

November 6, 2009

Washington Notes: Health Care Moving; Tax Hike Theory; Market Implications

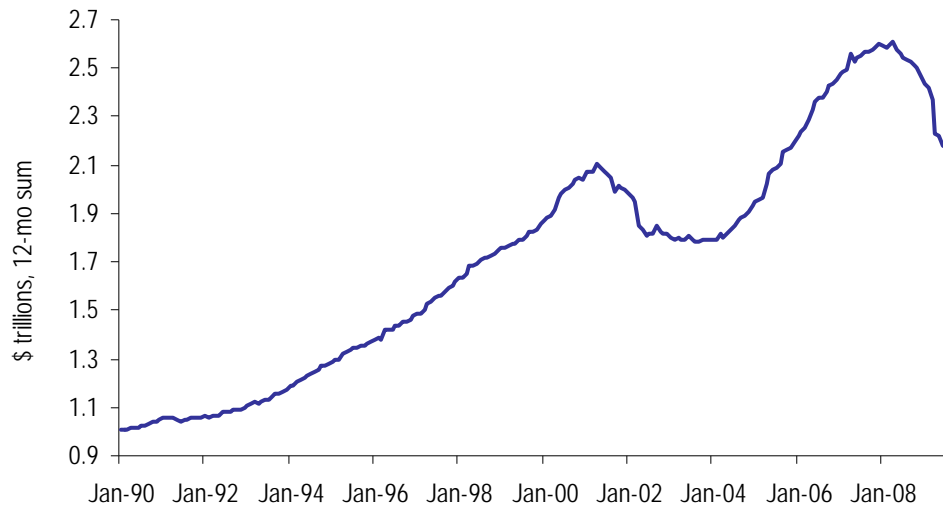
We expect the House to pass its health care reform bill, possibly Saturday evening, by a close party-line vote. We note the House's sense of urgency to be done with the issue, the length and complexity of the bill, and the willingness of a majority of members to vote, even at this early point in the recovery, for an increase in the top marginal tax rate -- the 5.4% surtax on income would be added to the current-law rate increase at the beginning of 2011 when the Bush cuts expire, pushing the top marginal rate on income to 45% from 35%, on dividends to 45% from 15%, and on capital gains rate to 25% from 15%.

- The House will then be able to move to other matters, including three tax bills from Ways and Means dealing with estate taxes, "routine" extensions of current law, and "special provisions" related to the fiscal stimulus bill.
- The Senate will take up its own health care bill, though the timing isn't clear. The President will get increasingly involved, but we think the first Senate bill may bog down in debate and amendments. There's a good possibility it will shift to a reconciliation vehicle sent from the House. That would allow 50-vote Senate majorities to push the bill to passage. While there would be parliamentary objections based on the reconciliation process, parliamentary disputes can be resolved by Senate votes, allowing an expansive health care reconciliation bill.
- If the Senate passes a bill, the House-Senate conference would be able to mesh the House and Senate versions, even adding a type of public option. We think the bills will be pre-conferenced with substantial White House input and no reliance on new CBO cost estimates. The proposed tax surcharge rate may shrink some in the House-Senate conference as some of the Senate's proposals to tax high-benefit health insurance plans are incorporated. The final votes will probably occur this year and impose substantial new taxes. Final passage of the conference report is by simple majority, with no CBO re-scoring of the final product and limited review by members (see our October 13 piece, Washington Notes: Legislative Process for Health Care Reform.)

Tax issues

October federal tax receipts continued to plunge. We expect the Administration's FY2011 budget (due in February) to provide sharp upward revisions to deficit estimates to incorporate weak receipts and much higher unemployment than anticipated in earlier budgets.

US Government Federal Receipts 12-mo sum (last obs. September 2009)



Source: US Treasury; Encima Global

The Joint Committee on Taxation, the official tax estimator, found that the House bill, which includes 13 taxes, would raise \$729.5 billion over ten years, \$460 billion from the surtax discussed above.

- The estimate uses the standard static modeling which assumes no change in economic growth rates from tax hikes no matter how big.
- The 5.4% surtax is applied to filers with adjusted gross incomes over \$500,000 (\$1 million married filing jointly). However, **the top tax bracket is not indexed for inflation, so bracket creep would capture more and more filers. Joint Tax assumes more tax receipts from this, but still no impact on economic growth.**

In his October 29 remarks to the Economic Club of New York, Larry Summers, director of the White House's National Economic Council, addressed top marginal tax rates and incentives:

“In the short run, our constraints are more on the demand side than the supply side. As I look at the evidence, the 90% tax rates at the top end that we had in the 1950s until 1964; the 70% tax rates we had at the top end from 1964 to 1980; the 50% top tax rate that we had in place for the vast majority of Ronald Reagan's presidency; the 39% tax rates we had in place during the 1990s when the economy created 23 million jobs:

“I don’t find there to be much evidence to suggest that raising top marginal tax rates from 35% to 39% as would be implicit in the repeal of the Bush tax rates will do substantial damage to the consensus on the economy.

“I’m much more struck that lack of spending power on the part of middle class families is likely to be a constraint on economic growth and that excessive government borrowing, which is not an alternative to spending cuts or to tax increases but only a way of postponing with interest, is likely to be a problematic strategy, likely to be much more problematic.

“I don’t think any of us should be under the illusion that somehow the whole fiscal problem could be solved by addressing any single segment of the population. But it does not seem to me that prudent changes in taxes (the kind for example contained in the President’s budget) would seriously threaten incentives in any important way -- though none of us would want to go back even to the kind of regime that was in place through most of Ronald Reagan’s presidency.”

Market implications

It’s hard for the market to price in legislation until it is close to enactment. We think equity markets haven’t reacted yet to the content of the House bill on the view that it might not pass the House or might be improved or stopped in the Senate. There are more immediate issues for the market to digest this November – growth, jobs, the dollar, etc.

- **However, we think a health care reform bill is likely, will be long and complex, and will include significant new taxes -- all substantial market negatives when the bill gets closer to passage.**
- **Next steps are: the House vote, probably November 7; Senate debate; a Senate switch to the powerful reconciliation process; then Senate passage. By that point, perhaps in mid-December, we think markets will need to have priced in the taxes and complexity.**

Notes:

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