Trend Macro

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POLITICAL PULSE

The Double-Dip Doomsday Machine

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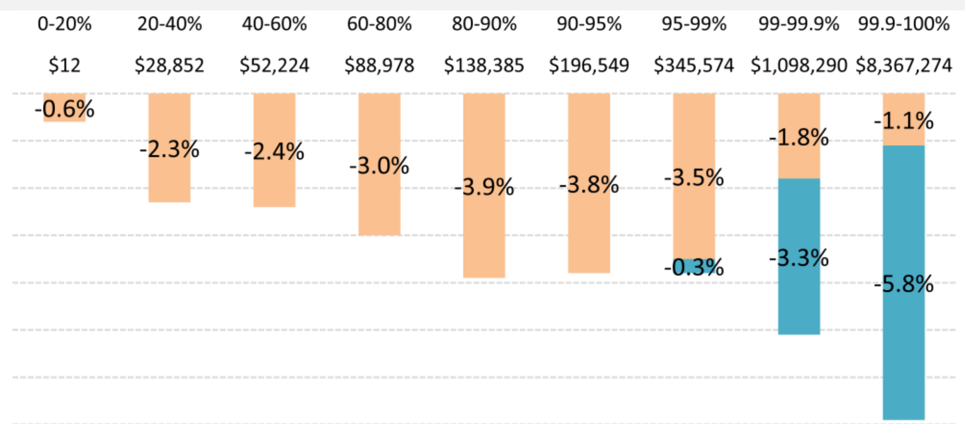
It's simple arithmetic -- failure to extend today's tax rates will cause a new recession.

Reportedly Congress will take up the matter of extending the Bush-era tax rates next week, before the pre-election recess. Democrats face a revolt within their own party, with five Democratic senators and 38 Democratic representatives having come out publicly in favor of the GOP's call for full extension -- including "the rich." Apparently it's seen as a lose/lose issue that they want off the agenda for the election. And the legislative process will likely be managed to maximize the appearance that the GOP is pandering to the rich and holding the middle class hostage. It will be set up as a game of chicken, in which the GOP will insist on *full* extension and the congressional leadership will insist on *partial* extension -- in a deadlock, the result could be *no* extension (see "Tax Cut Chicken" September 9, 2010).

No extension -- that is, the rolling off of all the Bush-era tax rates for 2011 -- would, without any ambiguity, trigger an immediate "double-dip" recession. The middle three quintiles would see their disposable income drop by 2.3%, 2.4% and 3.0% respectively (please see the chart below). Most of this income is consumed, and since consumption is about 70% of

Drop in annual disposable personal income
If failure to extend at all **If failure to extend for top earners**
AGI by percentiles, average AGI within percentiles



Source: Tax Policy Center

Update to strategic view

US MACRO: Letting the Bush-era tax cuts expire would unambiguously cause a "double-dip" recession. We don't expect that outcome ultimately, in fact we expect full extension. But short-term extension is of limited economic benefit, and to get it we may have to endure deadlock on the issue until the lame duck session of Congress. This will be a blow to already shaky confidence, and ensure a continuation of the "expansionless recovery."

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GDP, this would result in a penalty to output of about 1.75%. Even without what would likely be substantial spillover effects on the non-consumption economy, such a penalty would be enough to turn today's tepid real GDP growth rates negative.

To be clear: failure to extend the Bush-era tax cuts for at least the middle class is a double-dip doomsday machine. Like the doomsday machine in the film *Dr. Strangelove*, no one really wants to set it off -- but the structure of the political conflicts involved can act like an invisible hand whose finger nevertheless pulls the trigger.

