

POLITICAL PULSE

Plan B for Better

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Donald Luskin

Higher taxes, yes. But with "Plan B" the tax code will no longer be permanently temporary.

Since we wrote yesterday about the GOP's "Plan B" solution for the fiscal cliff (see ["Plan B for Blame Game"](#) December 19, 2012), more details have emerged about the bill itself and the politics surrounding it.

- Certain aspects of the bill make it more pro-growth than we had originally thought. More precisely, there are some hitherto unknown pro-growth elements in it that at least cut against the more obvious anti-growth elements.
- So if "Plan B" becomes law -- and that remains a big if -- we would become somewhat more optimistic than we have been about the macro environment in 2013.
- "Plan B" must be understood in comparison to its rival, the July Senate bill extending the Bush-era tax cuts for the so-called middle class which President Obama has [repeatedly challenged](#) the GOP House to sign on to (please see the table below).

Update to strategic view

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STOCKS: In the details of Boehner's "Plan B" are some pro-growth elements that somewhat offset the anti-growth tax hikes -- particularly, making permanent most of the major elements of the tax code that have been temporary for almost a decade. If "Plan B" becomes law, we would somewhat upgrade our pessimism about 2103. But this gambit complicates the politics by restoring the parity of forces between the Democrats and the GOP, setting the stage for a longer and more bitter fight. "Plan B" ought to be attractive to Democrats on several levels, yet after thinking about it for more than a whole day Obama said he'd veto it. There are now clear paths to avoiding the fiscal cliff, which is good -- but we still think there could be a major volatility event by year-end if the brinkmanship heats up.

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	S.3412: Middle Class Tax Cut Act	Plan B: Permanent Tax Relief For Families And Small Businesses Act
Extend rates for middle class	One year	Permanent
Expire rates for rich	Above \$250,000	Above \$1 million
Dividends and cap gains at 0%/15%/20%	One year	Permanent
Index AMT exclusion	For 2012 only	2012 and permanent
Repeal PEP/PEASE	For middle class	For all
Estate tax at 2012 level	No	Permanent
Section 179 expensing	One year	Permanent
Total tax cut 2013-2022	\$249.6 billion	\$4.1 trillion

Source: Joint Committee on Taxation, TrendMacro calculations

- As is already widely known, the most contentious difference is the income threshold defining "rich" -- where the Bush-era tax rates would be allowed to expire. For the Senate bill, it's \$250,000, and for "Plan B" it's \$1 million.
- But "Plan B" is a far more ambitious bill than that. [Scored by the Joint Committee on Taxation](#) from 2013 to 2022, "Plan B" is a tax cut *versus current law* of \$4.1 trillion, while the Senate bill is a cut of only \$250 billion.
- "Plan B" favors the so-called rich, in comparison to the Senate bill, by repealing PEP and PEASE (the personal exemption phase-outs) for *all* taxpayers, and by permanently extending current estate tax levels.
- "Plan B" makes extension of the Bush-era tax rates for the so-called middle class permanent, while the Senate bill extends them for only one year. The same is true for the indexation of the AMT exclusion and Section 179 expensing.
- Neither bill deals with the expiring Social Security tax holiday, extended unemployment benefits, the debt ceiling, the spending sequesters, or long-term spending reform.
- Neither bill gives anyone a tax cut versus today's rates. Versus that benchmark, taxes are going up. So we must continue to worry that in 2013 we will have to endure another year of our Not So Great Expansion, but with a higher tax burden.
- But versus *current law* -- which embeds massive tax hikes for all taxpayers -- "Plan B" offers more relief for both the middle class and the rich than the Senate bill, primarily by creating permanence for provisions that the Senate bill leaves as temporary.
- Because policy uncertainty has surely contributed to the lackluster growth in this business cycle, the substantial relief from tax policy uncertainty in "Plan B" should be a boost.
- *The Senate bill leaves another fiscal cliff almost as large as the current one for year-end 2013. "Plan B" completely takes cliffs out of the tax code.*
- That may or may not offset the tax hikes in "Plan B," but at least it helps.
- That said, relief from tax policy uncertainty would leave considerable uncertainty about the path of government spending, debt and deficits. All the more so with another political battle over hiking the debt ceiling inevitable in Q1 2013, as neither "Plan B" nor the Senate bill tackle this issue.

