TrendMacro

Trend Macrolytics, LLC
Donald Luskin,
Chief Investment Officer
Thomas Demas,
Managing Director

THOUGHT CONTAGIONS

To Get Rich is Glorious Again

Tuesday, December 7, 2010

Donald Luskin

The extension of the Bush-era tax cuts symbolizes that capital is still welcome in America.

Futures markets didn't react much at first yesterday evening when President Obama announced that the administration and congressional negotiators had agreed on a framework for extending all the Bush-era tax rates for two years. For one thing, it's not a done-deal until the Senate and the House vote on actual legislation. And it's not really much of a surprise at this point.

- We highlighted the first signs of it all the way back in July when the possibility was first raised by three Democratic senators (see "Good Week for Growth" July 26, 2010).
- We described the risky game-theoretic structure of the negotiation (see "Tax Cut Chicken" September 9, 2010).
- We identified the very strong bargaining power held by the GOP to get this done in the lame duck session with several new senators to be seated immediately after the election, and considering that failure to extend the present tax rates for the middle class would immediately produce a recession (see "The Double-Dip Doomsday Machine" September 21, 2010).
- And the day after the election it became just plain obvious to us. We noted that President Obama, in his morning-after press conference, replied to a reporter's question that he "absolutely" would compromise with Republicans on extension (see "The Pendulum Swings Back" November 2, 2010).

Even the complex of other tax provisions announced yesterday aren't particularly surprising, except in their details. It was predictable that Republicans would have to give the Democrats some of their preferred "stimulus"-type measures about which to claim victory -- it turned out to be a 13-month extension of long-term unemployment benefits, a temporary reduction in payroll taxes to replace "Making Work Pay," and short-term expensing of capital investments.

How pro-growth is this package of policies? It's a mixed bag.

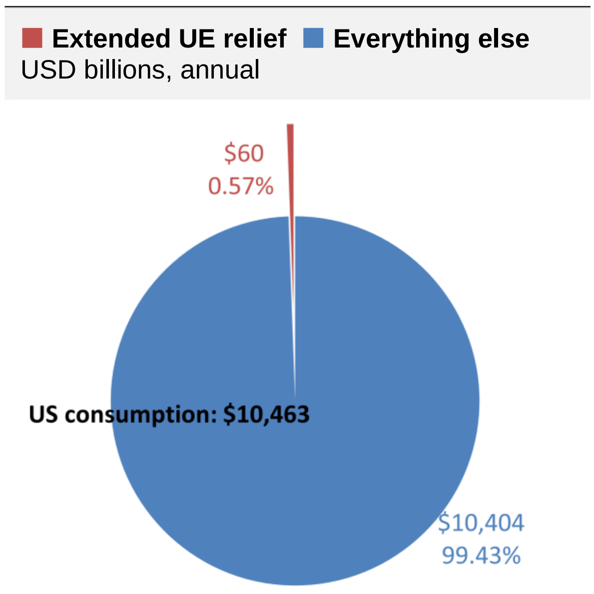
Update to strategic view

US MACRO: The compromise that will result in the extension of the Bush-era tax rates is all to the good, but hardly a pro-growth surprise at this point. It's real significance is that is symbolizes a change at the root of America's economic culture, where after two years of vilifying capital, capitalism and capitalists, once again "to get rich is glorious."

US STOCKS: No need for any year-end selling to lock in low capital gains tax rates -- they'll be around for at least another two years. But more deeply, extension of the Bush-era tax rates raises the value of the capital stock by symbolizing that capital is once again valued in this country. This transformation plays into our expectation for higher multiples in the coming year.

[Strategy Dashboard home]

- Extension of the Bush-era tax rates on incomes, dividends, capital gains and estates doesn't create any growth incentives that aren't already in place. It just prevents new disincentives in the form of higher tax rates.
- Extension alleviates uncertainty for firms and consumers to some extent, and this removes a friction opposing growth. In the near-term, it's a relief that a negotiating failure didn't occur, because letting *all* the tax rates sunset would have thrown the economy into an immediate recession.
- And at least we know what our tax rates will be for two years. But two years from now, it will all be up for grabs again, with the same high-risk game-theoretic dynamics. But there will be more Republican senators and representatives in the mix then. And as Paul Krugman lamented yesterday, "if tax-cut blackmail works now, why shouldn't it work again later?"
- The extension of long-term unemployment benefits should be a comfort to those who feared their lapse would be a blow to consumer spending. But in our view that's overdone. At most, it would be a vanishingly small $60 billion hit to the $1.4 trillion US consumption economy -- it barely shows on the chart (please see the chart at right).



