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MACROCOSM

Tax Cut Endgame

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Donald Luskin

The compromise tax bill will pass. Little warts and all, this is a pro-growth landmark.

We have little doubt that the extension of the Bush-era tax rates will occur in the lame duck session. The political futures markets at Intrade have come to agree with our long-standing view on that, now assigning only about a 9% probability of failure.

- A bill -- with the self-consciously Senate-centric and bipartisan title "The Reid-McConnell Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010" -- now exists in the Senate, will be voted shortly, and faces no serious opposition.
- There are enough votes in the House of Representatives to pass it (it would only take about 40 Democrats voting in favor). But the *average* House Democrat is against it, as evidenced by last week's caucus vote to oppose it.
- This split in the Democratic caucus leaves Speaker Nancy Pelosi (D-CA) in a no-win situation. She has unilateral power to block extension of the Bush-era tax cuts simply by not scheduling the Senate bill for a vote in the House. But unless doing so would cause the Senate to agree to the House's desired modifications -- which surely minority leader Mitch McConnell (R-KY) would block -- then Pelosi would have to assume personal responsibility for the economic mayhem that would ensue as we enter 2011 with higher tax rates on every working American (see "The Double-Dip Doomsday Machine" September 21, 2010).
- Pelosi is being "jammed" -- a legislative tactic that limits her to a yes-or-no decision in which *yes* is painful, and *no* is even worse. Her second-in-command Chris Van Hollen (D-MD) said yesterday, in effect, that she will choose "painful" rather than "even worse." The bill will come to the floor, he says, so that Democrats can make modifications, particularly with regard to the estate tax. But this will only be for show. The Senate and the White House will not grant the modifications, and then the bill will be approved by the House as is.

As we've discussed all this with clients last week, even though most are strongly in favor of extension of the Bush-era tax rates, we nevertheless continue to pick up a pervasive sense of hopelessness (see "The Enemy of the Good" December 2, 2010).

Update to strategic view

US MACRO: The budgetary and incentive downsides to the demand-side "stimulus" provisions in the compromise tax bill are small. They are a better than fair price to pay for extending the Bush-era tax rates, a key pillar underpinning better growth next year.

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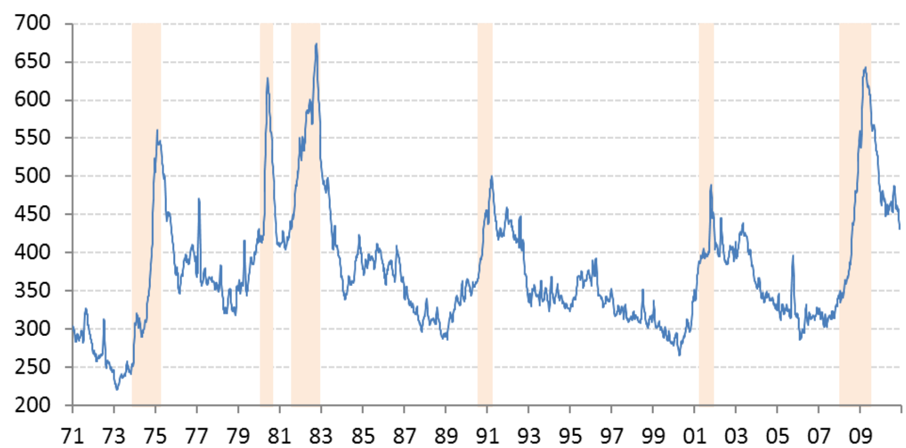
Some clients see the terms of the compromise brokered between congressional Republicans and the White House as fatally freighted with costly, useless demand-side "stimulus" measures. We think this view is too strong.

- The 13-month extension of federally funded long-term unemployment benefits is generally misunderstood. It does *not* extend the current maximum 99 weeks of benefits by an additional 56 weeks. The so-called "99ers" -- those whose long-term benefits are running out beginning this month -- will *not* have their benefits extended. 99 weeks remains the maximum that any unemployed person can get, depending on what state he lives in. The 13-month extension expands the availability of long-term benefits to the unemployed currently *below* the 99-week maximum.
- We'd have preferred to see no extension of the benefits, as we believe it encourages long-term joblessness (see "To Get Rich is Glorious Again" December 7, 2010). However, under the compromise bill, the longest-term unemployed who have become the most habituated to joblessness will face loss of benefits anyway. Extension of benefits is for the *more recently* unemployed, who are dwindling in number -- as seen in the steady decline of new jobless claims (please see the chart below). These workers

New jobless claims **Recessions**
4-week moving average, thousands



Source: Department of Labor, TrendMacro calculations

are likely still feeling the shock of income loss, and unlike those who felt the same shock initially 99 weeks ago, they face a job market where it is more likely they can get re-employed.
- Ironically, several weeks ago we were hearing widely that the exhaustion of long-term jobless benefits would be a major headwind to the better growth we've been forecasting for 2011 (see "Stock Outlook: Differences Make a Difference" November 10, 2010), thanks to the resulting loss of disposable personal income. Now that the benefits are being extended, *that's* being characterized as a headwind, too, because it perpetuates

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joblessness. It's certainly possible that the economy is in a no-win situation, damned if we don't extend benefits and damned if we do, but we don't see it that way. The gains from extending the Bush-era tax rates for two years, and all that it implies about improvement in the political process, far outweigh any penalties of extending long-term jobless benefits (see "The Pendulum Swings Back" November 2, 2010).

- Separately, we are hearing a great deal of angst about risk in the tax-exempt bond market with the failure to include an extension of the Build America Bonds subsidy in the compromise tax bill. We have real concern for the dangerous condition of state and local finances, but we think in the grand scheme of things BAB is just too small to make a difference. The annual value of the federal subsidy -- which, perforce, is the annual loss to states and localities when the subsidy is withdrawn -- is less than $500 million. Yes, that's million with an "m," not billion with a "b."
- We also hear -- in this case not from clients, but from the media -- that last week's continuation of the back-up in Treasury yields reflects the bond market's revulsion at the deficit-cost of the demand-side "stimulus" measures included in the tax compromise. We don't find that credible, as the estimated revenue cost of the provisions that couldn't have been reasonably expected by the market -- the jobless benefits extension and the payroll tax reduction -- total only about $100 billion. We continue to interpret the move higher in rates across the board as the absorption of better growth and inflation expectations for 2011, and evidence that QE2 is working (see "Eyeing an Exit from 'No Exit'" November 18, 2010).

We've also heard from client that the inclusion in the compromise tax bill of demand-side "stimulus" indicates that there is no fundamental reversal in the deficit-addicted political culture. We urge a little patience on that, and the recognition of the near-miracle that is happening before our eyes: a Democratic president and a Democratic congress are extending the much-loathed Bush tax cuts. The Republican House hasn't even been seated yet. This is a sea-change, and it's just beginning.

This supports our view that "3 is the new 2" for 2011. Expecting real growth in the high 3's puts us at the very top of the consensus range. But by historical standards it is a modest expectation at this stage in the business cycle. It is well supported by the extension of the Bush-era tax rates -- as well as by QE2, which finally moves the Fed off its too-tight posture (again, see "Stock Outlook: Differences Make a Difference").

Bottom line

The budgetary and incentive downsides to the demand-side "stimulus" provisions in the compromise tax bill are small. They are a better than fair price to pay for extending the Bush-era tax rates, a key pillar underpinning better growth next year.