This stylized analysis treats "Plan B" and the Senate bill as if they were the only two possible outcomes of the fiscal cliff negotiation. They are both viable last-minute escape hatches that could be used to avoid falling all the way off the fiscal cliff -- but other solutions could be found, or perhaps no solution can be agreed on.

- We think "Plan B" has been very cleverly designed to be quite difficult for the White House and the Democratic Senate to not agree to. Indeed, creating this difficulty for the Democrats was Job One for House Speaker John Boehner (R-OH), who we said last

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trendmacro.com

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Donald Luskin
Chicago IL
312 273 6766
don@trendmacro.com

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

Lorcan Roche Kelly
Sixmilebridge Ireland
212 537 9067
lorcan@trendmacro.com

John Clinton
Charlotte NC
704 552 3629
jclinton@trendmacro.com

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week would produce such a bill in order to better position the GOP as a source of constructive solutions in what has devolved into a blame game (see ["How the GOP Could Survive the Cliff"](#) December 10, 2012).

- With "Plan B," the GOP has emerged as the better friend of the so-called middle class -- making their Bush-era tax rates permanent, and permanently liberating them from the annual Sword of Damocles that is the AMT "patch." The latter is especially important to blue states with high state taxes, whose taxpayers (and treasuries) would lose the deductibility of those taxes under AMT.
- It is perhaps revealing that it took the White House more than one whole day after "Plan B" was announced to get around to [saying](#) that Obama would veto it. It must have been a close call for him. If you will forgive us for making what amounts to a subjective character judgment, it is plausible to us that Obama decided to reject what House Minority Leader Nancy Pelosi (D-CA) yesterday [called](#) a "victory" in large part because doing so would be to accept an idea that came from his arch-rival, and not himself. It seems to us that he is unable to follow [his own advice yesterday](#) to his opponents: "take me out of it."
- We are less worried about Senate opposition. Our sense is that if Obama gave the word, the Democratic Senate would sign on. Yes, Senate Majority Leader Harry Reid (D-NV) [rejected it](#) right away, but he must be getting pressure from blue state colleagues who wouldn't mind seeing AMT indexation made permanent, and from seven red state colleagues up for election in 2014.
- Just as tricky are the GOP's own internal politics. Grover Norquist's Americans for Tax Reform [declared](#) yesterday that voting for "Plan B" would not be a violation of his no-new-taxes pledge, and conservative icon Paul Ryan [is supporting it](#). But powerful conservative lobbies the Club For Growth and the Heritage Foundation [are against it](#), and the influential *Wall Street Journal* editorial page [has opposed it](#), saying it would be better to just fall off the fiscal cliff.

The good news here is that there is now a second safety hatch for avoiding falling off the fiscal cliff -- and it is better than the previously sole safety hatch, the Senate bill. Yes, under "Plan B" taxes would go up, but at least the tax code would no longer be permanently temporary. Either way nothing will have been done about spending, deficits or debt. But the GOP won't have surrendered its power to block a hike in the debt ceiling, and that threat will have more moral force with the GOP's having behaved constructively in the fiscal cliff debate.

But "Plan B," for all its virtues, complicates the political process through year-end. If the sole objective was simply to not fall off the fiscal cliff, then it would have been easier if the GOP had just caved (see ["What If the GOP Caves?"](#) December 3, 2012). For better or worse, "Plan B" takes this game into extra innings. We can see now more and better paths for avoiding the cliff. But if "Plan B" restores the GOP to parity of forces with the

Democrats, the likelihood of a short-term volatility event driven by last-minute brinksmanship has to be seen as going up.

Bottom line

In the details of Boehner's "Plan B" are some pro-growth elements that somewhat offset the anti-growth tax hikes -- particularly, making permanent most of the major elements of the tax code that have been temporary for almost a decade. If "Plan B" becomes law, we would somewhat upgrade our pessimism about 2103. But this gambit complicates the politics by restoring the parity of forces between the Democrats and the GOP, setting the stage for a longer and more bitter fight. "Plan B" ought to be attractive to Democrats on several levels, yet after thinking about it for more than a whole day Obama said he'd veto it. There are now clear paths to avoiding the fiscal cliff, which is good -- but we still think there could be a major volatility event by year-end if the brinksmanship heats up. ▶