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POLITICAL PULSE

Good Week for Growth

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Donald Luskin

New hopes for extending the Bush tax cuts, no carbon tax, and an easy Fed.

Last week was a step back from the risk of repeating the mistakes of 1937 and 1938 -- the tax hikes, the monetary tightening and the anti-business regulatory assault -- that led to the "recession within the Depression" (see our *Wall Street Journal* op-ed "Why This Isn't Like 1938 -- At Least Not Yet" July 9, 2010). That could be why in over a year of the S&P 500 eerily tracking its performance at the run-up to and onset of the 1937 bear market -- history's second worst -- we now have the second largest *positive deviation* from the historical pattern (please see the chart below). More than ever, we think we'll remain in an "expansionless recovery," without a "double dip," and the present correction in stocks will be a buying opportunity (see "Betting Against a 'Double Dip'" June 30, 2010).

Update to strategic view

US STOCKS, US MACRO: Extending the Bush-era tax cuts is still a big reach, even with three Democratic senators breaking ranks for the sake of the weak economy. But it raises …

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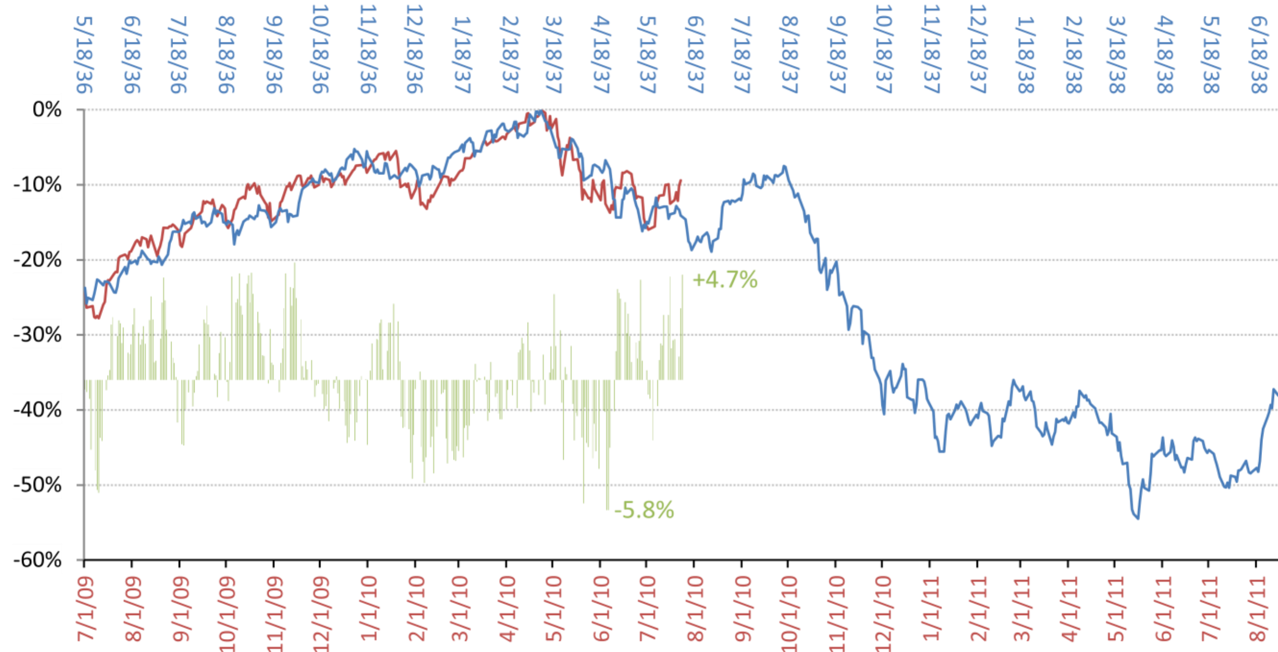
S&P 500 in post-1936 "recession in the Depression" — S&P 500 today — Difference

Percentage change from respective recovery peaks



Source: Standard & Poor's, TrendMacro calculations

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We have already noted the Fed's small down payment on accelerated monetary stimulus, in the form of talking down funds rate expectations to their lowest point ever (see "No QE2 Yet -- Just QE 1.1" July 22, 2010).

