## Economic Research Note

# Six more weeks of fiscal cliff – if you don't jump off one first

- **With the election behind us, the fiscal cliff is now the predominant issue for the US economy**
- **The fate of the upper-income Bush tax cuts remains the key stumbling block to reaching a broader deal**
- **There are several paths to compromise, none of which would matter much for the economy or the deficit**

The election has settled one source of uncertainty—who will set policy—but another source of uncertainty remains—how will the fiscal cliff be resolved. Unless the President and Congress reach an agreement, almost $600 billion of fiscal tightening is set to hit the economy on January 1, 2013. Out of this $600 billion, about ¾ is higher taxes, and about ¼ is reduced federal spending. Should all of this tightening be realized, the economy would almost certainly sink back into recession.

In principle, avoiding the fiscal cliff is simple; in practice, there are sharp ideological differences that complicate the issue. Among these differences, none is greater than the fate of the upper-income Bush tax cuts. These cuts amount to around $50 billion per year of extra federal revenue. Compared to the $600 billion fiscal cliff, or the more than $1 trillion annual deficit recently recorded, $50 billion may appear to be a relatively trivial reason for holding up the entire cliff deliberations.

Even so, small disagreements can have large consequences. Both Democrats and Republicans have vowed to block the extension of the Bush tax cuts—for both lower- and middle-income taxpayers as well as upper-income taxpayers—if they don't get their way on the upper income portion of the tax code. Thus, the resolution of the $50 billion in upper income revenue has implication for the larger $300 billion sum associated with the entirety of the Bush tax cut package. And since the resolution of the Bush tax cuts is likely to be central to any larger deal on the fiscal cliff—and on the debt ceiling for that matter—the fate of the upper-income tax cuts is a small but critical keystone in any deal to construct a bridge over the fiscal cliff as a whole.

There are essentially three ways this could be resolved. First, either one side or the other completely concedes the issue. This seems somewhat unlikely given that each side has legislation-blocking power. Second, neither side concedes anything on the issue, and we go over the cliff entirely. This is possible but certainly not appealing. Third, some middle ground is found.

Income tax rates for 2012

| Taxable income | | Marginal tax rate |
|---|---|---|
| Single | Married, filing jointly | |
| Up to $8,700 | Up to $17,400 | 10% |
| $8,701 to $35,350 | $17,401 to $70,700 | 15% |
| $35,351 to $85,650 | $70,701 to $142,700 | 25% |
| $85,651 to $178,650 | $142,701 to $217,450 | 28% |
| $178,651 to $388,350 | $217,451 to $388,350 | 33% |
| Over $388,351 | Over $388,351 | 35% |

Income tax rates for 2013, current law

| Taxable income | | Marginal tax rate |
|---|---|---|
| Single | Married, filing jointly | |
| Up to $35,350 | Up to $70,700 | 15% |
| $35,351 to $85,650 | $70,701 to $142,700 | 28% |
| $85,651 to $178,650 | $142,701 to $217,450 | 31% |
| $178,651 to $388,350 | $217,451 to $388,350 | 36% |
| Over $388,351 | Over $388,351 | 39.6% |

## Tax debate heats up

The origin of the current dispute lies with the 2001 and 2003 tax cuts, which reduced tax rates across the board and also made the tax code less onerous through several non-rate provisions, such as increased generosity of certain deductions and credits. Those two tax acts, which had the legislative acronyms EGTRRA and JGTRRA but are more commonly known as the Bush tax cuts, were both set to expire at the end of 2010, and the tax code would revert to its pre-2001 status. In late 2010 President Obama pushed to extend only the lower- and middle-income portion of the Bush tax code, but this policy preference was blocked in the Senate. A deal was reached in early December 2010 to extend the Bush tax cuts for two years, and a 2%-pt reduction in the payroll tax was added as a concession from the Republicans to the President and the Democrats.

The two-year extension of the Bush tax cuts is now about to expire, and getting to a compromise extension looks more difficult now than in 2010: the Obama Administration has insisted "never again" on extending the upper-income provisions of the Bush tax cuts. The Republican majority in the House, which had been elected but not yet seated at the time of the lame-duck deal in December 2010, has vowed that taxes should not be increased at all, hence the current impasse.

