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Fiscal Pulse

U.S. Agreement Sets Up Another Cliff

- **This assessment expands upon the note issued on January 1, 2013, shortly after the House vote, and summarizes the near term pros and cons for the economy and the remaining issues.**

The *American Taxpayer Relief Act of 2012*, spearheaded by Vice President Biden and Senate Minority Leader McConnell, is largely limited to the major tax relief expiring at the end of 2012. It will impair near-term growth through direct effects and added uncertainty, thereby making it difficult to achieve anything but a very tepid pace of economic growth in 2013H1.

Our 'pre-agreement' base forecast for the US economy assumes that additional fiscal restraint will result in a negative contribution to real GDP growth in 2013 of roughly one percentage point, ending as of fiscal 2013 a four-year string of federal deficits wider than $1 trillion. The fiscal restraint assumed is expected to constrain US real GDP growth in 2013 to about 2%, with the greatest growth challenge lying in 2013H1 before growth accelerates in 2014. Additional fiscal restraint is expected in fiscal 2014 and fiscal 2015, the price for gradually putting the US economy on a more sustainable footing.

For now, the agreement appears to be in line with our fiscal restraint assumption for 2013. The *Act* is, however, a partial solution, and it may set up a potentially bigger and riskier battle in 2013Q1 as the focus shifts toward pairing negotiated spending cuts with a necessary increase in the debt ceiling along virtually identical time horizons. The resulting spending restraint for 2013 could be greater than we have anticipated. Washington is now at its legislated borrowing limit, and the Treasury has said it will use extraordinary measures to postpone the ceiling's effective bite until February or perhaps March — just when this agreement's delay in automatic spending cuts expires. This period will result in prolonged uncertainty governing consumer spending, business investment, and market activity.

Uncertainty also remains on the tax side, in terms of the President's questionably timed reference to further reducing tax expenditures for high-income households that inevitably will conflict with the GOP's desire to have a broad re-writing of the tax system. A truly comprehensive corporate and personal tax reform package would be positive but, as the preceding debate over personal and corporate tax deductions has proven, scaling back entrenched tax deductions is controversial and will have a considerable impact on diverse sectors. Obama's remarks may add to the sentiment that this first agreement is a clear, overwhelming victory for the White House and a big defeat for the weakened Conservatives as tax revenues go up by an estimated $620 billion over ten years and yet spending is cut by only $15 billion, thus yielding little deficit improvement. An alternative perspective is that the House may now have far greater leverage to seek spending cuts over coming weeks thanks to the requirement to increase the debt ceiling.

The financial market implications may point to a near-term relief rally in equities, cheaper Treasuries, and a weaker USD driven by less risk aversion. Once reality sets in, and we begin to see the broadening impact of the deal on a variety of economic indicators and earnings reports, and negotiations transition towards the ceiling and spending cuts, market uncertainty is likely to negatively impact equities, keep Treasury yields later in Q1 well behaved in the 1.5-1.75% range, and result in renewed USD strength. Only after this period of uncertainty is the US economic outlook expected to improve late this year and into 2014 as GDP growth accelerates on weak 2013H1 base effects and bullish housing market prospects are increasingly unleashed.

What Will Hurt The Economy This Year

US Sovereign Ratings	
Moody's	Aaa (-ve*)
S&P	AA+ (-ve*)
Fitch	Aaa (-ve*)

* Negative outlook as of January 4, 2013.

1. The 2% social security payroll tax cut to the workers' share is gone permanently. As a consequence, disposable income will decline in January and Q1. By how much? Probably about $125 billion in aggregate over 2013. At the individual and family level, it will amount to about $2,400 annually for those with earnings at the 2013 cap of $113,700 or more and just under half that for the average family. This measure is generally thought to knock about a half point off annual GDP growth and is likely to hit consumption in Q1-Q2. It never really achieved the desired positive impact upon job creation. While reversing this tax stimulus is also likely to weigh upon consumer confidence through assessments of present conditions when lower after-tax paycheques are realized, modest-income families should be somewhat encouraged that the Bush tax rate reductions are now permanent and the prior expansion of several tax credits focused on lower-income families is extended for a further half decade.

2. Upper income earners (individuals earning over $400k and joint filers over $450k) face a permanent hike in their marginal tax rate to 39.6% from 35%. President Obama has remarked that further reductions in tax expenditures for upper-income earners will be sought as part of additional negotiations in 2013 to reduce spending and raise revenues. Thus, we cannot yet evaluate the full tax implications for upper-income earners.

3. For the same definition of upper-income earners, taxes permanently rise on capital gains and dividends from 15% previously to 20%. For this same group, a new 3.8% Medicare contribution tax (as specified under the *Affordable Care Act*) as of January 1st raises the total investment income rate to 23.8%.

4. The top estate and gift tax rate will rise to 40% from 35% previously for assets above the exemption. The estate and gift tax exemptions will remain at $5 million per individual (not the $3.5 million at a 45% rate that the White House sought) and $10 million for a family estate. Annual indexation of the individual/family exemption thresholds is expected to raise them to $7.5 million and $15 million respectively by 2020.

5. For the sequester, the foregone savings of $24 billion from the two-month deferment will be made up from a $12 billion spending cut split between Defense and domestic programs and a $12 billion revenue hike from altering the rules for transferring from 401(k) plans to Roth accounts.

