

EXHIBIT 2

LIHTC Benefits Under Proposed Law

	Without LIHTC investment	With LIHTC investment	Marginal Benefit of LIHTC
At Corporate Level:			
Net Income	100,000	100,000	0
LIHTC cost	0	1,000	1,000
Taxable Income	100,000	99,000	(1,000)
Corp Inc. Tax before LIHTC	28,000	27,720	(280)
LIHTC Credit	0	1,087	1,087
Corp. Inc. Tax After LIHTC	28,000	26,633	(1,367)
Net after tax earnings	72,000	72,367	367
At Shareholder Level:			
memo: Excludable Dividend Amount	52,000	49,461	(2,539)
Dividends received:	34,200	34,374	174
Shareholder taxable dividends	0	0	0
Shareholder dividend tax	0	0	0
Shareholder after-tax dividends	34,200	34,374	174
Capital gains change from retained earning	37,800	37,993	193
Retained earnings benefit adjustment	17,800	15,087	(2,713)
Taxable capital gains	20,000	22,906	2,906
Future capital gains tax	2,000	2,291	291
Shareholder after-tax capital gains	35,800	35,702	(98)
After-tax return to shareholders	70,000	70,076	76

Assumptions:	
Corporate Marginal Tax Rate:	35%
Corporate Effective Tax rate:	28%
LIHTC Annual Yield	8%
Dividend payout ratio	48%
Individual income tax rate	35%
Individual capital gains tax rate:	10%

EXHIBIT 3
Comparative Gains under Proposed Law

	Without LIHTC, Current Law	Without LIHTC, Proposed Law	Gains	With LIHTC, Current Law	With LIHTC, Proposed Law	Gains
At Corporate Level:						
Net Income	100,000	100,000	0	100,000	100,000	0
LIHTC cost	0	0	0	1,000	1,000	0
Taxable Income	100,000	100,000	0	99,000	99,000	0
Corp Inc. Tax before LIHTC	28,000	28,000	0	27,720	27,720	0
LIHTC Credit	0	0	0	1,087	1,087	0
Corp. Inc. Tax After LIHTC	28,000	28,000	0	26,633	26,633	0
Net after tax earnings	72,000	72,000	0	72,367	72,367	0
At Shareholder Level:						
memo: Excludable Dividend Amount	0	52,000	52,000	0	49,461	49,461
Dividends received:	34,200	34,200	0	34,374	34,374	0
Shareholder taxable dividends	34,200	0	(34,200)	34,374	0	(34,374)
Shareholder dividend tax	11,970	0	(11,970)	12,031	0	(12,031)
Shareholder after-tax dividends	22,230	34,200	11,970	22,343	34,374	12,031
Capital gains change from retained earning	37,800	37,800	0	37,993	37,993	0
Retained earnings benefit adjustment	0	17,800	17,800	0	15,087	15,087
Taxable capital gains	37,800	20,000	(17,800)	37,993	22,906	(15,087)
Future capital gains tax	3,780	2,000	(1,780)	3,799	2,291	(1,509)
Shareholder after-tax capital gains	34,020	35,800	1,780	34,193	35,702	1,509
After-tax return to shareholders	56,250	70,000	13,750	56,537	70,076	13,540
Percentage increase:			24%			24%

Assumptions:	
Corporate Marginal Tax Rate:	35%
Corporate Effective Tax rate:	28%
LIHTC Annual Yield	8%
Dividend payout ratio	48%
Individual income tax rate	35%
Individual capital gains tax rate:	10%