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POLITICAL PULSE

# Tax Cut Chicken

Thursday, September 9, 2010

**Donald Luskin**

**Forget stimulus. Focus on the high stakes poker over extending the Bush era tax rates.**

*In this report we ask:*

- *Will the Republicans take control of Congress in November, and does it matter to growth prospects?*
- *What are the policy risks in a lame duck session?*
- *Will there be further "stimulus," and will it help or hurt the economy?*
- *Will the expiring Bush-era tax rates be extended? Which ones, when, what market impacts -- and what risks in the process?*

## GOP congressional control

The political futures contracts traded online at Intrade give a 70% probability to the GOP taking control of the House (with an expected gain of 47 seats, with 40 needed), and a 25% chance of taking control of the Senate (expected gain of 7 seats, 10 needed). *Does this matter to markets? Apparently not, or not enough.* The stock market is about where it was late last year (please see the chart below) when the GOP's chances first started to accelerate (see "On GOP Wins in New Jersey and Virginia"

**— S&P 500 — Futures implied probability of GOP House control**


Source: Intrade, TrendMacro calculations

**Update to strategic view**

**US MACRO, US STOCKS:** Stimulus is a side-show. There's still plenty of ARRA money to come, and much of the money already dispersed to households was saved rather than spent anyway. The real issue is the Bush era tax rates set to expire this year. We are now in a risky game of chicken in which Obama insists on minimal extension and the GOP insists on full extension -- opening up the risk of deadlock, resulting in no extension. That would be a train wreck, and the risk of it is part of what is spooking stocks now. But latent in the game is a much better possible outcome than could have been expected a few months ago. If full extension can be achieved, that would be *ipso facto* an upside surprise for stocks, but as a second order effect it would establish the pro-growth *bona fides* of the GOP as a potential midterm sweep looms in November.

[Strategy Dashboard home]

November 4, 2009).

How to explain this chart, especially if one believes as we do that the economic policies of the Obama administration and the Democrat-controlled Congress have been strongly anti-growth? Why aren't stocks celebrating now?

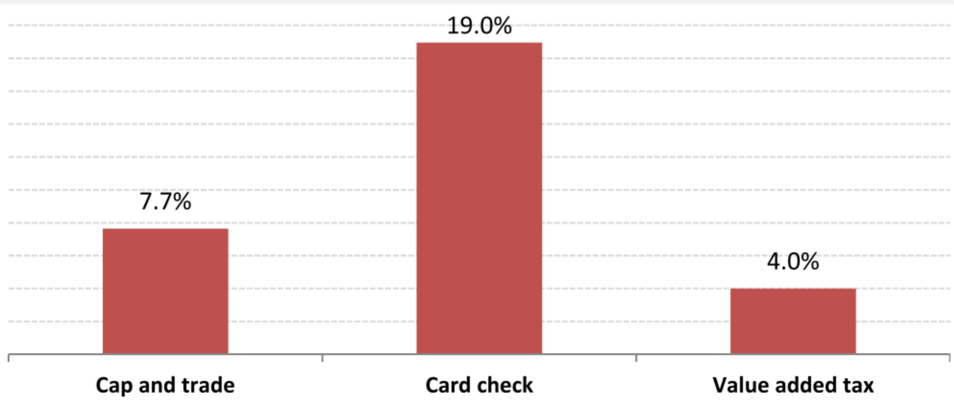
- Poor policy -- and uncertainty about even more poor policy -- has slowed growth in 2010. This has resulted in *both* poor stock performance and increased dissatisfaction with incumbents.
- A GOP House, or even a GOP Congress, is no guarantee against anti-growth policy. Pro-growth conservatives were ecstatic at the election of Scott Brown in January. But we warned at the time that Brown embodied the GOP's posture as a minority party, emphasizing populism and austerity, not growth (see "A Scott Heard 'Round the World?" January 19, 2010). Indeed, the draconian Dodd-Frank financial reregulation bill was passed only because Brown broke a GOP filibuster.

