

**POLITICAL PULSE**

## Trump's Tax Cut Nuclear Option

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To keep a precious break, eight Dems will have to help the GOP make tax cuts permanent.

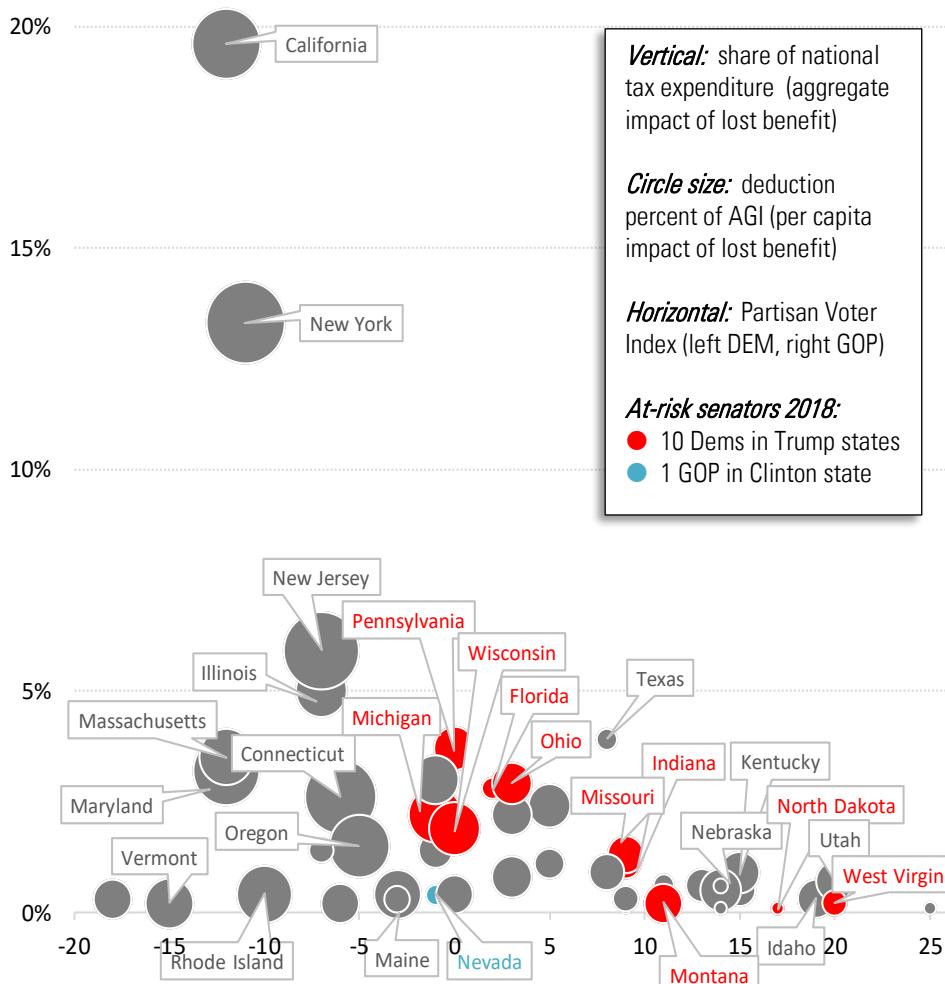
As we expected, the stock market has paused near all-time highs to digest the Trump administration's [seemingly chaotic tax cut roll-out](#) (see "[On Trump's Tax Cut Proposal](#)" April 26, 2017). [But the more we study it, the more we see it as a political masterstroke, strongly raising the probability of enacting pro-growth policy.](#) The chart below shows one major reason.

