TrendMacrolytics

Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

POLITICAL PULSE

A Setback for Extending the 2003 Tax Cuts

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Donald Luskin

Grassley's retreat to only one-year extension may be part of a broader retreat for pro-growth policy.

The headlines today are full of what a bad day yesterday was for **Republicans** in various **elections** across the country -- especially, for this **Californian**, the defeat of **reform initiatives** sponsored by **Arnold Schwarzenegger**. But for us the worst defeat was a self-inflicted wound in the **Senate Finance Committee**. **Chairman Chuck Grassley** released his **"chairman's mark"** of the **Tax Relief Act of 2005** -- the **revenue** side of this year's **budget reconciliation process** -- and it includes **extension of the 2003 tax cuts** on **dividends** and **capital** gains only to 2009, not to 2010 as had previously been signaled. It also includes extension of the **Alternative Minimum Tax** patch by one year, as expected. You can read a summary of it by clicking here; the entire mark document, and an evaluation of its "revenue costs," are posted on the **Client Resources page** of our website.

On the face of it, reduction in the extension of the 2003 cuts from 2010 to 2009 was to make room for various **Katrina**-related tax relief measures included in the bill, but these could easily have passed through separate legislation as have so many others. The real story is a dangerous evolution in the way **Congress** is perceiving the extension of the tax cuts in relation to the cuts in **entitlements growth** that are included in the spending side of budget reconciliation. As originally planned, there would have been a long gap between voting the spending and revenue components of reconciliation -- this year they are separate bills. That gap in time would have allowed a news cycle to go by, separating the two votes and insulating legislators from accusations that they were cutting benefits for "the poor" at the same time as they were cutting taxes on "the rich." Katrina mooted that plan, preoccupying Congress in September just when spending reconciliation had been scheduled to be voted. Now the legislative calendar has become so compressed into the end of the year that the anticipated gap in time between voting on the separate spending and revenue bills has evaporated. Thus tax cut extension has been caught in a crossfire. There are Republican **deficit-hawks** whose support for extension was contingent on achieving spending cuts -- and it looked for a while, before Katrina, as though spending cuts would not be achieved. But now that they *have* been achieved, and time is running out, so-called **"centrists"** in the **GOP** are seeing those same spending cuts as the reason not to support extending the tax cuts.

It ain't over till it's over. Next week we will see the chairman's mark from **House Ways and Means Committee chair Bill Thomas**. Reportedly he still supports two-year extension of the tax cuts -- instead of retreating to one-year extension, he is talking about dropping the AMT patch extension. This is a good strategy for the wily chairman, because AMT is primarily a tax on residents of **"blue states"** -- threatening to drop it is a way to elicit support from **Democrats** who, if they didn't have to bargain for its inclusion, would otherwise oppose revenue reconciliation *en bloc*. And when it comes to reconciling what may be two opposing tax bills in

House-Senate conference, we can't think of an instance in which Thomas has not bested Grassley. So hope is alive. Barely.

But what matters in all this, of course, is not the difference between extension by one year and extension by two years (especially when the tax cuts don't expire until 2008 to begin with). What matters is that we are seeing what may be the unraveling of a GOP **pro-growth consensus** that was never all that strong to begin with. The 2003 tax cuts barely passed in the first place -- and today, instead of arguing about one year or two years, the thrust should be to make the tax cuts permanent. Sadly, instead, the **Republican majority** is spending this week running a show trial of the **oil industry**, and promoting a return to the **energy regulatory policies** that failed so disastrously in the 1970s.

Bottom line: Yesterday's disappointments can't be good for **stocks**. That said, we've regarded a bet on the extension of the 2003 tax cuts as an out-of-consensus bet on an upside surprise. Therefore failure to extend the cuts will not be symmetrically as costly to growth expectations as success would be a boost to them. But seen as part of an evolving diminution of the viability of pro-growth policy -- whether in the mind of the Republican majority, or worse, in the mind of **the electorate** to whom the majority seeks to be responsive -- is another and much darker matter. We have been optimists on **the economy** so far, and very much correct to be so. But we're not afraid to change that view if, in the coming weeks, we see a breakaway toward the anti-growth impulses that are now surfacing.