With no clear pro-growth message coming from the GOP, stocks seem to be taking a "wait and see" attitude. For our strategic outlook, we'll count GOP House control as enough of a positive to limit the downside, underscoring our sense that 1040 on the S&P 500 is as bad as it's going to get in this correction (see "Betting Against a 'Double Dip'" June 30, 2010). We'll learn more about the GOP's growth *bona fides* as the debate over the Bush era tax cuts plays out over the coming weeks and months.

## Risk in a lame duck session

The conservative opinion media have highlighted the risks of Democrats ramming through unpopular anti-growth policies -- such as unionization card-check, cap-and-trade or a value added tax -- in a lame duck session. The political futures contracts traded online at Intrade give these outcomes very low probabilities (please see the chart below), and we agree that there isn't much real risk here.

**Futures implied probability of enactment in 2010**




Source: Intrade, TrendMacro calculations

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[About us]

**Recommended Reading**

**The Small Business**
**The 97% Fallacy**
Kevin Hasset and Alan D. Viard
*Wall Street Journal*,
September 3, 2010

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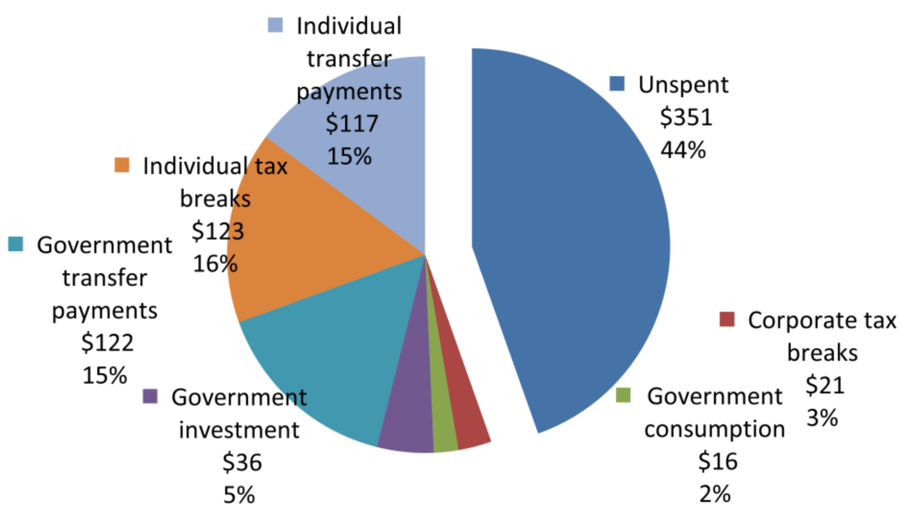
A key reason is that these initiatives were never deeply popular among Democrats in the Senate to begin with. And in a lame duck session there will very likely be at least two new Republican senators immediately taking the seats of incumbent Democrats. That's because of a peculiarity arising from the fact that incumbent Democrats in six states -- Illinois, Delaware, West Virginia, New York and Colorado -- are unelected appointees. The key two are Illinois and Delaware, where the incumbents are not running for re-election, and whoever replaces them would be seated immediately. In Illinois, Republican candidate Mark Kirk is slightly favored, and in Delaware Mike Castle is strongly favored. In Colorado and Florida Republicans are slightly favored, but it is not clear they would be immediately seated if they win. In West Virginia the incumbent Democrat is strongly favored -- and in New York law does not provide for immediate seating.

**Is more stimulus coming?**

We see the White House's latest stimulus proposal -- extending R&D tax credits, temporarily allowing 100% expensing for capital investments, and spending $50 billion on infrastructure over six years -- as mostly a political gesture. The expensing idea is particularly without substance, considering that it is the logical equivalent of an interest-free loan for businesses at a time when interest rates are effectively zero anyway. The infrastructure proposal is just a plain-vanilla highway bill positioned as stimulus, something that would probably get done sooner or later in any event. And wasn't last year's stimulus bill supposed to have done that already?

