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MACROCOSM

Tax Hikes Have Consequences

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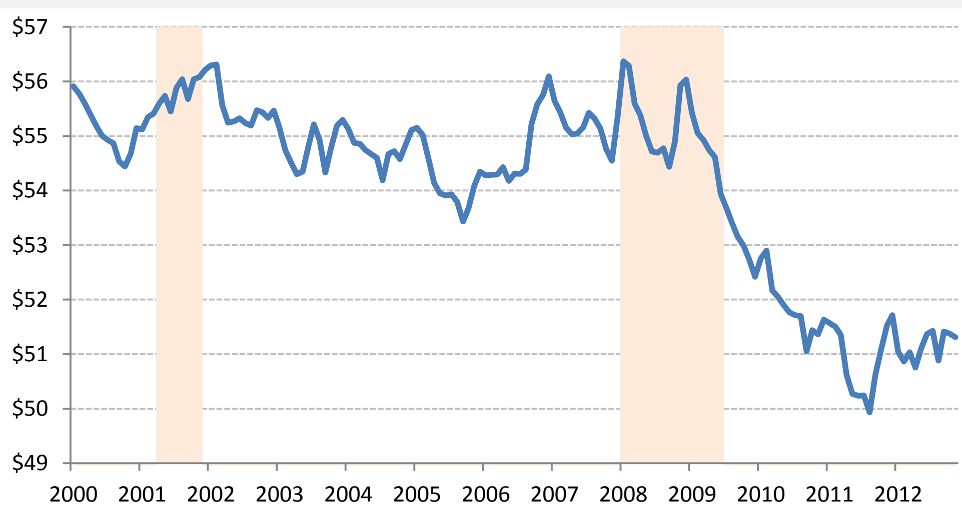
Donald Luskin

Taxes are going up on everyone -- big. It's a blow to growth, and there's no growth to spare.

The fiscal cliff drama is over, with far less of a volatility event for markets than we had expected (see, among others, "Step by Step, Toward the Cliff" September 25, 2012). Our preferred tactical posture -- an event-responsive regime of dynamic hedging, or "portfolio insurance" (see "Positioning for the Fiscal Cliff" October 3, 2012) -- proved to be more appropriate than simply going risk-off. Now, thinking more strategically, we think the Senate bill that the House approved last night is a major policy error that will have important negative economic consequences.

- It's a close call whether it will be enough to cause an official recession in 2013. But it will surely be a drag on growth, of which we have precious little to lose. We're still in a Not So Great Expansion -- *and now taxes are going up on everyone.*
- *Nobody* is getting lower taxes in 2013, despite the bill's Orwellian name: "The American Taxpayer Relief Act" -- or ATRA.
- For all working Americans the payroll tax "holiday" is over -- the bill does not extend it for 2013. This is a 2% cut in pre-tax pay in an economy in which household income is lower than at the 2009 official recession trough (please see the chart below).

Median household income (USD thousands) **Recession**



Source: Sentier Research, NBER, TrendMacro calculations

Update to strategic view

US MACRO, US STOCKS: The year-end fiscal crisis is over, without a significant volatility event. But the mis-named American Taxpayer Relief Act is a bad *fudge* -- a major anti-growth policy error, raising taxes on everyone, with likely very significant demand-side and supply-side effects. Superficially it stabilizes tax policy, but Obama made it clear that he intends to demand more tax hikes on the so-called rich -- so uncertainty remains. Since stocks never suffered much in the crisis, there is no reason to expect a lasting rally on its resolution -- this morning's global risk-on celebration notwithstanding. Soon it will become apparent that we are still in the Not So Great Expansion -- but with higher taxes. We aren't calling for a recession in 2013 -- but this is a blow to growth, and we don't have much growth in the first place.

[Strategy Dashboard home]

