TrendMacrolytics

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POLITICAL PULSE

Notes from the West Wing

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The war comes first. Nevertheless, the market underestimates the chances for pro-growth tax-cuts.

Yesterday I participated in a briefing/Q&A/roundtable at the **White House** in which a dozen economists met with **President George W. Bush**, **Treasury Secretary John Snow**, and **National Economic Council Chair Stephen Friedman**. The subject: the status and future prospects of the budget and tax policy negotiations between **the administration** and the **Congress**. Here are some insights I came away from the meeting with.

- I was surprised by the depth and intensity of Bush's commitment to pro-growth tax policy. With this year's proposed tax-cuts Bush has walked the walk -- now finally I heard him talk the talk. He extemporized at length about his commitment to reform the tax code to remove barriers to innovation and capital formation, with the goal to "forever change this country into 'entrepreneurial heaven.'"

- Bush sees the elimination of the double taxation of dividends and retained earnings for the *radical* -- i.e., "at the root" -- reform that it is, and he understands that it is the most important pro-growth component of his tax package. He clearly understands the difference between the pro-growth self-financing elements of his overall package and some of its other components that are there mostly for feel-good political effect, and would more likely be deadweight contributors to budget deficits. Bush is committed to the administration not "negotiating with itself" by offering to give it up or pare back dividend tax relief as part of an overall compromise.

- Bush is concerned that some **Republicans** who have failed to support his tax-cuts are baffled by the somewhat abstract nature of dividend tax elimination -- "it's not something that typical voters are talking about in coffee shops." He also worries that some Republican opponents are locked into reflexive anti-deficit positions, seemingly without the ability to discriminate based on the size or purpose of proposed deficits.

- Bush and Snow see the negotiation with Congress as taking place entirely at the margin, with just a couple of votes in the **Senate** making all the difference. Several approaches for securing those votes were discussed. I came away with renewed confidence in the position we have taken all along -- that the final form and size of the tax-cut package will be an upside surprise versus the market's pessimistic expectations (see "Tracking the Tax Wars" March 27, 2003).

- That said, Bush was very clear that the war in **Iraq** comes first. He spoke passionately and at length about his commitment to fighting terrorism at its root, and to enabling the birth of democracy in the Middle East. He is aware that the daily mood-swings of war news are fraying nerves and taking their toll on the markets. But he said, "I won't let the stock market drive the war." This is entirely consistent with our view of "war risk" as containing a very important political component (see "Going for Broke?" February 28, 2003; and "W's Bottom" March 24, 2003). In the near term, and on the downside, the war is a distraction from the pursuit of the President's economic agenda, and a risk to his prestige and effectiveness. But longer term, there is a significant potential upside. Bush understands that success in the war will result in a wealth of political capital for him. He says he is committed to invest that political capital in "big projects" -- dividend tax-cuts now, and Social Security and Medicare reform later. TM