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WASHINGTON POLICY STRATEGY

Potomac Perspective

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With five weeks until Election Day (and the day of the vice presidential debate), Vice President Kamala Harris maintains a small lead in the polls over Donald Trump, but we think Trump has a slight advantage in the Electoral College. As for Congress, we think there's a good chance that both chambers flip. Republicans seem well-positioned to win back the Senate, while Democrats have a good chance of flipping the House. Divided government seems likely to continue, and that has implications for both candidates' economic agendas and the looming tax debate.

PRESIDENTIAL RACE

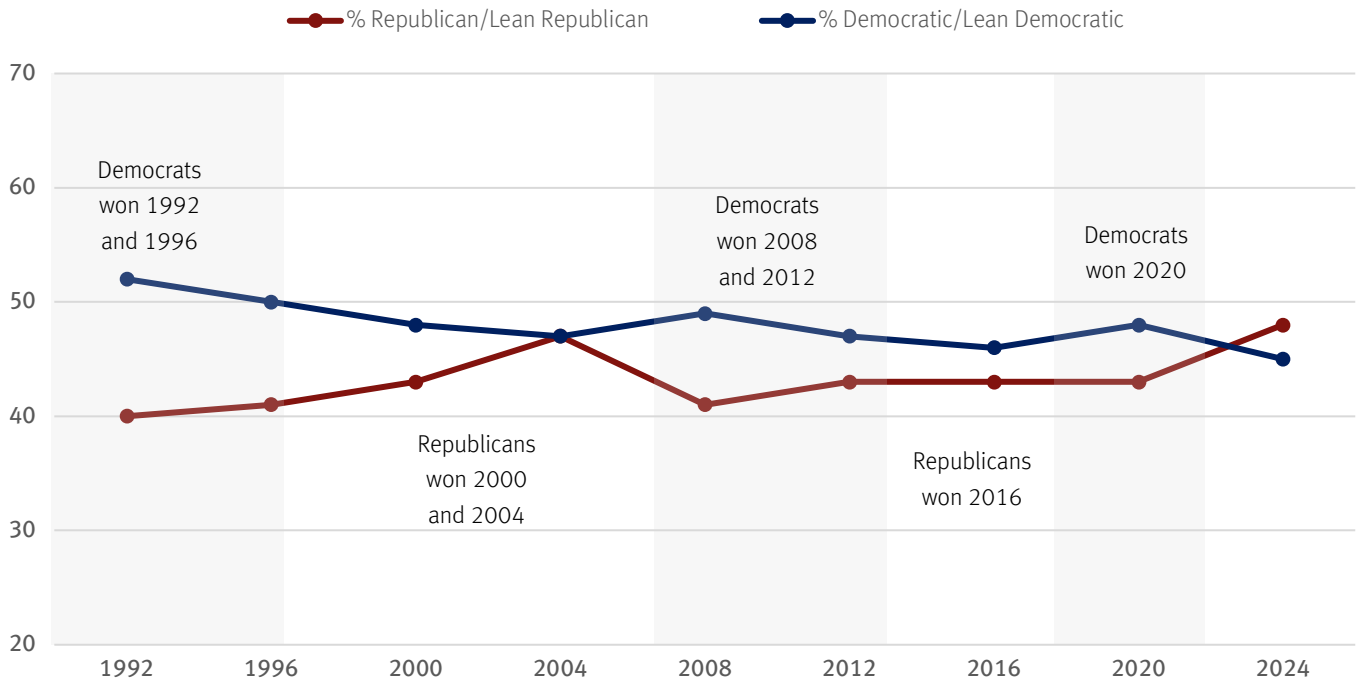
According to the RealClearPolitics average of polls, Vice President Kamala Harris holds a 2.0-point lead nationally over Donald Trump. The situation in the key battleground states is even tighter. According to the RCP, Trump averages a 0.1-point lead in those seven key states. Trump has small leads in Arizona, Georgia, and North Carolina, while Harris has small leads in Michigan, Nevada, Pennsylvania, and Wisconsin. If the current RCP average in those states reflects the outcome on November 5, Harris would win the Electoral College vote, 276-262 (all else being equal). Of course, polls can change, and all of these surveys are within the margin of error, so any small error could mask which candidate actually leads. Based on election fundamentals and comparisons of past elections to the current one, we think Trump is in a better position to win the Electoral College vote than some people realize. We offer explanations why either candidate could win the presidency.

Why Trump Can Win

There are several economic indicators that we think help Donald Trump. Regardless of what economists think about the state of the economy, voters are less sanguine. Last week, the Conference Board reported the largest one-month decline on consumer confidence since August 2021. Also, according to RCP, a majority of voters (61.3% - 28.4%) think the country is heading in the wrong direction. We note that Harris has closed the gap with Trump on the question of who can best handle the economy, but we still view the economy as a positive for Trump.

