TrendMacrolytics

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POLITICAL PULSE

Tax Cut Rashomon

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Even a call from the President couldn't get the 2003 tax cuts extended last week, but it's not over yet.

We keep learning more from sources about the politics of last week's failure of **House/Senate negotiators** to finish legislation extending the **2003 tax cut on dividends and capital gains** and the **Alternative Minimum Tax "patch"** (see "Two to Tangle the Tax Cuts" April 10, 2006). As in the classic film ***Rashomon***, the various witnesses tell very different versions of the same event, depending on their points of view. According to one source who was present throughout the negotiations, at crunch time on Thursday afternoon, **Ways and Means Committee chair Bill Thomas** was willing to compromise with **Senate Finance Committee chair Chuck Grassley** on just about any provision in the bill -- with the exception of the two-year extension of the 2003 tax cuts. Grassley never questioned that key provision. But at the last minute Grassley proposed a set of wholly new **"revenue raisers"** that had never previously been discussed in the negotiations, and had not been **"scored"** by the **Joint Committee on Taxation**. At that point **President Bush** personally called Grassley and said, "I need you to be with us on this." Grassley replied, "Mr. President, I need *you* to be with *me* on this."

If Grassley is indeed the sticking point here, the question is: *why?* We hear that Grassley was offended by what he saw as a pressure play when **House majority leader Bill Frist** announced on Wednesday afternoon, without Grassley's permission, that a compromise had been reached when one in fact had not. And we know that over years of negotiations like this one, the more aggressive Thomas has run roughshod over Grassley; perhaps now with Thomas having announced his retirement, Grassley is taking the opportunity to pay him back a little. It's horrifying to think that the fate of critical pro-growth policy could hinge on such petty personal considerations. **Tip O'Neill** famously said that "all politics is local" -- perhaps it's more true to say that all politics is personal. The good news is that we don't think Grassley wants the **tax reconciliation bill** to ultimately fail. While there is risk here to be sure, we still expect that the bill will pass.

Don't underestimate what's at stake here. The 2003 tax cuts on dividends and capital gains triggered a major turning point in the economy and the stock market. While we are long since past the point at which such policy is necessary to revive a sick economy, even the healthiest economy would be set back, at the margin, by a policy reversal that would effectively raise the **cost of capital** by lowering capital's **after-tax return**. To say the same thing In terms of **equity valuation**, **stocks** are formulaically worth more when their future **earnings streams** are taxed at a lower rate. Considering only this first-order valuation effect, we estimate that loss of the 2003 tax rates would result in a drop in **S&P 500** valuation by about 10%.

Second-order effects are even more important. One client commented to us yesterday that the **GOP's** ability to accomplish this legislation will determine whether the **Republican majority** can survive the November elections. Elections aren't quite that simple, of course, but there is certainly something to this view. The 2003 tax cuts are the signature economic policy of the Bush years -- we could even say that they represent the only *good* economic policy of those years, having to share the same pages in the history books with **Sarbanes-Oxley**, **steel tariffs**, and the **Medicare prescription drug benefit**. The **pro-growth conservative base** may well think, if that single good policy can't be extended for a mere two years, that it's not worth going to the polls. True enough -- but the consequence would be a **Democratic majority** that would be even worse for growth.

BOTTOM LINE: We reiterate what we said Friday morning, when stocks were still making new highs (see "On the Tax and Budget Breakdowns" April 7, 2006). 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. And the expectation that the tax reconciliation bill will pass when **Congress** returns from **Easter recess** would suggest that this dip should be bought. But the upside potential in stocks 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 and that a new era of higher taxes is at hand. TM