### Update to strategic view

#### US MACRO, US STOCKS, FX, ASIA STOCKS, EM STOCKS:

Trump's daring proposal to eliminate the deductibility of state and local taxes is a "nuclear option," an unbeatable bargaining chip against Democrats. Blue states get 65% of the \$62 billion tax break, with just six taking more than half. Under "reconciliation" in the Senate, the GOP can take that break away at will with no Democratic votes, provided it is willing to live with mandatory "sunsets" on tax reform. To preserve the break, eight of the ten Democratic senators facing re-election in 2018 in states Trump carried are likely to vote with the GOP, making tax reform permanent. The artful way Trump rolled out his tax initiative has his opposition on its heels, and has earned applause from conservatives who might have been blockers. Stocks have been soggy since the seemingly weak roll-out, but this is a very pro-growth policy thrust with a high chance of enactment. Demise of the BAT policy option, and the French election, have weakened USD, which is a positive for China and the emerging markets ecosystem.

### Gross impact of elimination of deductibility of state and local taxes



Source: IRS, Cook Political Report, TrendMacro calculations

- By daring to propose the elimination of the deductibility of state and local taxes, Donald J. Trump has threatened a tax-policy “nuclear option” against Democrats.
- Of the \$62 billion estimated deduction nation-wide for state and local taxes in 2017, 65% goes to states that voted for Clinton in 2016 and only 35% to states that voted for Trump.
- Just six large blue states – California, Illinois, Maryland, Massachusetts, New Jersey and New York – take 50.5% of the aggregate deduction.
- At the margin, for the very highest-earners – except for Californians, and New Yorkers living in New York City – the loss of the state and local deduction is offset by Trump’s proposed cut in the top federal bracket to 35%. But for states that voted for Trump, which tend to have lower top tax rates – giants Texas and Florida stand out, both with zero income tax rates – Trump’s proposal is a big net windfall.
- Yes, the Alternative Minimum Tax already disallows deductions for state and local taxes. But Trump’s proposal eliminates the AMT, yet leaves blue states still subject to one of its most expensive provisions.
- On net, the elimination of the deduction of state and local taxes is a large re-distribution of the overall federal tax burden from red states to blue states.
- So the worst negative buzz the mainstream media could generate last week was to claim “at least three House Republicans criticized” it. That means, what – four did?
- Democrats know that the GOP can impose this redistribution on their constituents at will, through the “budget reconciliation” process in the Senate that can pass a tax bill without a single Democratic vote – provided it is willing to live with automatic “sunset.” In order to bargain this nuclear threat away, Democrats in the Senate will have to agree to provide eight votes for whatever else the GOP wants, overcoming the filibuster-proof threshold of 60. Passed by a super-majority in the Senate, Trump’s tax cuts can be permanent.
- Obviously the extremely liberal senators from blue states that stand to lose the most – say, Minority Leader Schumer (D-NY) or Minority Whip Dick Durbin (D-IL) or Diane Feinstein (D-CA) – will never support anything Trump proposes, even when facing this nuclear threat. But hamstrung Democratic leadership will be able to horse-trade with others in their party to secure the eight necessary votes. There are 10 Democratic Senators running for re-election in 2018 in states that Trump carried who should be inclined to go along with Trump’s tax cuts anyway. Three of them – Heidi Heitkamp (ND), Joe Manchin III (WV) and Joe Donnelly (IN) – already risked party scorn to vote to confirm Neil Gorsuch to the Supreme Court.
- That’s the art of the deal here. Democrats can maintain the status quo on the state and local deduction in return for giving permanence to the rest of Trump’s tax agenda. If the Democrats don’t want to do that deal, well, “make my day.” A great redistribution of tax burden from red states to blue states will occur – and ten years will just have to be permanent enough.

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April 30, 2017

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Charles Blahous  
*E21*  
May 1, 2017

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Trump has brandished this nuclear option with great finesse and subtlety.