Another positive indicator for Trump is party identification. Last week, Gallup released a study which compares party identification to election outcomes. Since 1992, prior to the election, voters identified with the winning party's presidential candidate every time except in 2016. Clinton won the popular vote in that contest but lost in the Electoral College.

U.S. Adults' Party Identification and Leaning in Presidential Election Years



Figures are the average party identification and leaning in the third quarter (July –September) of each year
 Source: Gallup, “2024 Election Environment Favorable to GOP,” as of September 24, 2024.

Regarding the polls, history suggests they are underestimating Trump’s position. As we have previously noted, Trump’s current position vis-à-vis Harris is better than his position at this point in the 2020 campaign against Joe Biden and in the 2016 election against Hillary Clinton. This is true both nationally and in most of the battleground states. Also, not only is Trump’s margin against Harris as good if not better than against Biden and Clinton at this point in the race, but Trump’s share of the vote also appears to be higher than what it was in previous campaigns. Furthermore, in the last two elections, Donald Trump outperformed his final poll numbers by around three points. Of course, past performance does not guarantee future results, but if the pattern of the 2016 and 2020 polls repeats itself, then Trump is in a good position to win the Electoral College.

Why Harris Can Win

In a word – favorability. Voters continue to view Harris more positively than Trump. This could be a big advantage for Harris since there seems to be a correlation between how voters view a candidate and the likelihood of voting for said candidate. Henry Olsen, a political analyst, looked at the exit polls from 2016 and 2020 and found a close correlation between voters who had a positive view of Trump versus Biden and Trump versus Clinton and the likelihood that voters would vote of the candidate they view favorably. Harris’s favorability rating has surged since she entered the race, and she currently has an 8.6-point advantage over Trump. It also might explain the Harris campaign’s strategy of remaining vague on some issues. Harris seems to be relying on attracting voters who view Trump negatively and are committed voting against him. It could be a winning formula, although it might backfire if voters ultimately want more specifics and feel unsatisfied by the lack of policy details provided by the

Harris campaign. It is worth noting that Harris's advantage on favorability is greater than Clinton's advantage (7.2 points on this date in 2016) but less than Biden's advantage (15.8 points on this date in 2020).

CONGRESS

Over the past several elections, fewer voters have been splitting tickets (voting for a presidential candidate from one party and House or Senate candidates from the other party). We expect this trend will continue and maybe even intensify in the 2024 election. This leads us to expect Republicans will likely flip the Senate while Democrats could flip the House. Thus, divided government looks increasingly likely.

Senate

We think chances that Republicans win the Senate have risen in recent weeks. Currently, Democrats hold a 51-49 majority. Of the 34 Senate seats being contested this year, Democrats are defending 23 seats, while Republicans are defending 11 seats. Thus, Republicans have more pickup opportunities than do Democrats.

In the last two presidential elections, Senator Susan Collins (R-Maine) was the only candidate from either party to be elected in a state that voted for the other party's presidential candidate. Given this pattern, it appears Republicans are positioned to flip enough states currently held by Democrats and win back the Senate majority. The West Virginia seat held by Senator Joe Manchin (D, retiring) is virtually a lock to go Republican. In Montana, Senator Jon Tester (D) will need numerous Trump voters to split their ticket to reelect him. He currently trails in the polls, and this appears to be a likely gain for Republicans. Ohio is also in play for the GOP. Senator Sherrod Brown (D) is a solid campaigner and a Democrat who is well situated to win in a Republican state. Trump will probably win Ohio by around eight points (as he did in 2016 and 2020), which makes Brown's climb uphill.

The lack of ticket splitting also means Republican incumbents like Senators Ted Cruz (R-Texas) and Rick Scott (R-Florida), who will likely be in close races, will probably survive. In Maryland, former Governor Larry Hogan (R) is popular and well known, but Harris will easily win the state and will probably ensure a Democratic hold there.

We currently expect Republicans will gain at least the two seats (net) they need to flip the Senate.

House

Republicans currently have a slim 220-212 (3 vacancies). Polling on some of the key House races is scant, but Democrats lead in the generic congressional ballot by 1.8 points. If this holds and Harris wins the national popular vote (which we expect even if she loses the Electoral College), we think Democrats would likely flip the House and have a majority roughly the same size as the current Republican majority

POLICY RAMIFICATIONS

If we are correct and Congress is divided, it will make it difficult for either presidential candidate to pass their economic agendas. Divided government also has implications for the upcoming tax debate that will focus on the expiring provisions of the Tax Cuts and Jobs Act of 2017 (TCJA). Whereas we think it will be difficult to pass big, transformational legislation, the sunsets in the TCJA will force congressional action – neither party wants to see taxes raised on most taxpayers. Congress will have several options when it considers extending the TCJA sunsets. Divided government could either force a compromise in which some, but not all, of

the sunset provisions are extended long term. Also, Congress might simply extend the sunsets for a short period (two years?) and punt the fight to another day. Following is what we currently think about the expiring provisions of the TCJA:

