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MACROCOSM

Build Back Manchin

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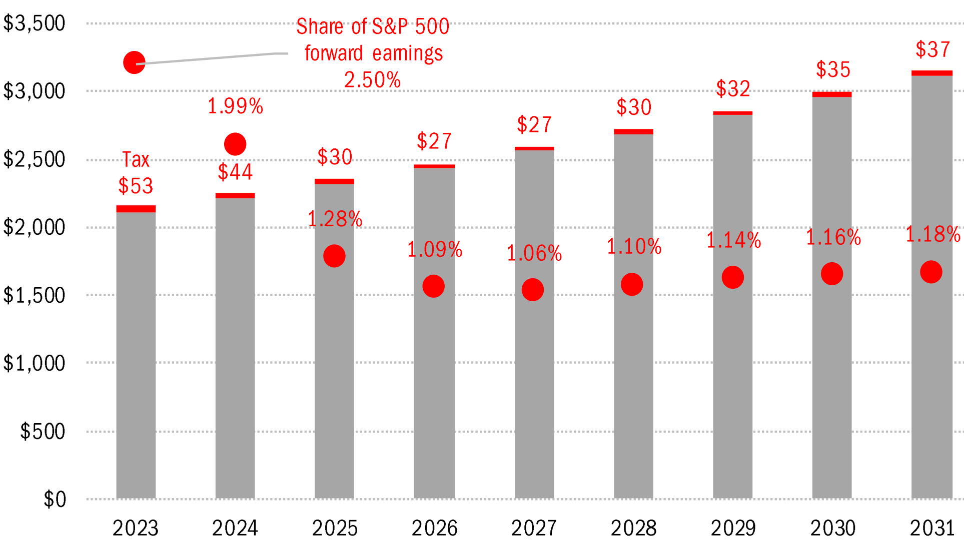
Donald Luskin

New taxes cost 2.5% of S&P 500 earnings – mere noise compared to BBB at almost 10%.

Last week Senator Joseph Manchin (D-WV) made a surprise announcement that he and Senate Majority Leader Charles Schumer (D-NY) had agreed on terms for The Inflation Reduction Act of 2022 – which, in reality, *has nothing to do with inflation, and is indeed the shriveled remnant of the aborted Build Back Better tax-and-spend bill* that Manchin torpedoed last December (see: "Video: at you're not hearing about... BBB RIP" December 20, 2021).

- The immediate market relevance is that, if passed as embodied in the present version of the legislative text, *it would increase corporate taxes by $313.1 billion over ten years*.
- The increase comes from what amounts to a new corporate Alternative Minimum Tax, under which companies valued above $1 billion would pay the greater of their normal tax bill or 15% of their GAAP earnings. This was part of the original BBB bill.
- *This is a dead-weight loss to S&P 500 earnings. We estimate it will take off 2.5% of 2023 earnings, settling in at a little more than 1% in the out years* (please see the chart below).
- It would hit industrial and other CAPEX-intensive sectors the

S&P 500 earnings (USD billions)