Source: Bureau of Economic Analysis, TrendMacro calculations

- On the other hand, in our judgment it's a blow to job creation. For workers, jobless benefits create a benefit for remaining jobless -- their unprecedented duration now explains the persistence of high levels of long-term unemployment.
- Expensing of capital investments is a good pro-growth incentive in principle. But because it effectively brings forward tax deductions that firms would get anyway, its economic value is smaller in today's ultra-low interest rate environment than it would otherwise be. Its key advantage is for firms that face financing difficulties.
- The temporary reduction in worker-side payroll taxes is an incentive for lower-wage workers to contribute more labor. That's all to the good, but in today's weak labor market, such workers have little actual discretion about how much labor they can contribute. With the fraction of the employed labor force working part-time involuntarily near all-time highs, there is already more

Contact TrendMacro

On the web at
www.trendmacro.com

Donald Luskin
Menlo Park CA
650 429 2112
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

[About us]

Recommended Reading

The seniority conundrum: Bail out countries but bail in private, short-term creditors?
Daniel Gros
VoxEU
December 5, 2010

Fiscal Commission Report: Too Much Taxes, Not Enough Spending Cuts
Brian M. Riedl
Heritage Foundation
WebMemo 3071
December 3, 2010

[Recommended Reading home]

than enough supply of additional hours worked. It would have been more powerful to locate the tax relief on the employer-side, thus lowering the after-tax cost of creating new jobs or expanding hours offered to existing workers.

In our view, the most powerful pro-growth element of the extension of the Bush-era tax cuts is the transformation of American economic culture that made it possible in the first place.

- The Great Recession, much like the Great Depression of the 1930s to which it is often compared, has been seen by many as a failure of capitalism, and the result of excessive wealth and power accrued by capitalists.
- So for two years, the US has vilified capital, capitalism and capitalists. While we all tend to focus day to day on particular event-risks, *this has been the greatest systemic threat of all -- because capital will not stay where it is disrespected, and growth is impossible without capital.*
- On the other hand, capital goes where it is welcomed. Deng Xiaoping initiated the capitalist ascent of China when he transformed that nation's repressive economic culture and welcomed capital by reputedly declaring that "to get rich is glorious."
- With the extension of the Bush-era tax rates in the lame duck session, the Democratic party has made a similar welcome to capital. We have noted that the process began in July when several Democrats, none of whom were up for election, took the position that we dare not raise taxes on anyone with the economy still weak. By arguing that raising top marginal tax rates would damage growth, *this is a tacit admission that low top marginal tax rates are pro-growth.* It is saying that we want growth, and that we are willing to let people get rich to achieve it. We are willing to make capital welcome again.
- Remember how difficult it must have been for Democrats to take this position. Other than the war in Iraq, the present low tax rates on capital on top incomes is the most loathed and reviled legacy of the Bush administration. For Democrats to have made the first move to preserve them in the name of growth, and well ahead of the mid-term election, implies the recognition of a fundamental change in the attitudes of the electorate.
- Don't dismiss these ideas just because they are more abstract than those investors think about typically from day to day. Such ideas affect the very root of economic activity and market response, and can drive key inflection points. We think this development is transformative for US growth prospects, and forms one of the pillars of our recent upgrade to our growth expectations (see "Stock Outlook: Differences Make a Difference" November 10, 2010).

Bottom line

The compromise that will result in the extension of the Bush-era tax rates is all to the good, but hardly a pro-growth surprise at this point. It's real significance is that is symbolizes a change at the root of America's economic culture, where after two years of vilifying capital, capitalism and capitalists, once again "to get rich is glorious." No need for any year-end selling to lock in low capital gains tax rates -- they'll be around for at least another two years. But more deeply, extension of the Bush-era tax rates raises the value of the capital stock by symbolizing that capital is once again valued in this country. This transformation plays into our expectation for higher multiples in the coming year.