

POLITICAL PULSE

Heading into the Tax Bill Endgame

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Stocks are priced neither for the best nor the worst policy outcomes.

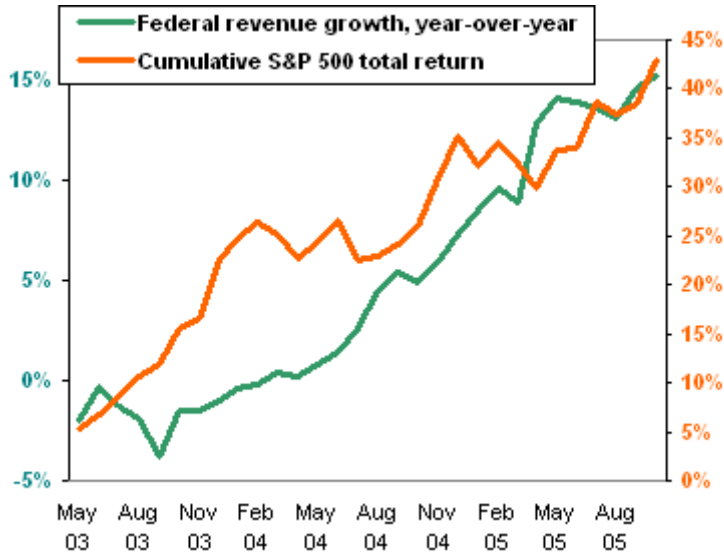
There's still a long a rocky road ahead for the potential extension of the **2003 tax cuts on dividends and capital gains** in this year's **Congressional budget reconciliation process**. We have to be clear-eyed about the risks to **equities** and to **economic growth** if the extensions are not enacted, or if onerous compromises are required to enact them. And while investors have been focused on dividends and capital gains extension, we can't ignore the risk that extension of the **Alternative Minimum Tax "patch"** might not be enacted, either.

Under current law, lower dividends and capital gains **tax rates** don't **sunset** until 2008 (meaning that 2008 would be the last tax year in which they apply). Therefore failure to extend those rates this year would have no immediate impact on **after-tax incomes**. The real impact would be on **expected after-tax returns** in the future. If an already shaky **Republican majority** tries and fails this year to extend today's lower rates, surely markets will have diminished confidence that those rates can be extended next year, or the year after. With the greater prospect of a higher **tax wedge** on **returns to capital** in tax years after 2008, surely the **present value** of equity securities should be marked down, all else equal. Our estimate of this **valuation effect**, assuming that expectations for the permanence of today's tax rates fell all the way from virtual certainty to total abandonment, is about 10% across the **S&P 500**. But beyond an **immediate valuation effect**, the resultant higher **cost of equity capital** would have negative knock-on effects that would ripple throughout the economy.

The AMT "patch" expires this year. If it is not extended, adjusting the **AMT exclusion** to \$43,500 for single filers, then the exclusion will fall all the way back to its 2003 level of \$33,750. Estimates vary, but if this happens, somewhere between 5 million and 17 million taxpayers would become subject to AMT in the 2006 tax year, triggering an average increase in tax obligations ranging averaging between \$2,000 and \$6,000, lodged upon taxpayers who probably think of themselves as middle class. The hit to both incomes and **incentives** would be very serious, and there would be considerable **political backlash**.

Our intuition is that **the consensus** already assigns a very low probability to extension of current dividend and capital gains rates. That's one of the reasons why the S&P 500 is up only 4.4% year to date, while at the same time **expected earnings** have risen 14.2%. And it's why **stocks** have been able to rally this last month, even as the legislative difficulties of enacting extension have become increasingly visible (see ["Beyond Disappointment"](#) November 11, 2005). Some hope, at least, springs eternal -- so actual failure to enact extension would no doubt be somewhat negative for stocks. And that means successful enactment would be an **upside surprise**. Extending the AMT "patch," though, is another matter. Because it enjoys some measure of bipartisan support -- and because the economic and political consequences of failure to extend are so well understood -- our intuition is that the consensus treats extension as nearly a foregone conclusion. Thus failure to enact extension would be a **downside surprise**. Our estimation is more bullish than the consensus on dividends and capital gains, and more

bearish on AMT. In other words, we would assign, say, a 55% probability for dividends and capital gains (versus the consensus's 15%); and we would assign, say, a 80% probability for AMT (versus the consensus's 95%).



There's no doubt that both the **White House** and **majority leadership** want to see the dividend and capital gains rates extended. They clearly understand the economic growth implications involved, and the associated **tax revenue** implications -- being well aware of the chart at left, which shows the bull market in both the stock market and **Treasury receipts** since the 2003 tax cuts were first enacted. They are aware of the political implications as well, with the **GOP's "growth wing"** pressuring leadership for doing such a poor job promoting this emblematic pro-growth policy, and being so incapable of raising

awareness of how well the economy is doing and getting any credit for it (see ["No Respect"](#) December 1, 2005). **President Bush's** statement this morning on the economy is surely a reaction to this pressure, as was **Senate majority leader Bill Frist's** statement that he intends to enact extension of the dividend and capital gains rates regardless of the fact that the **Senate Finance Committee** didn't include it in this year's **revenue reconciliation** bill. Our out-of-consensus bullishness on extension, such as it is, comes from our belief that leadership will do everything it can here to salvage its reputation with the "growth wing."