House Speaker Boehner recently reiterated his position that he is open to higher tax revenue, not higher tax rates. This would seem to imply that there are a few potential avenues of compromise, whereby each side could claim victory and save face. One compromise would be to allow the upper income, non-rate provisions of the Bush tax code to lapse. Prior to 2001, the personal exemption (which allows taxpayers to reduce their taxable income by $3800 for each member of the taxpayer's household) was phased out for upper-income taxpayers. This phase-out was eliminated in the Bush tax cuts. In addition, prior to 2001, the amount of itemized deductions available to upper-income taxpayers was limited (the so-called Pease limitations). This was suspended in the Bush tax cuts. Both of these measures affect upper income tax revenue but not upper income tax rates, and so allowing them to lapse may be an acceptable route to an agreement.

A second avenue of compromise would be revenue not directly tied to the expiration of the Bush tax cut. One such source of revenue that became a campaign topic is carried interest. Compensation of fund managers tied to the profit of the fund is currently taxed as capital rather than ordinary income. Taxing such compensation as ordinary income would produce relatively small revenue, about $2 billion per year, but could be on the table nonetheless. Similarly, there are numerous elements of the corporate tax code that could generate some revenue while allowing Congressional Republicans to have kept their promise on not allowing individual income tax rates to have increased.

A third compromise approach would see the Republicans yield some on upper income tax rates, but only provided that the definition of upper income is revised higher. For example, House Minority leader Pelosi and Senator Schumer have proposed a millionaire's tax. The Administration hasn't thrown its support behind this proposal, perhaps because it wouldn't do much to raise revenue. While an official "score" is not available, the revenue raised would obviously be significantly less than the $32 billion that would be raised by increasing marginal rates for those making over $200,000.

An important point to note about all three of the potential compromises mentioned above is that they each raise a fairly small amount of revenue. Indeed, even if all of the upper income measures expired they would only address about one twentieth of the deficit. At this point, however, the fiscal cliff debate is more about fulfilling campaign promises and parrying the opposition than about making a serious dent in the deficit.

It is also worth noting that the status of dividend and capital gains tax rates is especially murky. It is unclear whether the Republican opposition to higher tax rates applies to these forms of income as well. However, the prior warning applies here as well: a reversion to higher dividend and capital gain rates will make only a minor impact on the deficit. (See "The impact of higher dividend and cap gains taxes," *GDW*, Oct 5, 2012.)

Fiscal cliff and upper-income tax provisions

| | $ bn | % of GDP |
|---|---|---|
| Fiscal cliff | 572 | 3.6 |
| Bush tax cuts | 309 | 2.0 |
| Upper-income (>$200k) Bush provisions | 50 | 0.3 |
| Upper-income rates (36% and 39.6%) | 32 | 0.2 |
| Pease deduction limitation | 9 | 0.1 |
| Personal exemption phase-out | 3 | 0.0 |
| Treat dividends as ordinary income | 9 | 0.1 |
| Tax long-term capital gains at 20% | -3 | 0.0 |
| Memo: FY12 federal deficit | 1089 | 6.9 |

Fiscal cliff: J.P. Morgan modal forecast

| Measure | $ bn | Assumed multiplier | Share realized | Drag as % of GDP |
|---|---|---|---|---|
| Sunsetting of Bush tax cuts | 309 | 0.75 | 0.00 | 0.0 |
| Expiration of payroll tax holiday | 125 | 0.75 | 1.00 | 0.6 |
| Emergency unemployment benefits | 40 | 0.90 | 0.33 | 0.1 |
| Budget control act spending cuts | 98 | 1.00 | 0.50 | 0.3 |
| Total | 572 | | | 1.0 |

## Outlook

We continue to expect a deal to be reached before year-end that will avert most, but not all, of the fiscal cliff. In particular, it still appears that the payroll tax holiday set to expire at the end of the year faces an uphill battle in being extended. In addition, it is hard to see how some spending cuts associated with the Budget Control Act are entirely avoided, even if the draconian sequestration doesn't occur. Together, we think even with a deal the cliff-related measures will be a drag on GDP growth in the coming year.

The fate of the upper income Bush tax cuts is a critical element to any deal being formed. If there is no agreement on this issue, there is a risk of going off the cliff entirely. This week the CBO re-released analysis indicating that such an outcome would subtract about 3.0%-pt from GDP growth next year. Our own analysis has arrived at a very similar figure (see "US: fiscal cliff notes," *Special Report*, Apr 26, 2012). For an economy only growing a little over 2%, such a shock could prove to be quite nasty.

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