

POLITICAL PULSE

## Two to Tangle the Tax Cuts

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### How Chuck Grassley and Bill Thomas let a personal feud put growth at risk.

We now have details on exactly what derailed the completion last week of **House/Senate negotiations** on the long overdue **2006 tax reconciliation bill** -- which includes the two-year extension of the **2003 tax cut on dividends and capital gains** (see ["On the Tax and Budget Breakdowns"](#) April 7, 2006). It turns out that no important policy disagreements were in play. What put this **growth-critical legislation** at risk -- by delaying it until **Congress** returns from a two-week **Easter recess** -- was nothing more than a boiling over of longstanding personal animosity between **Senate Finance Committee chair Chuck Grassley** and **House Ways and Means Committee chair Bill Thomas**.

**Conservative columnist Robert Novak** reported on Saturday that Grassley and Thomas had agreed on legislation that resolved differences between divergent House and Senate versions -- but because the two were "feuding," Grassley peevisly refused to "walk across the Capitol to sign the conference report" on Thursday. According to our congressional sources, Novak's version of events is not entirely correct. There was not, in fact, an agreed report for Grassley to sign on Thursday. Grassley and Thomas could not agree on the details of the one-year **Alternative Minimum Tax "patch"** -- Grassley wanted a slightly more generous version, Thomas a slightly less generous one.

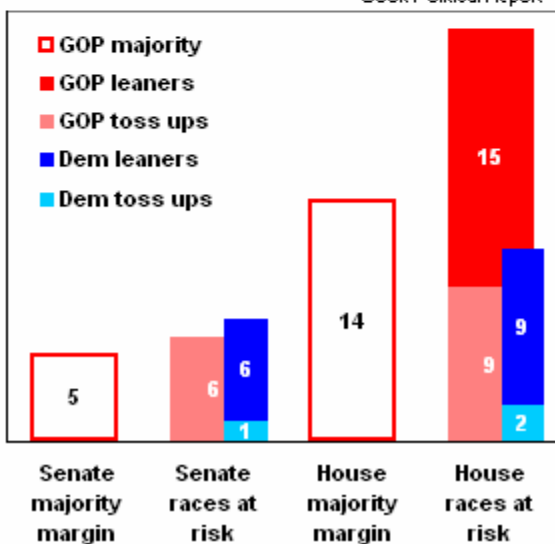
The difference in the **static "revenue cost"** of the two versions was only \$2 billion. But Thomas hadn't wanted any version of the AMT "patch" within the **filibuster-proof** reconciliation bill in the first place, preferring to see this popular measure handled in a separate bill. Grassley signaled that he couldn't support a reconciliation bill that *didn't* include an AMT "patch," preferring to see a multitude of **"extenders"** -- small-value provisions that perpetuated existing popular tax breaks for one or two years -- handled in a separate bill. Grassley is formally chairman of the **House/Senate conference committee** charged with coming up with compromise legislation, but apparently he did little to move the process forward other than make his broad wishes generally known. Finally, in frustration, Thomas drafted a proposed compromise that gave Grassley his AMT "patch" within the reconciliation bill -- but it was Thomas's preferred less generous version of the "patch." In place of Grassley's more generous version there were two of Thomas's favorite extenders -- the **look-through treatment** of payments between **controlled foreign corporations**, and the **active financing exception**. Grassley insisted on his own version of the AMT "patch" -- but even though the members who had most intensely advocated the two extenders told Thomas that they would be happy to see them in a separate bill outside of reconciliation, Thomas held firm. He was angry that Grassley had done so little to support the process initially, and was now being so inflexible. Grassley, for his part, was angry that Thomas was being so inflexible after having usurped control of the process.

**GOP House control futures at Tradesports.com**



**Bottoms-up race analysis**

Source: Cook Political Report



We report these messy details, in part, to indicate how terribly close to a tax reconciliation bill we really are. The great news is that there is no disagreement on the conference committee about the two-year extension of the 2003 tax cuts. There is even an agreed plan to deal with the **Byrd Rule's** constraint on out-year static revenue costs (see "[On the Byrd Rule and Extension of the 2003 Tax Cuts](#)" February 8, 2006); we don't have the exact details, but we hear from sources that the solution is to raise the limits on **Roth IRA contributions** and/or **small business expensing**, both **pro-growth** measures that can be engineered to deliver **static revenue gains** in 2011 and 2012, as required. Finally, we hear from sources that the stealth \$5 billion "**windfall profits tax**" included in the Senate's tax reconciliation bill last December -- exacted on the **energy industry** through changes in **LIFO accounting rules** -- will not appear in the conference report. So all else equal, there is reason to hope that **leadership** or the **White House** can knock some sense into Grassley and Thomas, and we will have a very positive tax bill to vote in two weeks.

**BOTTOM LINE:** But all else is not equal. The **GOP's** prospects for the November election are looking worse and worse. Over the weekend the **futures contracts on GOP House control** -- traded online at **Tradesports.com** -- fell to all-time lows at 50, effectively calling the November election a 50/50 coin-flip. Traditional **bottoms-up**

**race-by-race analysis** shows a situation no worse today than it was several weeks ago. But that analysis still shows 15 GOP House seats that are no better than leaning toward the incumbent, and 9 others toss-ups. Taken together that's more than enough to erase the GOP's **majority margin**. And far fewer **Democratic** seats are at comparable risk. In this kind of political environment of uncertainty and fear, commitments are volatile. We believe the tax reconciliation bill had just barely enough votes last Friday, but we can't say for certain whether it will when congress reconvenes in two weeks, assuming that Grassley and Thomas do indeed deliver a bill. As a general proposition, considering the broad disarray in which the **Republican party** finds itself, expectations for continued pro-growth policy are more than ever at risk. So as we said Friday morning, when **stocks** were still making new highs, we expect that stocks will retrench or consolidate here. We do still see **equities** as deeply **undervalued**, and thus priced to be fairly robust to a great deal of bad news. But their upside potential won't be unlocked if failure to pass a tax reconciliation bill including extension of the 2003 tax cuts on dividends and capital gains, and an AMT "patch," signals that the pro-growth consensus is moribund. **TM**