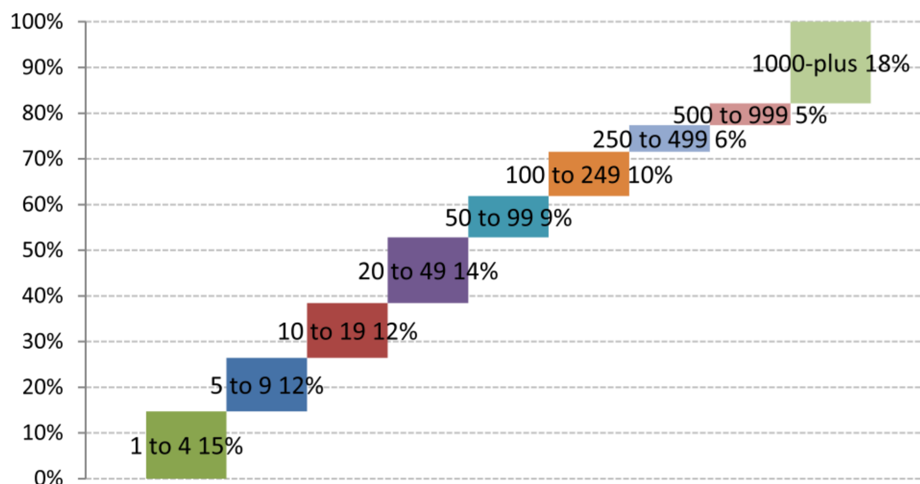
Another pro-growth policy victory last week was the official shelving in the Senate of the Obama administration's "cap and trade" carbon tax. This is especially salient from our point of view coming the same week as the Dodd-Frank financial re-regulation bill was signed into law. Handing over the commanding heights of the economy to councils of regulators is a serious blow to growth prospects, but at this point it was no particular surprise (though already surprising unintended consequences are starting to emerge). But that "cap and trade" couldn't get any traction -- even after the Obama administration's second major legislative victory, and after months of bullying the energy industry in the aftermath of the Gulf oil spill -- is compelling evidence for our thesis that there are hard limits to how much anti-growth policy can be rammed through (see "Wolf in the Fold" May 18, 2009).

But the most exciting policy development last week was three Democratic senators -- Bayh (IN), Conrad (ND) and Nelson (NE) -- saying publicly that they would support extending the Bush-era top marginal tax rates, at least temporarily, given the weak state of the economy. We'd pretty much given them up for dead, assuming today's low top rates on wages, dividends, capital gains and estates, would all sunset away at year-end.

Extending them would be a non-trivial boost to the economy, especially given its present weakness. Here's why:

- **Job creation:** Since 1992, 38% of total gross job gains have come from firms of fewer than 20 people (please see the chart below), most of which are organized as sole proprietorships, partnerships, S-corporations or LLCs -- Trend Macrolytics LLC is an example.

Percentage of gross job gains since 1992, by firm size



Source: Bureau of Labor Statistics, TrendMacro calculations

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…the expected outcome for job creation and asset values. Combined with a more easy Fed and the Senate shelving "cap and trade," we are all the more confident that there will be no "double dip" and that the correction in stocks is a buying opportunity.

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Owners of such firms report profits as personal income, and many pay taxes at the top marginal personal rate. So if the Bush-era top rate goes from 35% to 39.6% -- a 13.1% increase -- that means the risk/benefit calculus of adding a new employee for this key job-creation segment faces a 13.1% higher hurdle rate.

- **Wealth effect:** The prices of capital assets, including stocks and real estate, are fundamentally determined by the anticipated value of after-tax cash flows. Surely those prices have already fallen in expectation of higher dividend and long term capital gains tax rates (the capgains rate, determined at the time of sale, not acquisition, has effectively already gone up, given the required one-year holding period). Reversing those expectations by extending the lower 2003 rates would increase asset prices, and thus increase household wealth.
- **Cost of capital:** If asset prices were to increase, by definition the cost of capital would fall, and some capital investment projects that don't pass a risk/benefit test today would do so. Capital investment as a fraction of GDP made all-time historic lows in the recent recession, and so should be especially well-primed for recovery kick-started by lower capital costs.

All that said, extending the Bush-era tax rates still faces enormous political difficulties.

- **Tough in the best of times:** Remember, these rates weren't easy to get even when Republicans controlled both houses of Congress and the White House. The 2003 tax cuts passed the Senate by a 50/50 vote, with Vice President Cheney casting the tie-breaker. The 2005 extension was debated into 2006 and then passed the Senate by a 54/44 vote. Both times three Republicans broke ranks.
- **The White House is opposed:** Last week the Obama administration repeatedly expressed its opposition to extension via statements by Tim Geithner. The White House position is and always has been to preserve the Bush-era tax rates for households below $250,000 AGI, but to let them sunset for those above. The dividend rate would be capped at 20%.
- **Risky talking point in the November elections:** Unless Bayh, Conrad and Nelson can convince the bulk of Democrats to agree with them on extension, the Democrats will adopt the White House's position. They will vilify Republicans who stand in the way of preventing middle class tax hikes by insisting on continued low rates for "the rich."

While we hold out only faint hopes that the Bayh, Conrad and Nelson "liberal tax revolt" can actually lead to an extension of the Bush-era tax rates, it is good news in that it puts the debate about extension on the front-burner and shifts the debate's center of gravity in the direction of extension.

- **Certainty would be an improvement:** At least the battle is joined. The sooner it is resolved, the sooner the market will have certainty about 2011 tax rates.
- **Growth is on the agenda:** The "revolt" demonstrates that growth is still a policy criterion. It entrenches divisions with the Democratic party and confirms that anti-growth initiatives will continue to be difficult to complete.
- **We can now expect a higher-value outcome:** By three Democrats putting *full* extension in play, it increases the chances that we'll end up with at least *some* extension. The economy could do a lot worse than end up with the White House's preferred outcome -- for example, instead of capping dividends at 20%, they could revert all the way back to 39.6% as they were pre-2003.

Bottom line

Extending the Bush-era tax cuts is still a big reach, even with three Democratic senators breaking ranks for the sake of the weak economy. But it raises the expected outcome for job creation and asset values. Combined with a more easy Fed and the Senate shelving "cap and trade," we are all the more confident that there will be no "double dip" and that the correction in stocks is a buying opportunity.