- In the House, [reportedly]() speaker Nancy Pelosi (D-CA) is considering offering two separate bills, one to extend for the middle class and another to extend for top earners, with both under "suspension of the rules." This is a fast-track procedure that eliminates debate and requires a two-thirds majority for passage.
  - The middle class bill would require all 257 Democratic votes plus 31 GOP votes. Abstractly this is no problem, since there is virtual unanimity on this part.
  - But the high earners bill would require all 178 GOP votes plus 110 Democratic votes, and so far only 38 Democrats have declared that they would support it.
  - So the only move for the GOP would be unanimously vote against the middle class bill -- at the risk of being seen in November by their own base as has having opposed tax cuts, and by everyone as holding the middle class hostage -- hoping its defeat would result in a new unified bill that would be offered under regular rules later.
  - That may ultimately work, but getting there requires at least temporarily setting off the doomsday machine. Minority leader John Boehner (R-OH) has [indicated last week]() that he would not pursue this risky course, but that resulted in an immediate backlash from other GOP leaders insisting that they would fight to the bitter end for full extension.
- In the Senate, [reportedly]() majority leader Harry Reid (D-NV) is considering offering a bill with only middle class extension, forcing Republicans to offer an amendment to include top earners.
  - Such an amendment would need 19 Democrats to overcome a filibuster, and right now there are only 5 dissidents.

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Recommended Reading

Uniqueness or Similarity? Japan's Post-Bubble Experience in Monetary Policy Studies
Masaaki Shirakawa, Second IJCB Fall Conference, Institute for Monetary and Economic Studies, Bank of Japan
September 16, 2010

Principles for Economic Revival
George P. Shultz, Michael J. Boskin, John F. Cogan, Allan Meltzer And John B. Taylor,
Wall Street Journal,
September 16, 2010

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    - So just as in the House, Republicans and dissident Democrats would be faced with the necessity of voting against middle class tax cuts -- and at least temporarily triggering the doomsday machine -- in the hopes of later getting a bill for complete extension.
- So we may go into the election with the doomsday machine triggered, with markets and economic actors waiting until the lame duck session for it to get untriggered.
- If that happens, we would expect it to be resolved in the lame duck session, probably with full extension. But the intermediate period will be fraught with uncertainty.

It doesn't have to play that way. Senator Joe Lieberman (I-CT) is reportedly brokering a compromise that would have permanent extension of the middle class tax rates, and a one-year or two-year extension of the high earner rates. That would avoid triggering the doomsday machine. But while it avoids the truly bad outcome, other than that we think it should be seen as only good, not great, for markets and the economy.

- One or two years of extension is better than nothing, but does little to encourage long-term risk-taking in an economy already beset by extreme risk aversion.
- Given the necessary one-year holding period to qualify for the low long-term capital gains rate, one-year extension is no extension at all, and two-year extension is effectively only one-year extension for new capital commitments. With two years, an investment would have to be made in 2011 and then liquidated in 2012 in order to qualify. Most likely, that would result in little new investment -- but at least a spreading out over two years of the lock-in selling that has no doubt already been happening intensely this year.
- One or two years from now when further extension would be up for consideration, it would be difficult to achieve further extension. The middle class tax rates would not be on the table, having been made permanent, and thus could not be held hostage in the negotiation. Such a negotiation would take place with Obama still president, and the GOP working only with whatever congressional gains it can make in *this* election.

The best hope is that any extension of the top earner tax rates this year would signal a quantum shift in political sentiment toward growth, which could possibly acquire critical mass by the time further extension is debated. Don't rule this out. Consider how remarkable it is that the only reason we are even talking about the possibility of full extension is that Democrats raised the possibility (see "Good Week for Growth" July 26, 2010). Now even a non-incumbent Democratic senatorial candidate has come out in favor.

But this remains only a hope. Clearly a shift is underway, a continuation of the political re-equilibration that began a year ago as Obama's approval ratings began to markedly deteriorate (see "2009's Economic Chart of the Year" December 28, 2009). But we have yet to see whether this shift, symbolized this year so dramatically by the rise of the Tea Party movement, is indeed toward growth. Political sentiment that emphasizes shrinking the size and cost of government -- the signature plank of the Tea Party platform -- can embrace high taxes as the solution to excessive deficits. To see this one needs look no further than anti-deficit fundamentalist Alan Greenspan, who has advocated letting all the Bush-era tax rates expire, regardless of the toll on growth.

Bottom line

Letting the Bush-era tax cuts expire would unambiguously cause a "double-dip" recession. We don't expect that outcome ultimately, in fact we expect full extension. But short-term extension is of limited economic benefit, and to get it we may have to endure deadlock on the issue until the lame duck session of Congress. This will be a blow to already shaky confidence, and ensure a continuation of the "expansionless recovery."