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

POLITICAL PULSE

# Tax Bill Game Theory, and Why It Matters

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**Donald Luskin**

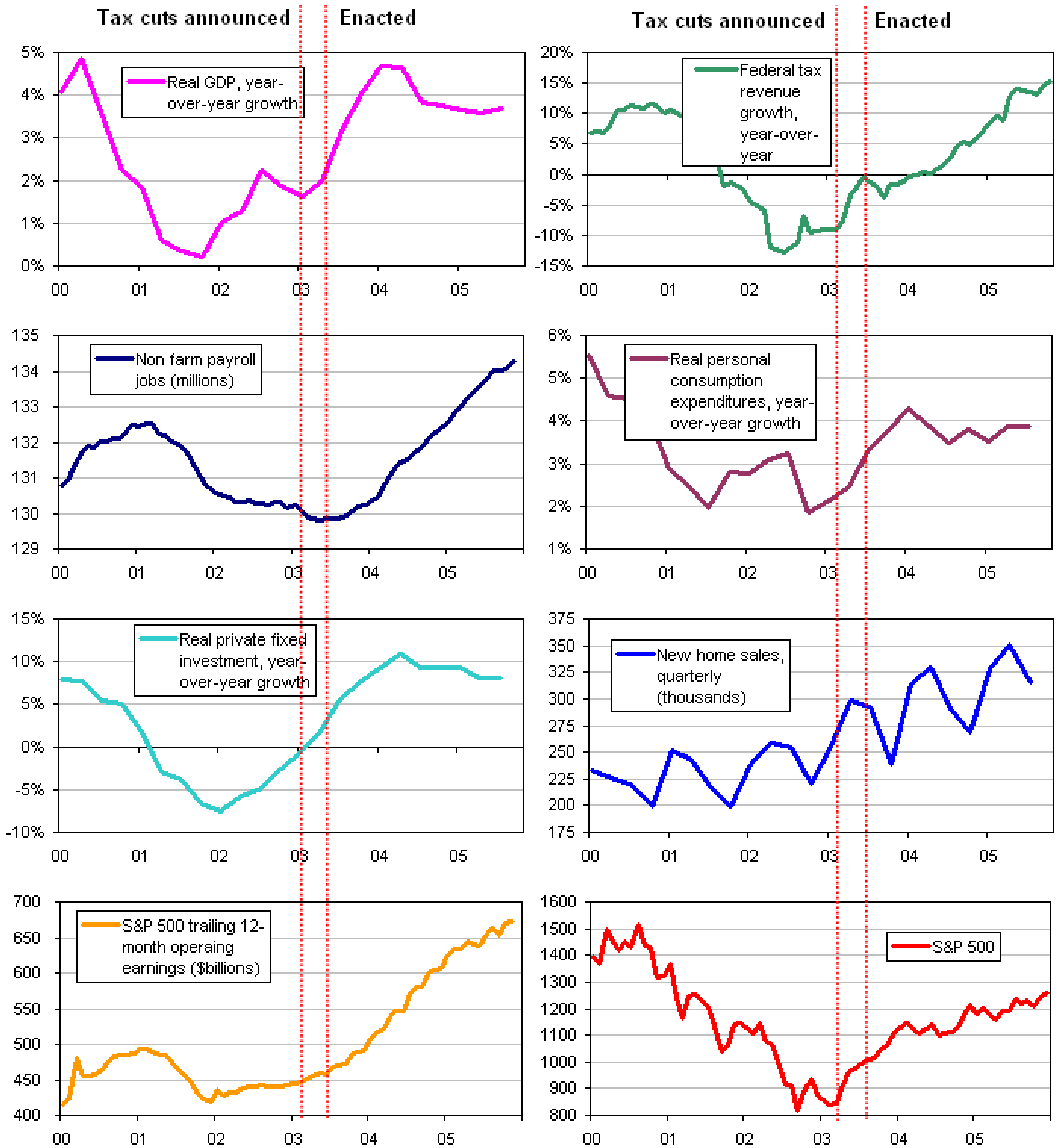
**More thrills and spills on the way to extension of the 2003 tax cuts -- and a remembrance of what those cuts have done for the economy.**

We will probably know by the end of the day whether the **Republican pro-growth** forces in the **House of Representatives** have the votes to approve the **Ways and Means Committee's revenue reconciliation** legislation, which would extend the **2003 tax cuts on dividends and capital gains**. Moments ago the House voted down an "amendment in the nature of a substitute" -- introduced by the **Democrats** -- that stripped out extension, and instead provided for a one-year **Alternative Minimum Tax "patch,"** which the Ways and Means Committee's legislation lacked. The next step would be to approve the Committee's original legislation. We're hearing that there are sufficient votes for passage -- but it will be a very close call.

The House yesterday passed, with overwhelming bipartisan support, separate legislation outside of the **revenue reconciliation** process intended to address the AMT "patch." In the calculus of legislative game theory, the separate bill allows members -- especially in the **northeast**, where high **state and local taxes** make taxpayers so vulnerable to AMT **bracket-creep** -- to return to their districts over the holiday recess and say that they have not ignored the risk of ensnaring upper-middle class taxpayers in AMT obligations. This also opens up the possibility of handling the AMT "patch" entirely outside of reconciliation in upcoming **House/Senate conference** -- leaving sufficient capacity within the $70 billion limit of the **filibuster-proof** reconciliation process to easily cover dividends and capital gains extension. In a perfect world, we would thus end up with a best-case win: tax legislation embracing *both* the AMT "patch" and dividends and capital gains extension, an outcome difficult to achieve within reconciliation (see "Heading into the Tax Bill Endgame" December 2, 2005). The downside is that the threat of *not* agreeing to the AMT "patch" has always been the Republicans' secret weapon -- one which might be used to pry out a critical cross-over Democratic vote or two, if need be, to pass dividends and capital gains extension within reconciliation. That weapon will still have potency provided that the Republicans insist that reconciliation without the AMT "patch" be voted *first* -- before separate AMT "patch" legislation is voted (since it can't pass without the support of the Republican majority). We hear from **congressional** sources that this is exactly the **GOP leadership's** strategy. Whether they can pull it off, especially in the face of internal Republican dissension, is problematic.

If it seems as though we've been putting too much emphasis on this legislative process, think again. We can't emphasize enough how critical the 2003 tax cuts on dividends and capital gains have been to the current **expansion**, and how much risk would be created if Congress signals to the market that it will allow these lower tax rates to roll off after 2008, as current law provides. As the charts on the next page demonstrate, the 2003 tax cuts were present at the creation of all the key trends that have defined the expansion. You can be the judge as to the robustness of the cause-and-effect relationship in each case. But in our model, the diminution of **disincentives** to **capital investment** and **risk-taking** is the single most potent key to **growth**.

The growth phenomena that we have seen since the 2003 tax cuts were enacted are precisely what our model predicted. So our advice to Congress is: *don't mess with taxes.*




**Bottom line:** We still think stocks are priced for disappointment in the tax policy process this year. Extension of the 2003 tax cuts on dividends and capital gains would be an upside surprise. And the development of alternative legislative means for enacting the AMT "patch" probably lessens the risk of a worst-case conclusion in which *neither* extension *nor* the "patch" are enacted. So 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 5.4%, while the **10-year Treasury** total return has been 2.1%. TM