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Get Ready for Tax Chaos

We now think an expiration of the Bush tax cuts is more likely than an extension. If so, it's unlikely that Congress will be able to quickly reverse expirations given the divided Congress, legislative procedures, the President's views, and the big deficit impact under CBO scoring rules (which explicitly ignore the positive impact of lower tax rates on economic growth).

- We think the resulting tax chaos that would emerge in December and extend into 2011 will be a major negative for both the U.S. economy and markets, with several aspects not yet fully priced in.
- While Congress might still act in December, the legislative obstacles are high -- need 60 sitting Senators to vote for a much bigger tax-cut-related fiscal deficit even though there's no agreement between the two parties on tax policy.
- In addition, **the prospect of Fed quantitative easing (deus ex machina) gives Congress a timely excuse for inaction.**

Big, Broad Tax Increase

The increasingly likely tax hike will be the **biggest in history**, some \$6 trillion over 10 years by CBO scoring. This counts the Bush expirations, the AMT patch and the miscellaneous expirations like the R&D credit. It's also a **very broad tax increase**, hitting income, dividends, capital gains and estate tax rates.

- 69 provisions from the 2001 and 2003 Bush tax cuts are set to expire at year end, with many hitting low and middle income workers.
- While there has been talk that Treasury would avoid or delay a change in withholding taxes, we doubt it – **take home pay is likely to go down on January 1 for almost all working Americans.**
- In addition, many separate provisions (sometimes called "extenders") are also set to expire including the research and experimentation credit (expired at end of 2009), the Making Work Pay tax credit (\$800 tax credit for couples with incomes up to \$150,000) and the American Opportunity tax credit (\$4000 tax credit for community service.) These are scored by CBO at \$2.2 trillion over ten years (part of the \$6 trillion total increase.)

- **It's unclear whether Congress will renew funding for Build America Bonds** (the federal subsidy for issuance of taxable muni bonds that expires at year-end). **Their benefits go mostly to profligate cities and states, so it will be an early test of whether the election alters Congress's eagerness to spend.**
- We think almost all of the extenders and Bush cuts will be allowed to expire. While the R&D tax credit has almost always been extended and has clear bipartisan support, extending it will increase the fiscal deficit projections and require some kind of bipartisan agreement, a high hurdle after the bitter election battle. Given the wildness of the election, even this credit may end up expiring with some in Congress promising to address it in 2011.

Despite the market's assumption that the new Congress will quickly reverse many of the tax hikes, **we expect a very long legislative squabble.** Given the built-in legislative obstacles to tax cuts, **we think markets will have to price any January 1 tax increases as if they are permanent.**

- The President's Deficit Commission is scheduled to report on December 1, highlighting the magnitude of the deficit and debt crisis and making tax cuts more difficult both in the lameduck and in 2011. Funding for the government runs out on December 3, so extending the spending bills will occupy most of December.
- To get new tax legislation in 2011 or 2012 will require President Obama's signature and either a 60-vote Senate majority or a favorable House-Senate budget resolution that opens a path to a 50-vote reconciliation bill that could then win the President's support. **Even with the Republican takeover of both houses in 1981 and President Reagan's support, the 1981 tax cut wasn't enacted until August, 1981.**
- Greenspan supports the Bush expirations on the view that this will reduce the fiscal deficit without hurting the economy all that much. President Obama has characterized tax cuts as the equivalent of expenditures, something we can't afford. On CNBC, Howard Dean was outspoken in advocating a grand compromise between Republicans and Democrats (meaning a big tax hike).
- **So the battle lines for a 2011 stalemate are already drawn,** pitting the election outcome against the President's tax views and the heavy bias in Congressional scoring rules against tax cuts. In the scoring rules, economic growth and innovation are assumed to be unaffected by tax rates, so tax cuts are scored as increasing the fiscal deficit, increasing the interest burden, and making the income distribution tables look worse.

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