But it won't be easy. The Senate's bill doesn't include dividend and capital gains extension, and the **House Ways and Means Committee's** bill -- which *does* include extension -- hasn't passed the full House yet. It has been widely reported that House leadership didn't have the votes to pass the bill before the **Thanksgiving** recess, and therefore didn't even try. It's entirely possible that the necessary votes will have materialized by next week when the House reconvenes, just as the necessary votes materialized in order to pass the House's controversial **spending reconciliation** bill several weeks ago, after an initial attempt had to be aborted. With each passing day, a vote for what are demonized as "tax cuts for the rich" gets further separated in time from what are demonized as "spending cuts for the poor" (which, of course, are not "cuts" at all, but rather an infinitesimal deceleration of federal spending from a planned annual compound growth rate of 4.67% over the next decade to 4.63%).

Assuming that the House does pass Ways and Means's revenue bill, then the House's version and the Senate's version have to go to **conference**, where they will be melded into a single bill. That's not going to be easy, because the two bills are very different, and there isn't enough money to go around in order to enact everything that both chambers want.

- The Senate bill calls for tax cuts netting \$57 billion; the House's bill calls for \$56 billion.
- Provisions common to both versions total \$29 billion, including extension of **research tax credits** (\$9.9 billion) and expansion of **small business expensing** (\$7.3 billion).
- Of the provisions unique to the Senate bill, the AMT "patch" is the single largest (\$30.5 billion). The Senate version also calls for various forms of tax relief for **hurricane victims** (\$7.2 billion), and for various **"offsets"** designed to raise tax revenues by

closing **loopholes** and enhancing **enforcement** (\$19 billion). An especially critical provision among the Senate bill's "offsets" is a rule change on **LIFO inventory valuation** for **integrated oil companies**, which would have the effect of a one-time **windfall profits tax** of about \$4 billion (see ["A Whiff of Windfall Profits Taxes"](#) November 17, 2005).

- Of the provisions unique to the House bill, two-year dividends and capital gains extension is the largest (\$20.5 billion). There are also two provisions affecting **controlled foreign corporations** (\$5.5 billion). The House bill does not contain even a single "offset."

If all the provisions called for in both versions were approved, the total value would be \$84.5 billion, yet reconciliation instructions only provide for \$70 billion. Some provisions will have to be abandoned, or at least removed from the reconciliation process and voted separately. Further, if any of the Senate versions "offsets" are removed, the problem gets worse. For example, if House conferees try to block the Senate's windfall profits tax (either on ideological grounds, or because the White House has threatened to **veto** any bill that contains it), then the total value of remaining provisions rises to \$88.5 billion, requiring that *more* tax cuts either be abandoned or moved outside of reconciliation. Considering that dividend and capital gains extension is universally opposed by **Democrats**, and opposed by a small number of **"moderate"** GOP swing votes, it's not difficult to imagine it being abandoned under pressure, regardless of leadership's wishes. Drop dividend and capital gains taxes for \$20.5 billion in exchange for dropping the windfall profit tax for \$4 billion, and call it a day at \$68.5 billion. Leadership may well rationalize such a solution by taking pride in having courageously defeated the windfall profits tax, while telling themselves they have three more years to take another crack at dividend and capital gains extension.

Another scenario would be one in which living with the windfall profits tax becomes part of the price of getting a dividends and capital gains extension, perhaps only for a single year. Such a solution would send a disturbing political signal, but it's hardly the worst thing that could happen here. After all, the LIFO inventory rule change being proposed is not a true windfall profits tax, acting as a permanent marginal disincentive to capital investment in the oil industry. Instead, it's a one-time punishment, a speeding ticket if you will -- pay it once, and get back on the freeway and accelerate right back up to 90 mph.

The worst-case scenario is a deadlock in which conferees hold each other's most important differing provisions hostage -- dividends and capital gains for the House, and the AMT "patch" for the Senate -- thus throwing the entire process out of reconciliation. If that happens, any and all subsequent provisions would require 60 votes in the Senate to be passed, while only 50 votes are required under the protection of reconciliation. In that scenario, we could end up with no dividend and capital gains extension *and* no AMT "patch."

Bottom line: We think stocks are generally priced for some kind of disappointment in the tax policy process this year -- perhaps the failure to extend current dividends and capital gains rates, perhaps extending them only for one year, and perhaps a one-time windfall profits tax on oil, or some combination of those things. Anything better would be an upside surprise, one which we would by no means rule out. The worst-case scenario, in which there is no dividend and capital gains extension *and* no AMT "patch," is possible but unlikely -- it would be a serious downside surprise if it occurred. While we wait, we continue to see the pattern of possible outcomes as asymmetrically positive for stocks. Thus stocks remain the king of the **carry trades** (see ["The King of Carry Trades"](#) June 14, 2005). So far this year, that carry trade has worked: the S&P 500 total return year-to-date has been 6.0%, while the **10-year Treasury** total return has been 2.0%. **TM**