

POLITICAL PULSE

How the GOP Could Survive the Cliff

Monday, December 10, 2012

Donald Luskin**Passing a pre-emptive tax hike bill in the House would restore the balance of terror.**

Little has changed in the fiscal cliff negotiations, except that the White House has further radicalized its already radical negotiating position.

- When asked in a [CNBC interview Wednesday](#) "is the administration prepared to go over the fiscal cliff?" Treasury Secretary Tim Geithner said, "Oh, absolutely."
- House Speaker John Boehner (R-OH) has made no such threat, and [continues to offer](#) \$800 billion in new revenues -- provided it is not achieved through higher tax rates, and that it is matched with substantive spending reform.
- Though the GOP has taken the more conciliatory position -- and though the legislative reality is that *all three* of the White House, the House and the Senate must agree on legislation, so *any one* of them could block it -- nevertheless polls show that a majority of the public is poised to blame the GOP if we fall off the cliff. According to [a Pew survey released Tuesday](#), 57% of adults would blame Republicans in congress, while 27% would blame the president. This is an identical finding to [a similar survey conducted just after the election](#).
- The [dominant media narrative](#) is that the president holds all the cards, and that the GOP is in disarray. Magnifying the smallest differences in GOP opinion, the media is now lionizing Representative Tom Cole (R-OK) because [he advocates, purely as a tactical matter](#), agreeing to President Obama's demand to extend the Bush-era tax rates except for top earners (see ["Back to the Cliff"](#) November 28, 2012) -- and Senator Bob Corker (R-TN), because [he advocates, only as a trade-off against major entitlement reform](#), agreeing to higher tax *rates* for top earners.

We don't think the GOP's hand is as weak as all that. And with arrogant and reckless remarks like "Oh, absolutely," the White House's hand is on the verge of being overplayed. Nevertheless, let's explore where the conventional wisdom of GOP disarray takes us. Last week, as a thought experiment, we considered what it would mean to the economy and to markets if the GOP caved (see ["What If the GOP Caves?"](#) December 3, 2012). Now let's consider what the GOP could do to change the dominant narrative so that instead of caving it could make a tactical retreat.

**Update to
strategic view****US MACRO, US**

STOCKS: Nothing has changed this week in the fiscal cliff negotiations except that positions are more dangerously polarized. It's getting near midnight -- by about this date in 2010 the Bush-era tax cuts had already been extended. Though it is the White House, through Geithner, that says it is "absolutely" willing to go off the cliff, the dominant media narrative is that the GOP is in disarray because it fears it will be blamed. The next move may be for the GOP to change the narrative by the House passing a pre-emptive tax hike bill that protects existing tax *rates*. That would create a useful fallback for year-end, but in the meantime would restore a balance of terror permitting maximum brinksmanship. We still think markets are in for an important volatility event by year-end.

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- What it would mean for the GOP to cave would be for the House to accept the bill passed by the Democratic Senate last July, [S.3412](#), which extends the Bush-era tax rates for the so-called "middle class," but not for the so-called "rich." As we described last week, while that would avert the near-term crisis of falling all the way down the fiscal cliff, it would be very bad for long-term growth and even worse for capital markets.
- The fact that this bill -- which would in fact avert the worst near-term demand-side effects of fiscal cliff -- has already passed the Senate gives the Democrats the moral high ground in the negotiations. After all, the GOP agrees that the Bush-era tax rates *should* be extended for the middle class, and the bill does that. [Obama says](#), "I'll sign this bill as soon as Congress sends it my way." Failure of the House to adopt the Senate bill is portrayed as obstructionism. Representative Cole's initiative is designed to avoid this charge -- but at the price of outright capitulation.
- Last week a politically savvy client proposed an alternate stratagem for the GOP, and we have since learned from one Washington source that something like it is being developed as an option by Boehner's team.
- The idea is for the House to pass a pre-emptive tax hike bill, one that -- like the Senate's -- protects the middle class, but which would raise taxes on the rich without growth-killing hikes on tax *rates* on wages, dividends and capital gains. Such a House bill would produce \$800 billion in new revenues (more than the \$710 billion raised by the Senate bill), but without raising tax *rates*, by using instead [any of numerous ways](#) to eliminate or limit various deductions (please see the chart below).