6. Tax refunds for early filers may be delayed several weeks, with guidance on the tax filing season expected shortly. That could push some household income realization back several weeks, distorting seasonal adjustment factors for personal income for early 2013. It may take until Q2 before we get cleaner data to evaluate trend consumer income growth. A small positive is that delayed tax refund pay-outs will give the Treasury a bit more flexibility with respect to the debt ceiling. It is unlikely, however, to push the debt ceiling timeframe beyond a March horizon.

7. Personal exemptions and itemized deductions will be capped for adjustable gross incomes of over $250k for individuals and over $300k for couples. Permanently restoring the Personal Exemption phase-out and the Pease provision after the late Donald Pease (Democrat) that limits itemized deductions is estimated to add just over 1% to the highest marginal tax rate.

8. 401(k) plans may be rolled into Roth IRA plans and hence taxes will have to be paid up-front on gains in the plan. The carrot is that pay-outs from Roth plans are not taxed. Roth plans offer no tax deductions on contributions but shelter investment income upon distribution. They contrast with 401(k) plans that offer deductions on contributions, but then tax investment income flows upon withdrawal. Washington's move therefore captures higher near-term tax revenues at the expense of longer-term tax revenues as baby boomers retire. It is likely a relatively short-sighted near-term revenue grab that fits the pattern of kicking the can down the road.

9. The agreement blocks the 0.5% cost-of-living pay increase for federal employees anticipated at the end of March, suggesting a pay freeze through fiscal 2013, with Congress yet to set the federal government's pay scale for 2013. Remuneration for Congressional members also is likely to be frozen.

What Will Help The Economy This Year

1. Those with up to $400k/$450k of individual/household income will have the reduced Bush era tax rates permanently extended. This is not added stimulus, but averts a tax hike for 99% of filers. Some may question whether permanent extensions represent good policy for a heavily indebted government running enormous long-term deficits and it may not be surprising to see 'permanent' being revisited in future.

2. The broadening of the Alternative Minimum Tax in 2013 will no longer occur. The AMT will be indexed annually on a permanent basis, removing the scramble to adjust the tax each year-end.

3. For those below the $400k/$450k individual/family income thresholds, the 15% tax rate on dividends and longer-term capital gains is unchanged, as is the zero rate applying to the lowest two brackets.

4. Depreciation incentives for businesses to write off up to 50% of equipment spending will be extended for another year, as will the Corporate Income Tax credit for research & experimentation and tax credits and incentives for renewable energy. These are pluses for business investment, but they require confidence for their effects to be unleashed and that isn't likely until later in the year. As well as personal income tax reform, a comprehensive corporate tax overhaul has been urged to support US competitiveness *(see chart)*.

5. Unemployment insurance benefits that were lengthened in the crisis will be extended for another year at a CBO estimated cost of $30 billion. We'll be having that portion of the debate again by late 2013. At nearly two years, the US offers jobless insurance as generous as the most liberal of European economies.

6. To assist low-income families, the expansion of the Earned Income Tax Credit and the Child Tax Credit in the 2009 stimulus legislation will be extended for five years, alongside the American Opportunity Tax Credit offering a tax credit of up to US$2,500 for college tuition. Also extended is the marriage penalty relief.

7. A scheduled 27% cut in physicians' reimbursement for their services to Medicare is blocked for 2013, following similar actions since 2003.

8. At least for now, the GOP fully backed away from efforts towards using chained CPI indexing of entitlement spending which would have represented cost savings to the government.

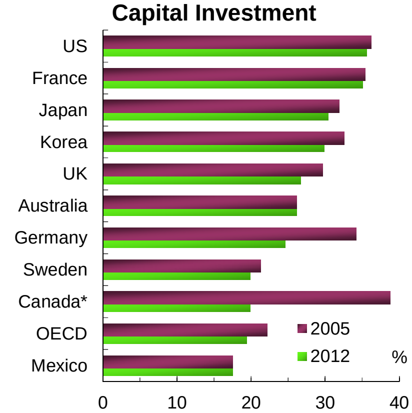
9. Existing federal farm subsidy programs will be extended through September 2013, including dairy subsidies to avoid substantial price hikes for milk.

What Remains To Be Addressed

There is no agreement on the debt ceiling which has been reached once again. A large risk facing the US economy is how $110 billion in spending cuts, now delayed by this agreement for two months, will be tied to an increase in the debt ceiling required by February or March after the Treasury takes extraordinary measures to postpone the ceiling's binding effects. Republicans are again stipulating that each dollar hike in the ceiling be matched by at least one dollar of expenditure cuts. Now reinforcing their expenditure reduction demands is their compromise in the agreement allowing higher taxes for top-bracket Americans. On balance, the agreement provides for a somewhat more progressive personal income tax structure.

Markets are expected to remain on edge for some time as this mini-deal fails to address the spending and borrowing sides of the picture. It may be that the GOP waved the white flag on the first leg of the negotiations, only to gain leverage in their quest for spending cuts by an administration that has thus far demonstrated that deficit reduction is just one of several priorities.

Marginal Effective Tax Rates on Capital Investment



* Canada's 2012 METR below 17%, but rises to 19.9% in 2014 as BC returns to a PST and federal accelerated depreciation on manufacturers'/ processors' M&E expires. Source: D. Chen, J. Mintz, The School of Public Policy, University of Calgary, September 2012.

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