None of it matters much. We ignore the bearish chatter that the economy is sure to fall into a "double-dip" recession now that last year's massive stimulus is running out -- the reality is that only 56% of the money has been spent so far (please see the chart below). And there's no way to rigorously show that it has done any good so far, so when it does finally

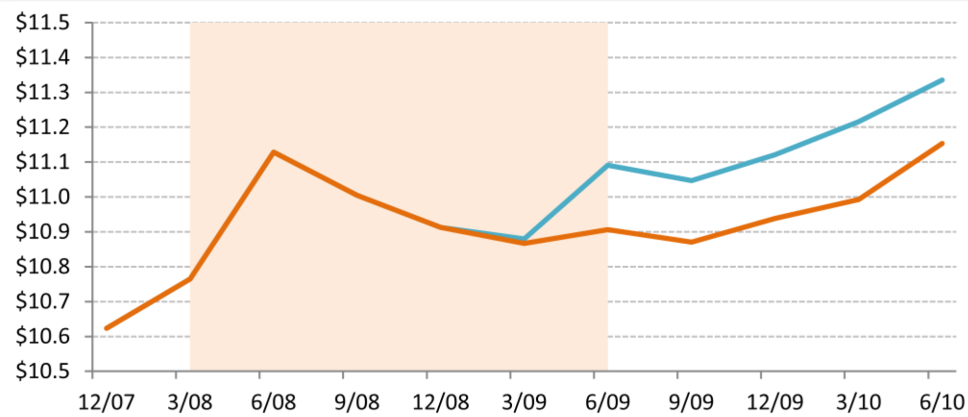
**Allocation of $787 billion from American Recovery and Reinvestment Act**
As of 2Q 2010




Source: Bureau of Economic Analysis, TrendMacro calculations run out there's no rigorous reason to believe it will do any harm.

Of the money spent so far from the American Recovery and Reinvestment Act (ARRA), $240 billion, or 55%, has been in the form of income subsidies or tax reductions for individuals, thus boosting disposable personal income considerably over the last six quarters. After an historic drop from mid-2008 to early 2009, reported DPI finally recovered to new all-time highs in Q1 2010 -- but only thanks to the contribution of ARRA (which can be measured precisely based on the actual value of transfer payments and tax reductions, without recourse to any theoretical notions of "multipliers"). By Q2 2010, DPI had surpassed the 2008 high-water mark organically, that is, without ARRA (please see the chart below).

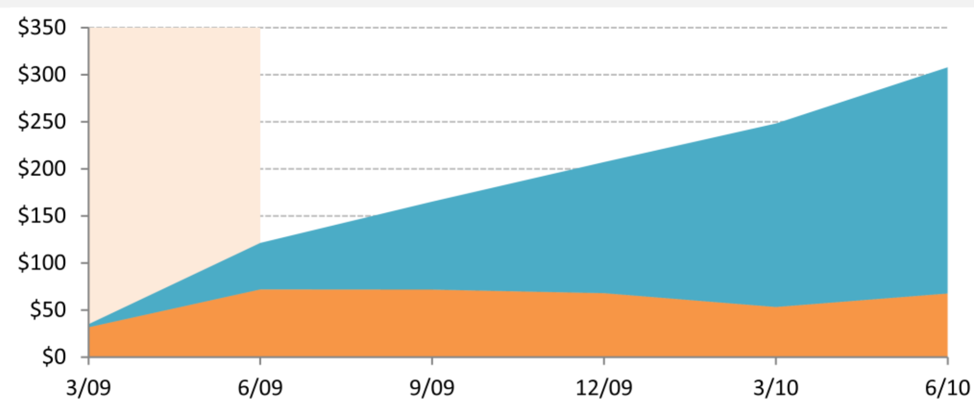
**Organic disposable personal income** **With ARRA** **Recession**
USD trillions, nominal, SAAR