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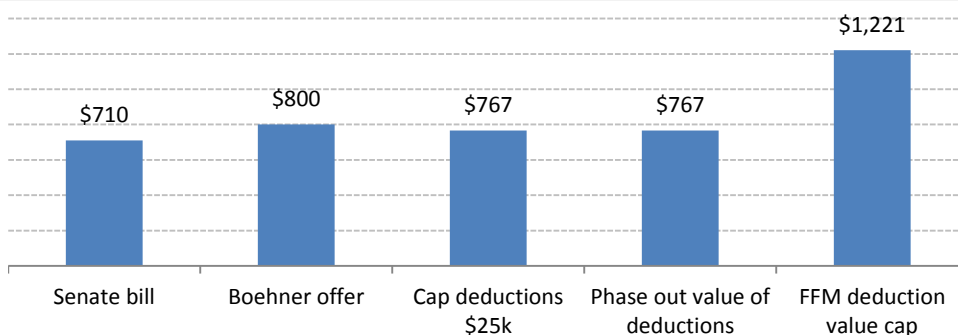
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10-year revenue estimate USD billions



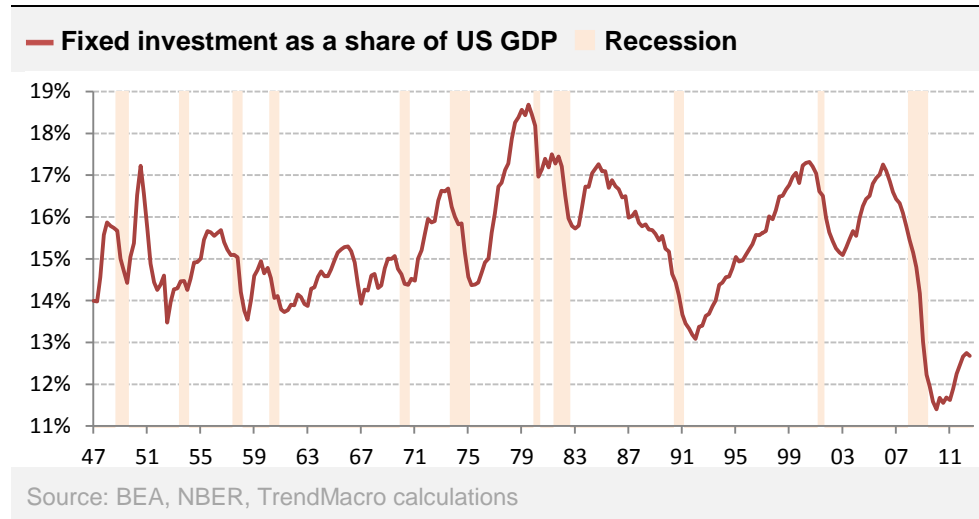
Source: Committee for Responsible Federal Budget, TrendMacro calculations

- With this House bill in place, the GOP would achieve parity with the Democrats. Each would be challenged to agree to a bill passed by the other that achieves what the other says he wants. From there, accusations of obstructionism would be symmetrically powerful.
- It could even be said that the GOP has the high ground. After all, it will have conceded on raising taxes on the rich -- all the Democrats are being asked to do is concede on the precise means for doing it.
- Indeed, this bill would raise taxes, which the GOP doesn't want to do. It's a serious concession. But it is better than the alternative of