- This is a large demand-side blow. Across the whole economy, it sums to $115 billion per year. That's more than a quarter's worth of growth in nominal personal consumption expenditures.
- Apparently the Obama administration is not proud of this element of ATRA. The White House Office of Management and Budget completely fails to mention it in [its statement yesterday] which otherwise brags about how much new revenue is being raised -- though it is the biggest single revenue raiser in the bill.
- The supply-side effects are significant, too.
- The supply of labor will continue to be artificially held back -- extending the pervasive joblessness of the Not So Great Recovery -- by the perpetuation of extended unemployment benefits, which act as a disincentive to find work.
- For the so-called rich -- now defined as joint filers with taxable income above $450,000 -- the top rate on wage income goes to 39.6%, with significant curtailment of exemptions and itemized deductions beginning at $250,000. Actually, it goes up an additional 90 bp thanks to the Medicare payroll tax hike under Obamacare.
- It doesn't matter much that the definition of "rich" has been drawn at $450,000 instead of $250,000 as President Obama had initially demanded (in fact, the 90 bp Obamacare tax starts at $250,000). *What matters is that the top marginal rate -- the disincentive operating against the most productive economic actors -- is going up.*
- The top rate on dividends and capital gains is going from 15% to 20% for joint filers above $450,000 (plus a 3.8% surtax on passive income under Obamacare for joint filers above $250,000).
- It is difficult to estimate the first-order valuation effects of a capital gains tax hike -- holding periods vary, and inflation has to be considered for this unindexed tax. But from first principles we know that a higher capital gains tax raises the cost of capital -- and drives stock prices lower. A sensible investor will demand higher expected pre-tax returns in the presence of a higher tax rate.
- The valuation calculation for dividend taxes is more straightforward -- values simply equilibrate to a given after-tax yield for any given tax rate. For taxable investors in the top tax bracket -- who receive about 25% of all dividends paid by US stocks -- this calculation implies a drop in value for stocks of about 10%.

Is there anything good about The American Taxpayer Relief Act?

- Make no mistake about it -- ATRA is what we've been calling in our scenario modeling a *fudge* (see, among several, ["Toxic Fudge"] December 17, 2012). It's not what we've been calling *grand* -- a grand bargain like Simpson Bowles -- or even what we've been calling *baby grand* -- a small down-payment on a grand bargain. It's just a tax hike. And a big one.
- The best thing we can say about it is that, like "Plan B" offered by House Speaker John Boehner (R-OH), it takes most of the cliffs out of the tax code -- at least for individual taxpayers -- by making most

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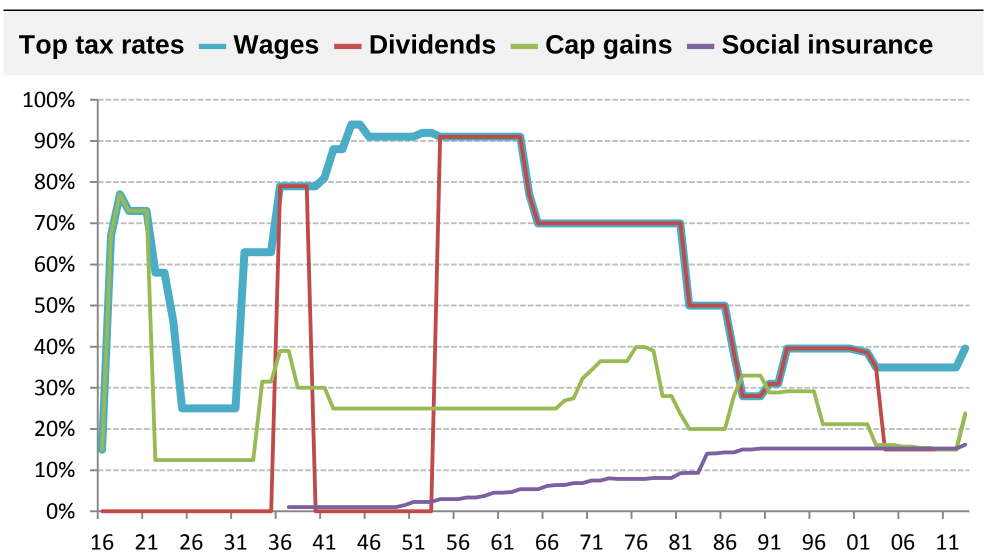
[About us]

Correction

In our report on Monday, through an editing error, we mistakenly gave Senator Mitch McConnell's title as House Minority Leader. He is Senate Minority Leader. A corrected version of the report can be downloaded by clicking here.

provisions no longer subject to sunsets (see "Plan B for Better" December 20, 2012).

- The estate tax has been set permanently, after gyrating wildly for twelve years. The new 40% rate is lower than the 45% for 2013 programmed under pre-existing law, but higher than 2012's 35%.
- It is especially useful that the AMT "patch" -- the inflation-indexation of the exclusion level that has had to be painfully enacted one year at a time for a decade, lest tens of millions of new taxpayers be ensnared in AMT -- has been made permanent.
- On the face of it, this addresses one of the issues underlying the Not So Great Recession -- uncertainty about tax policy, holding back capital investment by raising the risks of long-term economic forecasting. Indeed, this is one of the rationales being offered by House Republican leaders to justify voting "yea" on the Senate's tax-hike bill last night.
- But for corporations -- a sector critical to capital investment -- all the sunsets are still there. Bonus depreciation, the research and development tax credit, Section 179 expensing and a raft of other so-called "business extenders" have been extended only through 2013.
- The price to partially reduce policy uncertainty has been high. Do the individuals now *certain of higher taxes* really prefer that to their prior *uncertainty of lower taxes*?
- But that's not even the trade-off we've achieved. More likely we now have higher taxes and just as much uncertainty as before.
- Even without legislated sunsets, the reality is that the tax code can be changed anytime congress is in session. It often has been (please see the chart below), and now there's every reason to fear that it will be changed again, and perhaps quite soon.
- In triumphally announcing the deal struck between Vice President Joe Biden and Senate Minority Leader Mitch McConnell (R-KY) on Monday, Obama made it clear he intends to demand more "sacrifice from millionaires or companies with a lot of lobbyists… there's still more work to be done in the tax code to make it fairer."