Source: Joint Tax Committee, Bloomberg, TrendMacro calculations

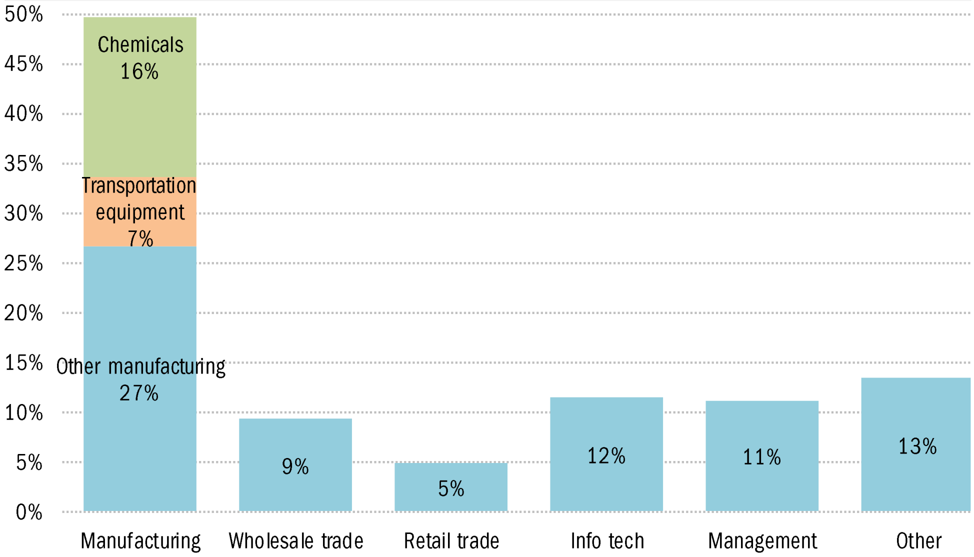
Update to strategic view

US MACRO, US STOCKS: Schumer and Manchin secretly negotiated a shrunken version of Build Back Better that resurrects what amounts to a new Alternative Minimum Tax on corporations. Companies would pay the greater of the tax due under current law, or 15% of GAAP net income. In the first year it would cost about 2.5% of S&P 500 earnings, and then settle in at about 1% over a decade. This is a considerably smaller impact than the almost 10% tax cost of last year's BBB. Positioned as the Inflation Reduction Act of 2022, it fails to address inflation at all, and even the Democrats' supporters in the media are calling it "the climate bill" instead. In our monetarist model, its small scale and long disbursement schedule would have no meaningful impact on money supply growth. The bill faces less internal Democratic opposition than BBB, but Sinema, who was not included in the negotiations and has opposed tax hikes in the past, is still an unknown.

[Strategy dashboard]

hardest, because tax law allows for more rapid depreciation than GAAP (please see the chart below).

Distribution of proposed corporate Alternative Minimum Tax by industry



Source: Joint Tax Committee, TrendMacro calculations

- There's nothing good to say about reducing S&P 500 earnings, except that *this is about one quarter, initially, and one eighth over time, of the reduction contemplated under last year's failed Build Back Better initiative*.
- We were correct last year when we said BBB could never pass (see first, see "Video: What you're not hearing about the coming battle for post-pandemic tax hikes" March 29, 2021 and finally "Video: at you're not hearing about... BBB RIP" December 20, 2021). But we warned that a smaller version might slip through (see "On the Coming Corporate Tax Hikes" March 31, 2021) – and perhaps now it is about to, with a considerable lag.
- Among our many reasons for skepticism last year was our belief that Manchin, representing the reddest of red states, would never go along with it. His acquiescence now is hard to explain. Perhaps it's the swing in mid-term Senate polling since the Supreme Court's *Dodd* decision reversing *Roe v. Wade*, with what looked like a strong red wave substantially evaporating for the Senate (but not the House – please see the charts on the following page). That may have led Manchin to reason that a legislative victory for Democrats, a possibility suddenly worth fighting for, will keep his party in the majority and preserve his power and prestige as its critical swing vote.
- Manchin's statement announcing his agreement with Schumer is, well, simply nonsense.
- It focuses primarily on inflation reduction (rising inflation has been his go-to rationale for not supporting BBB until now). Presumably the re-christening of Build Back Better to the Inflation Reduction Act of 2022 was intended to support this narrative. But the widely-respected and non-partisan Penn-Wharton Budget Model finds any

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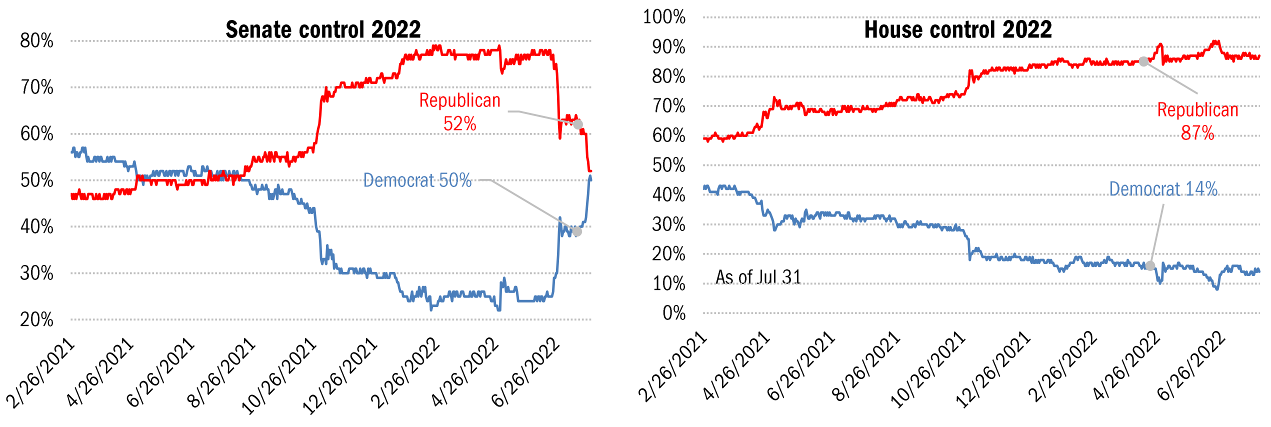
Market implied probabilities for congressional control at 2022 mid-terms



Source: Predict-It, TrendMacro calculations

effects " statistically indistinguishable from zero, thereby indicating low confidence that the legislation will have any impact on inflation."