- **Individual income taxes** – The Congressional Budget Office (CBO) estimated that extending all of the expiring provisions of the JCTA would cost the government \$4.6 trillion over 10 years. Extending the current rates on individual income taxes is the largest driver of that number. It seems likely Congress will extend the current rates for most tax brackets, but Congress might allow the top rate to reset higher. That would mitigate the cost of the extensions, and some House Republicans who represent poor districts will be reluctant to spend political capital on maintaining lower rates for the wealthiest taxpayers.
- **Limiting the Alternative Minimum Tax (AMT)** – The TCJA increased the threshold for coverage by the AMT, which is one of the laws costliest provisions. We are unaware of Ms. Harris’s position on the expanded AMT exemption but doubt the AMT resets to its 2017 level regardless of who wins the presidency. Because of the cost of extending the current AMT threshold (\$1.4 trillion/10 years according to CBO), there could be a compromise that sets the AMT exemption somewhere between the current and 2017 levels.
- **State and Local Tax (SALT) Deduction cap** – The \$10,000 cap on the SALT deduction also expires after 2025. While Mr. Trump recently backed the restoration of full SALT deductibility, that would cost the government another \$1.2 trillion over 10 years. An increase in the cap to \$20,000 is possible but, given the budget math, full restoration seems like a long shot.
- **Estate tax exemption** – The exemption from the estate tax would revert from the current level of \$27.2 million for married couples to the 2017 level of \$11 million, plus an inflation adjustment. The cost estimate for continuing the higher exemption is relatively low compared to other sunset provisions. Also, the estate tax hits numerous small businesses and family farms. In short, allowing a reset might not produce much juice for the squeeze, so the chances of extending the current threshold are relatively good.
- **Health insurance premiums** – The American Rescue Plan and the Inflation Reduction Act expanded tax credits used to buy health insurance under the Affordable Care Act. These expanded tax credits expire after 2025 along with the TCJA sunsets. The odds of extending the expanded tax credits would be higher in Harris wins, but we think chances of an extension are decent even if Trump wins and there is divided government (our base case). Congressional Democrats will have some leverage to extend them as part of the TCJA extension debate. Some Republicans will also want to avoid being labeled as the “party of the rich” if most of the benefits of a TCJA extension will be enjoyed by wealthier taxpayers. Also, the beneficiaries of the health insurance tax credits live in Republican areas, which will incentivize some Republicans to support an extension of these credits.

In addition to the sunsets, investors and managements might want to keep an eye on provisions that are not scheduled to expire, but a compromise on the above sunsets, plus the current fiscal situation, might force some changes in the following areas:

- **Corporate rates** – The current corporate income tax rate of 21% is not scheduled to change after 2025, but a change in the rate could be part of the looming tax debate. Ms. Harris has proposed increasing the corporate rate to 28%, while Mr. Trump has proposed cutting the rate to 15% or even lower. If Harris wins, we doubt Congress will raise it to 28%, but a small increase (in the range of 23-25%) is possible. If Trump wins, we doubt Congress will cut the corporate rate to the

level he proposed, and Congress could even raise the rate as a way to pay for the extension of lower individual income tax rates. Populist congressional Republicans are unlikely to fight for a lower corporate income tax rate and, we think, some of them would support a small increase.

- **Buyback tax** – Harris proposed increasing the buyback excise tax from 1% to 4%. That seems unlikely, but a smaller increase is possible. Again, we think some congressional Republicans could support an increase as a “pay-for” for other concessions.
- **Capital gains taxes** – Ms. Harris has proposed an unrealized capital gain tax for taxpayers with net wealth above \$100 million, a 28% capital gains tax rate for taxpayers earning more than \$1 million per year, and an increase in the net investment income tax to 5% from 3.8% on wealthier taxpayers. Even if Democrats were to sweep the 2024 elections and have unified control of Congress and the White House, we think these proposals would face opposition in Congress, including among some congressional Democrats. The unrealized wealth tax is, in our view, both unconstitutional and an operational nightmare (i.e., the valuation of illiquid assets and the determination of which taxpayers are covered would be extraordinarily difficult, and the tax would probably fail to generate the forecasted revenue). Also, Democrats had a chance to pass a higher capital gains tax when they controlled Congress in 2021-2022 and failed to do so. We do not think the political situation to implement a hike has dramatically improved since then. We should note, though, that some populist Republicans might be more open to an increase in the capital gains tax than they have been in the past, but if Trump wins, we think these proposals are DOA.

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