Source: Bureau of Economic Analysis, TrendMacro calculations

On the back of this, personal consumption has risen to all-time highs, despite the "expansionless recovery" (see ["The Consumer: QED"] April 16, 2010). But if ARRA money were to suddenly stop, it would seem that DPI would fall, and this ought to drive a drop in consumption. But not necessarily. More than all the ARRA supplements to DPI were saved, rather than spent (please see the chart below). This confronts us with the

**Personal savings** **Organic** **ARRA** **Recession**
Versus 2008 average, cumulative, USD billions, nominal, SA




Source: Bureau of Economic Analysis, TrendMacro calculations

Kafkaesque economics of stimulus -- it is as though the government debt funding the stimulus was itself funded by the savings made possible by the stimulus. Perhaps this is what Ben Bernanke would call "the portfolio rebalance channel" -- a version of the way the Fed's purchases of MBS are funded by the sellers depositing the proceeds with the Fed as excess reserves. In that light, consumption can be seen as having been stimulated not by a gift of spending money, but rather by a gift of prudential savings. Thus any future drop in ARRA subsidies may well come out of future incremental savings, and not out of future consumer spending. Be that as it may, according to Recovery.gov, there remains $145 billion in ARRA income subsidies and tax benefits yet to be distributed, so we won't have to cross this bridge until mid-2011.

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**The dangerous battle for the Bush era tax rates**

We've assumed that the market and the economy have thoroughly discounted the Bush era tax cuts -- under current law expiring at the end of this year -- to be extended for households earning less than $250 thousand, with no extension for those above. We'll call that "minimum extension" We've treated the possibility that they might be extended for everyone -- "full extension" -- as an embedded out-of-the-money upside option. That option became less out-of-the-money six weeks ago when four Democratic senators declared their preference for full extension, in light of the weak economy (see "Good Week for Growth" July 26, 2010). This week a number of Democrats in the House are reported to have taken the same view. And today "moderate" Maine Republican Olympia Snowe, whom Democrats must have hoped would oppose full extension, came out in favor of it. All of this would seem to increase the likelihood of *at least* getting minimum extension.

It probably does, but it creates a new out-of-the-money downside option, too -- the risk of no extension at all. With full extension now a live possibility worth fighting for (for the GOP) and defending against (for the administration), there is now the possibility of a deadlock, a game of chicken, a prisoner's dilemma, in which neither side will give in and no compromise is possible, resulting in no extension. While markets have probably absorbed the anti-growth implications of minimum extension, no extension would be an outright train wreck, throwing the economy into a "double-dip" recession.

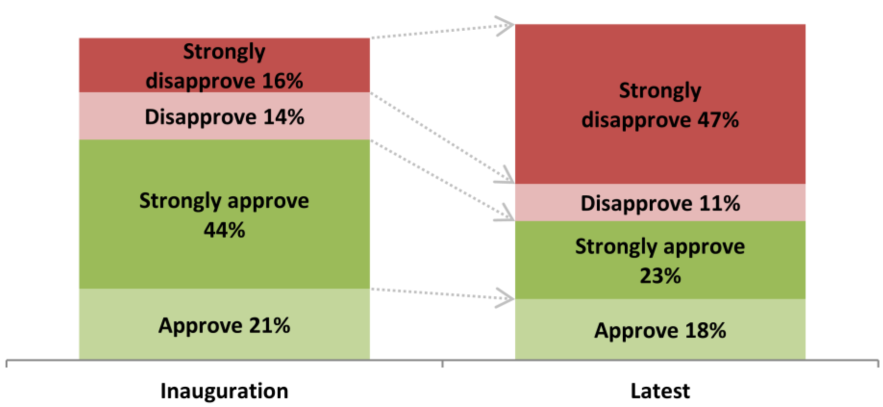
The White House is already risking setting this train wreck in motion. It has leaked to the media its hardened opposition to full extension. And President Obama is implicitly playing the game of chicken by accusing the GOP of playing it. In his speech in Cleveland yesterday he said,