- Even the liberal-leaning media, eager to declare a turnaround in President Joseph R. Biden's popularity heading into the mid-terms, isn't buying it. The *New York Times'* story never mentions the bill's name, referring to it as the "climate bill" (focusing on the green subsidies that make up much of the bill's spending, and bragging that it is "transformative"). It mentions inflation only to make the absurd claim that subsidies for electric vehicles will allow consumers to use less gasoline.
- Clients have asked us whether the budget impact of the bill could have an effect on the money supply, potentially offsetting (or worsening, some have asked) the pass-through of money growth into future inflation, per the monetarist model we have written about over the last several months (see, among many, "Video: What you're not hearing about what Jerome Powell knows about inflation" June 24, 2022). Our answer is that *this bill, quite small compared to the stimulus bills in 2020 and 2021, and much slower in terms of disbursements of subsidies, will be lost in the noise of factors affecting M2 and other money aggregates*.
- And, of course, if you want to attack inflation on the supply-side, you wouldn't raise the after-tax cost of CAPEX that could make production more efficient and less costly.
- Manchin's statement supports the hike in corporate taxes by claiming that the new AMT closes a "loophole." We don't see why tax laws that treat depreciation differently than GAAP constitute a loophole (nor, for that matter, what's so bad about loopholes). Indeed, the new AMT would give the unelected and entirely private Financial Accounting Standards Board what amounts to tax-writing power, by making the standards it sets the law of the land. It's not clear to us that such delegation would stand Constitutional scrutiny.
- Manchin's statement tries to make it seem as though this new bill has nothing to do with BBB – "Build Back Better is dead," he says. Yet the proposed corporate AMT in this exact form was in BBB,

and the new bill has the same legislative file number as BBB (H.R. 5376).

- What's especially galling is his statement's protestations that this bill represents bipartisanship ("bringing Americans back together," "compromise" and so on). Obviously his swing vote wouldn't be important in the first place if this were not being done under filibuster-proof reconciliation procedures on a straight party-line vote with the vice president casting the tie-breaker.
- And the term sheet Manchin and Schumer put out simply lies when it claims "There are no new taxes on families making $400,000 or less." The Joint Tax Committee of Congress's distribution analysis shows that Americans of every income bracket will pay more, with the exception of the narrow sliver between $10,000 and $20,000).
- *Will this bill pass? Because its tax effects are so small, it probably doesn't matter a lot one way or the other. As of this writing, it feels to us like there is sufficient momentum for Democrats to ram it through. But there are still safety valves.*
- The bill has not been taken up yet by the Senate. Presumably it will pass with little alteration, but *then it goes to the House of Representatives where it could undergo substantial modification that may or may not be to Manchin's liking, or for that matter to the liking of Democratic moderates in at-risk seats. There are only a few of those, but the Democrats can only survive four defections*.
- Pramila Jayapal (D-WA07), the leader of the House Progressive Caucus who did much last year to make BBB so bloated as to doom any possibility of its passage, and opposed the bipartisan infrastructure bill because it was too small, has said of this even smaller bill "It's never too late to do the right thing." At this time, though we don't know what she will think "the right thing" is.
- The "SALT caucus" in the House bedeviled BBB last year by insisting that any tax law changes restore the deductibility of state and local taxes. It is looking at the moment like it could cave. One of its leaders Thomas Suozzi (D-NY03) indicated last week that he and his fellow-travelers could look the other way this time because "If they don't touch personal income taxes it doesn't really raise the specter of SALT."
- All that said, *there is still Senator Kyrsten Sinema (D-AZ) who, last year, was as much a blocker as Manchin – but less publicity-hungry about it. Last year, she staunchly opposed raising taxes on anybody or anything*. Reportedly, Sinema did not know about the negotiations between Schumer and Manchin, she failed to attend a Senate Democratic caucus meeting to discuss it, has said she needs to review the legislative text and that she will have changes. Today she said she will refrain from any comments until the Senate Parliamentarian rules on any Byrd Amendment issues.
- At the same time, Republicans – who reasonably feel cheated that Schumer assured them that no reconciliation bill was in the works when they helped pass the CHIPS Act last week, giving Biden an important legislative victory – will now do everything they can in both chambers of Congress to slow down, confound and confuse the process, and take reprisals by opposing other legislation in the works.

- It's still early days, but at the moment this feels like it could pass. But it faces lots of obstacles and lots of determined opposition, and Democratic internal coherency is far from insured. The bottom line for markets is that at least the corporate tax provisions here are not very consequential.

Bottom line

Schumer and Manchin secretly negotiated a shrunken version of Build Back Better that resurrects what amounts to a new Alternative Minimum Tax on corporations. Companies would pay the greater of the tax due under current law, or 15% of GAAP net income. In the first year it would cost about 2.5% of S&P 500 earnings, and then settle in at about 1% over a decade. This is a considerably smaller impact than the almost 10% tax cost of last year's BBB. Positioned as the Inflation Reduction Act of 2022, it fails to address inflation at all, and even the Democrats' supporters in the media are calling it "the climate bill" instead. In our monetarist model, its small scale and long disbursement schedule would have no meaningful impact on money supply growth. The bill faces less internal Democratic opposition than BBB, but Sinema, who was not included in the negotiations and has opposed tax hikes in the past, is still an unknown.