Fiscal Pulse

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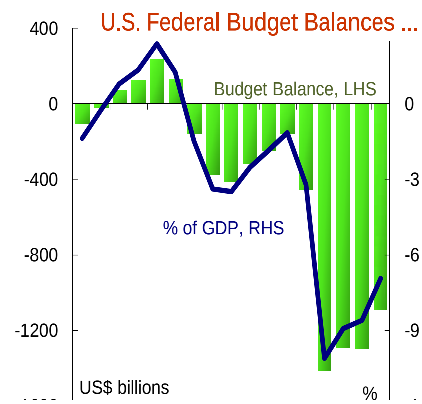
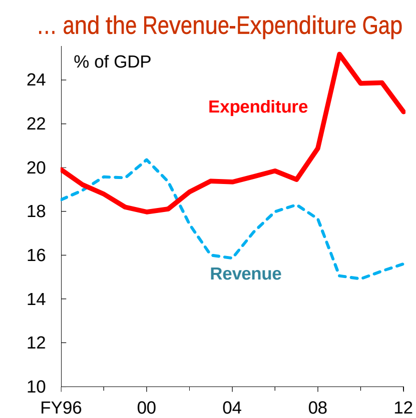
The Long Shadow of the U.S. Fiscal Cliff

- **Look for a temporary "fix" to extend much of the expiring tax relief to buy time for a more comprehensive fiscal restraint package.**

As intended, the U.S. fiscal cliff entering 2013, followed shortly thereafter by a required increase in the U.S. debt ceiling, is forcing post-election Washington to return to the negotiating table on deficit reduction. The final U.S. federal deficit for fiscal 2012 (FY12)[1], though narrower than generally expected at roughly 7% of GDP or $1.1 trillion, still marks the fourth year of budget shortfalls wider than $1 trillion *(top chart)*, with less-than-spectacular progress in scaling back the red ink since the deficit ballooned to $1.4 trillion (10.1% of GDP) in FY09.





Source: U.S. Office of Management and Budget,

Although broadly acknowledged that federal deficits this wide are unsustainable for the future, consensus has not emerged on an appropriate budget target for 2020. One option is balanced books by the end of this decade, allowing Washington's publicly held debt to drop well below its 72½% share of GDP as of September 2012, but this involves numerous tough trade-offs. Yet with the leading edge of the baby boom generation starting to retire, Washington should not miss its window of opportunity over the next few years to substantively address its budget gap before the rising number of Seniors begins to pressure key programs such as Social Security, Medicare and the long-term care services financed through Medicaid. The current budget gap is wide *(bottom chart).* In FY12, federal revenues totaled 15.6% of GDP compared with an average of almost 18% over the past four decades, while FY12 expenditures, though lower than FY11 at 22.6% of GDP, were still well above the 21.0% historical average.

Last spring, the Congressional Budget Office (CBO) estimated that the legislated revenue hikes and spending cuts slated for this January totaled just over $600 billion in FY13, with the expiry of current tax relief and several new taxes accounting for two-thirds of this total. The net change in the FY13 deficit, however, was estimated to be just $560 billion, given the lower revenues and higher spending resulting from the anticipated downturn in economic growth. For calendar 2013, Scotiabank Economics' forecast of a 1.9% increase in U.S. real GDP assumes a partial implementation of the slated deficit reduction measures, resulting in a negative contribution of roughly one percentage point to output growth.

A wealth of detail lies behind the fiscal cliff measures. Concerns remain over terminating the emergency unemployment benefits, estimated to cost over $25 billion for calendar 2013, but some agreement has emerged that the payroll tax reduction for employees, in place for 2011 and 2012, could be discontinued for 2013. In addition to the contentious debate on raising personal income tax rates for the top income bracket, is the issue of the estate tax and higher tax rates on dividends and longer-term capital gains. As well, the President's health legislation includes a new 3.8% Medicare contribution tax as of 2013 on certain unearned income, such as investment income, of individuals and trusts in the top bracket. With respect to the sequester,

[1] The U.S. federal fiscal year ends September 30. All data are in US dollars. An initial version of this article was published in *Global Views*, November 16, 2012.

the CBO estimates the automatic reductions in defense and non-defense spending for FY13 at $24 billion and $40 billion, respectively.

The post-election difficulties in negotiating a resolution to the impending fiscal cliff, even one that defers substantive details to 2013, are discouraging. The hurdles anticipated in gaining Congressional approval of a compromise package are particularly concerning given the breadth of issues facing Washington over the next few years. Even agreements in principle, such as trimming the scheduled increase in the top personal income tax (PIT) bracket rate by limiting deductions, involve controversial details *(side table)*. The sensitivities inherent in limiting deductions for items such as mortgage interest, charitable donations or state & local government taxes have prompted proposals for an absolute or percentage ceiling on an individual's total deductions. Altering, even gradually, the extent of these PIT deductions will have significant sector impacts.

The fact that many U.S. businesses are organized as 'small business' paying taxes through their owners' personal tax returns further complicates PIT reform. Achieving greater tax efficiency remains a hard sell without a comprehensive personal and corporate tax overhaul that can offer some balance across competing interests. For now, unconvincing in Washington are the economic benefits of shifting some of the tax burden to new, more efficient taxes, such as a value-added consumption tax at a low 3%-5% rate.