- Trump preserved his future negotiating leverage by sending surrogates – National Economic Council Director Gary Cohn and Treasury Secretary Steve Mnuchin – to handle the policy rollout on Wednesday.
- They came armed with only a seemingly amateurish single page of bullet-points, instead of an elaborate white paper. And Cohn was programmed to begin the roll-out press conference with Trumpian chest-beating about how this is going to be “one of the biggest tax cuts in the American history.” This tricked Trump’s opponents, such as the New York Times’s Paul Krugman, into wasting their initial shots in predictable *ad hominem* attacks on the style, rather than the substance, of the policy. And the soi-disant “fact checkers” all began their stories with refutations of Cohn’s “biggest tax cut” claim – rendering inoperative the potential criticism that Trump’s plans are “too big,” or “budget-busters.”
- We said all along that budget-hawks weren’t going to be the problem (see “Does AHCA Kill Tax Reform?” March 27, 2017). Indeed, Trump’s tax proposal has received glowing endorsements from such potential blockers as the Koch Brother’s Americans for Prosperity, FreedomWorks, the Heritage Foundation and the Club for Growth.
- Trump’s threat to remove deductibility of state and local taxes – now a break for the richest taxpayers in the richest states – takes the wind out of his opposition’s sails when they, representing those taxpayers in those states, try to portray Trump’s proposals as benefitting the rich. For example, when the New York Times accuses Trump of “failing ‘the Mnuchin test” that there should be no absolute tax-cut for the wealthiest, its analysis has to rather obviously cheat by omitting the large effects on the rich of eliminating deductibility of state and local taxes.
- On “Fox News Sunday” yesterday, Schumer got so flustered when he finally dared to mention it that, in the same sentence, he mistakenly said Trump was trying to take away the mortgage interest deduction. He was mercilessly called out on that by Chris Wallace.
- Cleverly, this nuclear policy option was not mentioned explicitly in the one-page document. That leaves those whose oxen are gored by it in the embarrassing position of having to raise the issue themselves and reveal their self-interest – as happened to Schumer.
- At the same time, the one-pager was equally silent as to the continued deductibility of 401-k plan contributions, and Press Secretary Sean Spicer was unclear on the matter the next day. In straightening it out later, the administration had the opportunity to say that, of course that deduction – an “exclusion” really, and hence the lack of clarity – is being preserved as part of Trump’s commitment to working people. Once again it seems Spicer’s blunders play to Trump’s advantage.

While markets have been a little soggy since Trump’s tax initiative –

indeed, producing a disturbing “rally failure” by missing new all-time highs by just a few basis points – we think this is mostly a reaction to [the unusually ambiguity-tolerant style with which Trump pursues policy](#) (see [“From Executive Orders to Spontaneous Order”](#) February 17, 2017).

- [We think that, on balance, Trump’s tax policy proposal is very pro-growth](#) – it looks very much like the bold proposal we lauded early on during the campaign when no one else took Trump seriously (see [“Sympathy for the Donald”](#) March 2, 2016).
- [And we think that most of it has a very good chance of enactment.](#)
- The dangerous and divisive border-adjustment tax idea was absent in the one-pager, and as we expected, will be effectively absent from the debate (see [“Trump Gives the BAT the Boot”](#) April 17, 2017).
- [Incidentally, the removal of the BAT threat and the boost for confidence in the euro currency following the French presidential primary](#) (see [“On the French Presidential Primary”](#) April 24, 2017) [come together to confirm our long-standing contrarian expectation for US dollar weakness](#) (see [“Our Contrarian View on the Dollar”](#) January 5, 2017). [This is a strong positive for China and the whole emerging markets ecosystem.](#)
- And again, most critically, the nuclear option of removing deductibility of state and local taxes is an unbeatable bargaining chip against Democrats, leaving the final substance of an actual bill to be sorted out mostly by Republicans.

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### **Bottom line**

Trump’s daring proposal to eliminate the deductibility of state and local taxes is a “nuclear option,” an unbeatable bargaining chip against Democrats. Blue states get 65% of the \$62 billion tax break, with just six taking more than half. Under “reconciliation” in the Senate, the GOP can take that break away at will with no Democratic votes, provided it is willing to live with mandatory “sunsets” on tax reform. To preserve the break, eight of the ten Democratic senators facing re-election in 2018 in states Trump carried are likely to vote with the GOP, making tax reform permanent. The artful way Trump rolled out his tax initiative has his opposition on its heels, and has earned applause from conservatives who might have been blockers. Stocks have been soggy since the seemingly weak roll-out, but this is a very pro-growth policy thrust with a high chance of enactment. Demise of the BAT policy option, and the French election, have weakened USD, which is a positive for China and the emerging markets ecosystem. ▶