

MACROCOSM

## Tracking the Tax Wars

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### Bush's defeat in the Senate on tax-cuts is a victory -- but what kind of victory?

The markets are struggling to shake off years of intense risk-aversion, and it's not made any easier by a media environment that seems determined to both build up and dash expectations on a nearly daily basis. Coverage of the war in **Iraq** swings wildly back and forth between "we're winning" and "we're losing." We think it's critical that investors not allow themselves to be whipsawed by these self-interested antics. And that applies not just to war news, but to news of the progress of **President Bush's** tax-cut proposals.

News of the on-again off-again budget voting in **the Senate** over the last several days has centered on how Bush's proposed \$725 billion in tax-cuts has been "slashed" -- with the President betrayed by a handful of so-called "moderates" in his own party. But investors who realize that Bush's tax-cuts will have powerful pro-growth effects should not interpret this to mean that "we're losing." No, if anything, these developments mean that "we're winning."

From what we have been able to tell talking to investors and economists over the last couple months, Bush's tax-cuts have been regarded by the market as pretty much "dead on arrival." Distracted by the diplomatic/political crisis leading up to the onset of war, and with falling approval ratings, the most revolutionary shift in tax policy since the **Reagan** years just wasn't seen as having a chance. Now with that crisis behind him, Bush's popularity is resurgent -- and all of a sudden tax-cuts that were assumed to be zero just a few weeks ago now have a \$350 billion floor under them.

Now the question for investors is: how much *more* than \$350 billion will the tax-cut be? And exactly *which* of Bush's many proposed cuts will survive? The full proposal is a mixed bag. Strongly pro-growth self-financing tax-cuts sit side-by-side with others that are nothing but deficit-makers that have no virtue except to create political cover against charges that the pro-growth cuts are "sops to the rich." No doubt some of *both* will be bargained away in the coming congressional committee process, and some of *both* will survive. But it is at least possible that we could end up with a set of cuts that, while smaller overall, would actually be more effective in promoting economic growth with minimum deficits than the package as originally proposed.

It must be said that the opposite is possible, too. Some recent statements from **Republican** senators, who are supportive of Bush's proposals overall, have revealed a loss of political momentum for the elimination of the double taxation of dividends and retained earnings -- the single most powerful pro-growth feature of the proposal. But political momentum is precisely what is most difficult to predict here. From conversations with our contacts in the **Bush administration**, there is no doubt in our minds that the White House knows exactly which tax-cuts are the important ones -- but the White House has other things on its mind now, too, and the effectiveness of the President's influence will be highly variable as sentiment about the war ebbs and flows. **TM**