Expenditure cuts beyond the legislated discretionary spending caps, though receiving less media coverage, are equally contentious, beginning with the split between defense and non-defense items. As in other developed economies, managing future health expenditure growth is critical. In the U.S., the administration's measures to substantially extend health care coverage rely in part upon Medicare savings exceeding US$700 billion over a decade from health care providers such as hospitals, private insurers and pharmaceutical firms. Contested, therefore, is the administration's focus on providers for additional health savings.

For Social Security, a suggestion with merit is directing all of the savings from reforms back into the program to bolster its sustainability, but this limits the availability of these savings for near-term priorities. The latter are substantial. Numerous issues in the wings include reassessing federal support for all types of transportation, lingering residential mortgage concerns and a possible restructuring of interest on the student loan burden.

The variance in the estimates of the economic impact of the various fiscal cliff measures reflects the range of possible assumptions. For instance, moderating the automatic across-the-board sequestration could offer a larger boost to economic activity in 2013 than an equivalent amount of extended tax relief if households are inclined to save a significant share of any tax savings anticipating slower economic growth or a heavier tax burden in the future. If all of the legislated fiscal cliff measures proceed unaltered, U.S. economic growth in 2013 probably will stall, with the steepest slowing likely during the first half of 2013. Shadowing the fiscal cliff is the President's extensive health reform, to be operational by 2014 with on-line health insurance exchanges in every State to dramatically expand health insurance.

A Sample of Potential U.S. Federal Deficit Reduction Options

	Estimated Saving for Deficit in 2020 US$ billions
Modify Existing Personal Income Tax (PIT)	
Limit the tax benefit of itemized deductions to 15%	150
Eliminate the deduction for state and local taxes	110
Gradually eliminate the mortgage interest deduction	50
Include life ins. & annuity investment income in taxable income	30
Curtail deduction for charitable contributions	30
Adjust tax exemption for state/local bonds to subsidy for issuer	30
Accelerate and adjust excise tax on high-cost health coverage	40
Include employer premiums for LT disability ins. as taxable income	40
Raise maximum taxable earnings for Social Security payroll tax	60
Use chained urban CPI to index PIT parameters	10
Modify Corporate and Other Taxes	
Extend period for depreciating investments	30
Repeal deduction for domestic production activities	20
Raise excise tax on motor fuels by 25¢/gallon	30
Possible New Taxes	
Value-added tax of 5% on broad base	320
Impose a price on greenhouse gas emissions	140
Health Care	
Raise Medicare Eligibility Age from 65 to 67	30
Repeal health insurance expansion under *Affordable Care Act*	150
Raise Medicare Part B* basic premium to cover 35% of costs	40
Convert federal Medicaid payments for LT care to a block grant	50
Require manufacturers pay a minimum rebate on drugs covered under Medicare Part D for low-income beneficiaries	15
Trim payments for medical graduates at teaching hospitals	10
Limit medical malpractice torts	10
Social Security:	
Limit initial Social Security benefits to avg. prices, not avg. earnings	30
Raise full retirement age	30
Raise earliest eligibility age	30
Tie cost-of-living adjustments to chained urban CPI	20
Limit initial Disability Insurance benefits by 15%	20
Defence Discretionary Programs	
Maintain 2013 appropriations at original *Budget Control Act* level	75
Reduce across-the-board pay adjustments for federal civilians	4
Cap increases in military basic pay	2
Non-Defence Discretionary Programs	
Limit highway funding to expected highway revenues	11
Eliminate federal grants for drinking water/wastewater facilities	4
Increase fees for aviation security	2
Trim funding for National Institutes of Health	4
Raise payments from tenants in federally assisted housing	4
Eliminate the transit Starts programs	2
Finance Food Safety & Inspection Service through fees	1

* Includes medical services such as visits to doctor, medical equipment and supplies and mental health services. Source: Congressional Budget Office, November 2012.

One solution to the fiscal cliff is a multi-stage approach, with the first stage extending a sizeable portion of the expiring tax relief, beginning with the Bush tax cuts for all brackets up but the top bracket where compromise is required. In 2013, the sequester would be replaced by a package of further reductions, in addition to the caps on discretionary appropriations already in place from the *Budget Control Act of 2011.* Staging the solution would buy some time to develop a framework for the long-awaited overhaul of the U.S. tax code and a strategic expenditure reduction plan. Yet this is a tall order, given the failure of Congress before the November elections to pass the required appropriations legislation for FY13 and the history of stand-offs on a number of unresolved issues.

Highlighting the risk is a statement by Moody's Investors Service following the November elections, updating their earlier remarks. If policymakers can reach a consensus that stabilizes and then reduces the U.S. federal debt relative to GDP, the rating agency indicates that it would likely affirm the United States' Aaa sovereign rating and shift the outlook from negative back to stable. If the fiscal cliff is allowed to occur, even with the immediate deficit improvement Moody's would delay considering a return to a stable outlook until there is evidence that the U.S. economy can rebound from the shock. For a scenario implementing bridging measures in order to develop a more comprehensive strategy, Moody's warns that an apparent lack of commitment to agreeing on reforms on a credible deficit reduction schedule would be 'inconsistent with maintaining the highest Aaa rating'.

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