> *So let me be clear to Mr. Boehner [House minority leader] and everybody else: We should not hold middle-class tax cuts hostage any longer. (Applause.) We are ready, this week, if they want, to give tax cuts to every American making $250,000 or less.*

Obama is no doubt thinking of the budget showdown in late 1995 between new House speaker Newt Gingrich and President Clinton. In that deadlock, nonessential government services were shut down twice, and the political theater of it ended up casting Gingrich as the villain who failed to reasonably compromise. But this situation is different in several key ways. A brief government shutdown is a short-term annoyance with some symbolic value, but letting the Bush era tax rates expire for all taxpayers would be an outright economic catastrophe. Obama is in charge -- not the out-of-power GOP -- so it would be on his head, despite the inclination of the media in his favor. And the GOP is perfectly willing to give Obama what *he* wants, if he will just give the GOP what *it* wants. That's a win-win bipartisan proposition, while Obama is advocating a partisan win-lose proposition. Even while the ink is still wet on Obama's threats, his own base is softening. On Monday the liberal *New York Times* ran an op-ed by former Obama OMB director Peter Orszag urging the president to hold his nose and agree to full extension, rather than risk no extension.

Why is Obama even pushing the issue now just ahead of the mid-terms, when so many Democratic incumbents are already at risk, and being attacked by GOP candidates for the weak economy? Perhaps he's a true believer, which a dangerous thing to be when playing a game of chicken. Who could blame him for having a bunker mentality as his approval slips to new lows (please see the chart below)? More likely he hopes he can buy

**Obama approval, daily tracking poll**




Source: Rasmussen Reports

off the GOP by dangling the prospects of extending the R&D tax credit and offering 100% expensing, and get it done during the briefly open window before Republicans from Illinois and Delaware tip the balance in the Senate in the lame duck session. But why would the GOP give him that legislative victory just before an election that is theirs to lose?

All in all, here's how we see it:

- Two months ago we would have said that there was a 10% probability of no extension, and a 90% probability of *at least* minimum extension -- which includes interior to it a 10% probability of full extension.

- Now we think there is a 25% probability of no extension, and a 75% probability of *at least* minimum extension -- but now that includes interior to it a 45% chance of full extension.
- Probability-weighted and risk-weighted, it's not clear that today's situation is better, especially considering the very high penalty on risk in the present excessively cautious environment.
- But today's situation contains more potential upside, and of all the possibilities, we make full extension to be the single most probable one now.
- This is brinksmanship. It's risky, and right now markets hate risk. But this could be leading to an outcome better than anything we dared to expect just a few short months ago.
- If the GOP can win this hand of high stakes poker, it will establish pro-growth *bona fides* that will get markets a lot more excited about the probability of a GOP Congressional sweep in November.
- Even if the result is deadlock pre-election, the issue can be revisited in the lame duck session, or for that matter retroactively early in 2011, when Republicans will surely have more votes. The period of agonizing uncertainty may be lengthy, but at least if the game of chicken results in a seeming crash in the first instance, there are multiple chances to recover.

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**Bottom line**

Stimulus is a side-show. There's still plenty of ARRA money to come, and much of the money already dispersed to households was saved rather than spent anyway. The real issue is the Bush era tax rates set to expire this year. We are now in a risky game of chicken in which Obama insists on minimal extension and the GOP insists on full extension -- opening up the risk of deadlock, resulting in no extension. That would be a train wreck, and the risk of it is part of what is spooking stocks now. But latent in the game is a much better possible outcome than could have been expected a few months ago. If full extension can be achieved, that would be *ipso facto* an upside surprise for stocks, but as a second order effect it would establish the pro-growth *bona fides* of the GOP as a potential midterm sweep looms in November.