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# Cliff Notes

## *Thoughts on the Partial Fiscal Cliff Resolution*



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Since everyone's talking about cliffs these days, you might be interested to know that the biggest cliff in the world is the east face of the Great Trango Tower in northeast Pakistan. With a mind-numbing plunge of 4,396 feet (1,340 meters), Great Trango is the greatest nearly vertical drop in the world. Picture the U.S. fiscal cliff transposed onto Great Trango's drop of over eight-tenths of a mile, and imagine a year-long free-fall that began at midnight on January 1 — the official edge of the fiscal cliff. With the U.S. Congress passing legislation to avert the worst of the cliff's enormous tax hikes late in the evening of January 1, this would equate to a fall of only about 12 feet from the top of the cliff. Not a terrible fall, but with the U.S. having stared at a possible plummet of over 1.3 kilometers and Democrats and Republicans arguing over the only parachute, the relief at a deal — any deal — was palpable.

The overall impact of the legislation is slightly friendlier than we had anticipated, though far from a perfect resolution, or the "grand bargain," that many had wished for. We will summarize some of the major features of the legislation and the potential impacts on economic growth for 2013 and beyond.

## The Deal

Hashed out on December 31, the legislation practically sailed through the Senate, with 89 voting for it and 8 voting against. The House of Representatives passed the measure late on the evening of January 1 with a margin of 257 to 167. The final measure is heavy on tax fixes, but light on spending solutions. Here are some of the main features:

- The tax cuts from early last decade were permanently extended for households with less than US\$450,000 of income or individuals with less than US\$400,000. For those incomes above these levels, the marginal tax rate rises from 35% to 39.6%.
- The tax rate on capital gains and dividends moves from 15% to 20%.
- Limits on itemized deductions will be reinstated for households and individuals with income of US\$300,000 and US\$250,000, respectively.
- The payroll tax holiday that reduced withholding by two percentage points was not extended, so all workers paying that tax will face some loss of disposable income.
- The alternative minimum tax (AMT) was patched for last year and indexed to inflation, so it will not hit a multitude of middle income taxpayers.
- The surge in the estate tax was also corralled and limited to a rise in the top rate from 35% to 40%; the current five million dollar exemption per person was permanently extended and will be adjusted for inflation.
- There is a one-year extension of unemployment insurance benefits.
- The Medicare "doc fix" was extended, meaning no reduction in payments to medical providers for one year.
- The automatic budget cuts (sequestration) that were to go into effect were delayed for two months.
- "Bonus depreciation" was extended for a year, meaning that businesses can still deduct 50% of the cost of many types of investments.
- There were a variety of other tax expenditures that were extended, plus a change to a dairy program that avoided the "dairy cliff," which could have doubled the retail price of milk.

## CLIFF NOTES: THOUGHTS ON THE PARTIAL FISCAL CLIFF RESOLUTION

**The Results** — Overall, there is bound to be a drag on U.S. economic growth in early 2013 as the economy adjusts to the tax implications not only from this legislation, but also from the tax effects of the Affordable Care and Patient Protection Act (a.k.a. “Obamacare”) that take effect this year. All of this suggests to us slower growth in the first half of the year. And if the higher tax rates on capital and investment are not tempered with broad-based tax reform later this year or next, there could be some long-term reduction in the potential growth rate of the U.S. economy. Further, with new spending and no budget cuts, there is no way this bill could be called deficit reduction — trillion-dollar deficits are still ahead as far as the eye can see. So while it avoids the worst of the immediate economic drag, the partial resolution sets up two months of policy uncertainty about the spending side of the budget. This likely means that financial markets will remain volatile and gains may be tempered until the debt ceiling and spending debates are resolved, hopefully in late February or early March.

**The Positives** — While the government’s solution fell short of the grand bargain that many wanted, there were some notable achievements. Congress resolved tax policy uncertainty and likely avoided a tax-induced recession. Middle-income earners have more certainty about their tax situation, and may be more apt to boost consumption with that knowledge in their pocket. This would, in turn, be good for businesses, which could ramp up output to meet that renewed demand. Also, small businesses have less to worry about from estate taxes. Another big positive is that the contentious debate has more or less forced the vast majority of Congress to recognize that tax hikes are indeed an economic drag. Further, the delay of the sequestration spending cuts, the extension of unemployment benefits, and the higher threshold for tax rates increases were all slightly better than we had expected for our baseline economic scenario.

**The View from the Edge** — Looking ahead, consumer confidence has improved to recovery-era highs over the last few months and this bill should not diminish that. U.S. home prices are rising and residential housing is super affordable. The drags from spending cuts and layoffs by state and local governments are likely over. Meanwhile, business profits have been robust and balance sheets continue to be strong. Interest rates are ultra-low and lending standards are easing. Coupled with an improving recovery in China and lower odds of a calamity in Europe, the outlook for 2013 may have gotten a little bit better.

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