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

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On Another Tax Bill Breakdown

Thursday, April 27, 2006

Donald Luskin

We have learned from sources late in the day that **House/Senate negotiations** to work out a **tax bill** -- including a **two-year extension of the 2003 tax cuts on dividends and capital gains** and a **one-year Alternative Minimum Tax "patch"** -- have broken down yet again. **Conference committee chair Chuck Grassley** has headed back to **Iowa** for a long weekend, so hopes that we heard expressed in the marketplace early today that the bill would be concluded this week have been dashed.

This drags out the waiting, and the risk. But **Republican leadership** of both chambers remains solidly committed to forcing the principle negotiators -- **Senate Finance Committee** chair Grassley, and **House Ways and Means chair Bill Thomas**, who reportedly despise each other -- to come up with something viable for the good of the party. And there remains no real disagreement between Grassley and Thomas about the core contents of the bill -- extension of the investor tax cuts and the AMT "patch." What remains in contention are the fine points, and the **legislative strategy**. Specifically, which components will be put in a **filibuster-proof reconciliation bill** capped at $70 billion, and which will be put in a separate bill subject to the risk of filibuster, and the potential addition of **amendments** such as some kind of **windfall profit tax** that could force a **presidential veto**.

One new idea on the table is the inclusion in the separate bill of a **second year of the AMT "patch,"** intended as a sweetener to attract **Democratic** votes. On the one hand, such a provision would make it difficult for Democrats representing **high-tax states**, whose residents would be most helped by the "patch," to vote against the bill. On the other hand, the very popularity of the AMT "patch" makes it a valuable all-purpose legislative weapon, which the Democrats may believe could fall into their possession next year if the Republicans don't retain their **House majority** this November. Democrats could risk voting against a bill containing the "patch" *now* on some pretext, believing that they could attach it to some bill *next year* for which they want support of what will surely remain a Republican majority in the Senate.

BOTTOM LINE: Whatever advantage, real or spurious, that the **stock market** might have gained from hearing that **Ben Bernanke** say explicitly today that **the Fed** may **pause** in its **rate-hiking campaign** is surely blunted by this latest breakdown in negotiations on a tax bill. Our view remains just where it was three weeks ago when we wrote that stocks would stall out until the tax bill negotiations were resolved (see "On the Tax and Budget Breakdowns" April 7, 2006) -- and stocks are just where they were the day we wrote that. We continue to think that the tax bill will indeed pass, and there's some **upside** in stocks to be captured when that happens. But the less likely **downside** if it *doesn't* happen is worse. If the 2003 tax cuts aren't extended now, they never will be. Legislative failure would lead to the loss of the Republican majority in the House, and years of automatic tax increases as the tax cuts of earlier years **sunset** out (see "High Noon" April 25, 2006). TM

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 544 6900