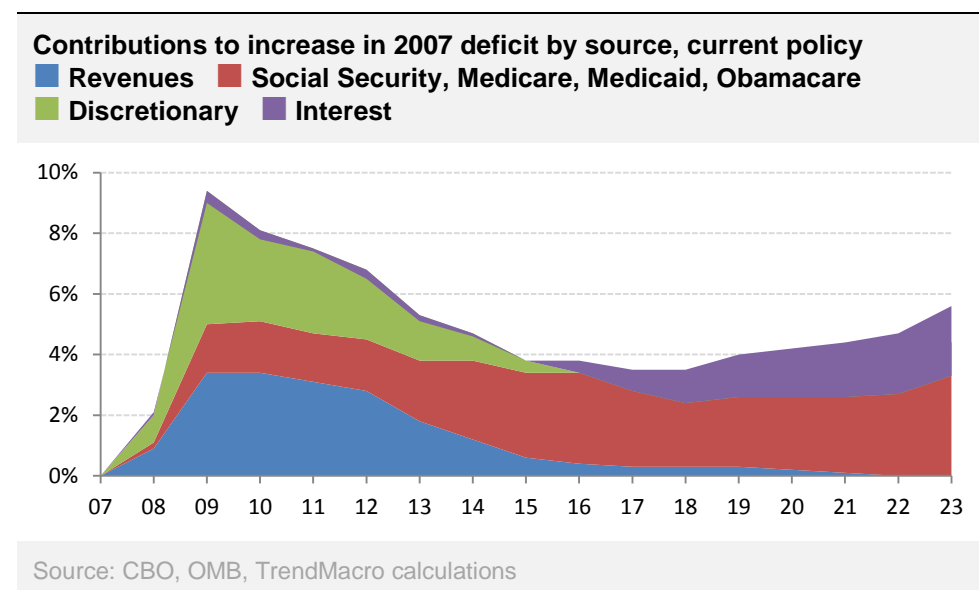
being stampeded into raising tax *rates* -- or, by doing nothing, to be blamed for pushing the US off the fiscal cliff.

Let's say Obama and the Democratic Senate agree to a House bill along these lines. The unambiguously good news is that the worst of the fiscal cliff would thereby be averted.

- But make no mistake about it -- even under this House bill, taxes will go up. That's a bad thing long-term because it transfers resources from the private sector to the public sector, at a time when private sector investment is near all-time lows (please see the chart below).



- Adding insult to injury, the penalty to growth from higher taxes will have failed to seriously address the US's long-term fiscal issues. The ballooning US deficit since 2007 has been driven mostly by spending increases, not revenue shortfalls. Within just a couple years it will be *entirely* due to spending, even holding today's tax policies constant (please see the chart below).



- But perhaps this stratagem, by putting the GOP on higher moral ground, would set the stage for more substantive reforms when it comes time to hike the debt ceiling.

Don't draw a lot of comfort that this leads inevitably to a reasonably benign version of our *fudge* scenario for year-end, neatly skirting the toxic alternatives *fail* and *doomsday* (see "[Mandate for Volatility](#)" November 13, 2012).

- Though we've expended a great many words talking about this possible GOP stratagem, we don't mean to imply a high level of certainty that it will happen. It's a smart idea, and it's a live possibility.
- Even if it does happen, it's not at all clear that Obama would accept the House bill. After all, he has demanded much more than the \$800 billion in new revenues such a bill would concede. Obama is demanding [\\$1.6 trillion in new revenues](#), and permanent [presidential authority to raise the debt limit at will](#), subject only to congressional supermajority override.
- And don't forget that while the pre-emptive House tax hike bill we're talking about here is a useful safety valve for year-end, prior to the midnight hour it may in fact make negotiations more contentious.
- Now the balance of terror between the parties is in disequilibrium, in favor of the Democrats. We have argued that markets are quiescent because they believe the present disequilibrium will lead inevitably to the GOP caving to avoid the cliff.
- A bout in which both combatants are equally strong is likelier to take longer to play out, and involve more and heavier blows.

Even if the GOP does not adopt a stratagem like the one we've outlined, there are still many games within games to be played before year-end. And midnight is coming. In 2010 the Bush-era tax cuts had already been extended by about this date (see "[Tax Cut Endgame](#)" December 13, 2010). We still think that markets are in for an important volatility event by year-end.

Bottom line

Nothing has changed this week in the fiscal cliff negotiations except that positions are more dangerously polarized. It's getting near midnight -- by about this date in 2010 the Bush-era tax cuts had already been extended. Though it is the White House, through Geithner, that says it is "absolutely" willing to go off the cliff, the dominant media narrative is that the GOP is in disarray because it fears it will be blamed. The next move may be for the GOP to change the narrative by the House passing a pre-emptive tax hike bill that protects existing tax *rates*. That would create a useful fallback for year-end, but in the meantime would restore a balance of terror permitting maximum brinksmanship. We still think markets are in for an important volatility event by year-end. ▶