Source: Various, TrendMacro calculations

He made the same point in a statement [last night].

- With the nation's debt ceiling [already breached] -- and with the bill passed last night delaying the spending sequesters by two months -- it won't be long till the president and the GOP go at it again, hammer and tongs, over spending reductions that were utterly ignored in ATRA. Obama's remarks Monday, and last night, were a shot across the bow -- if the GOP demands spending cuts, Democrats will demand more taxes.
- This is the first major federal tax hike since 1993, and it came attached to absolutely no entitlement reforms. But the ever-deepening indebtedness of the US government as a fraction of GDP is almost entirely a function of entitlement growth (see ["How the GOP Could Survive the Cliff"] December 10, 2012). There *will have to be* more debates -- contentious ones -- about spending. Obama's message is that any such debates will include a dangerous, growth-killing irrelevancy: higher taxes.
- Fearing blame for falling off the fiscal cliff, the GOP caved this time (see ["What If the GOP Caves?"] December 3, 2012). If the highest goal is political coherency, then it may seem pleasant to believe that the coming debates will be similarly mastered by a strong president facing only cowardly opposition. But the results of such a configuration would be more anti-growth policy errors like ATRA. As the election fades in recency, and with it the presumption of Obama's mandate (see ["Mandate for Volatility"] November 13, 2012) -- and as GOP senators and representatives take heat back home for the cowardice -- the opposition will probably gain courage. That may prevent or reduce the scope of further policy errors like ATRA, but it means that there will be very little political coherency -- and lots of brinksmanship.
- Don't kid yourself. There is still plenty of policy uncertainty. There are still plenty of cliffs.

What this means for stocks is that any rally coming from having put the year-end fiscal cliff crisis behind us will be disappointing. Obviously, there is a global risk-on celebration this morning. We doubt it will be durable.

- We've argued all along that stocks have never really reflected anything but complacency about the cliff. So why should there be much of a rally if a relatively peaceful resolution is what was expected all along?
- Stocks are undervalued, but not wildly so. At Monday's close the S&P 500 risk premium was 0.85 standard deviations above its elevated mean during the post-2007 crisis era.
- And why should a rally last when it's so clear that the bill passed last night is so anti-growth -- when growth is already so sluggish -- and that it imposes so many disincentives on capital investment and penalties on valuation -- when capital investment is already so weak and the cost of capital so high?
- It's possible we'll see a little extra growth in the first quarter, driven by the acceleration of income -- especially from dividends -- in the fourth quarter -- similar to what we saw in late 1992 in anticipation of the Clinton take hikes. But this will be only a passing illusion --

one that will no doubt be exploited politically to prove that tax hikes don't hurt growth.

- There are true positives we can point to in the global backdrop. Europe is no longer a systemic threat. China appears not to be headed for a hard landing. Housing continues to gradually recover. These are non-trivial plusses -- they are what is keeping us from making an outright recession call here.
- Nevertheless, with the S&P 500 equity risk premium supported by forward EPS stalled at a sub-dial tone 4.8% YOY rate, and with forward sales growing even more slowly at 3.0% YOY, it's evident to us that we are still in the Not So Great Expansion following the Great Recession. And now we have higher taxes.

Bottom line

The year-end fiscal crisis is over, without a significant volatility event. But the mis-named American Taxpayer Relief Act is a bad *fudge* -- a major anti-growth policy error, raising taxes on everyone, with likely very significant demand-side and supply-side effects. Superficially it stabilizes tax policy, but Obama made it clear that he intends to demand more tax hikes on the so-called rich -- so uncertainty remains. Since stocks never suffered much in the crisis, there is no reason to expect a lasting rally on its resolution -- this morning's global risk-on celebration notwithstanding. Soon it will become apparent that we are still in the Not So Great Expansion -- but with higher taxes. We aren't calling for a recession in 2013 -- but this is a blow to growth, and we don't have much growth in the first place.