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Economic Brief - The Budget Deal

- *The House (by a vote of 257-167) and the Senate (by a vote of 89-9) approved the Senate's plan to avoid most of the fiscal cliff. The president is expected to sign the bill into law.*
- *The plan would raise taxes on upper income households, provide a permanent fix to the Alternative Minimum Tax, and postpone spending cuts for two months. It does not prevent a 2% increase in payroll taxes, which will have a significant impact on consumer spending growth in the near term, nor does it address the federal debt ceiling.*
- *The deal sets up further confrontation over spending cuts, the debt ceiling, and the longer-term budget outlook.*

A summary of the package:

Marginal tax rates rise permanently to 39.6% (from 35.0%) for upper income households (individuals with incomes above $400,000, families with income above $450,000). Marginal tax rates for others permanently remain lower.

The tax rate on **capital gains and dividend income** for upper income earners permanently rises to 20% (from 15%), but stays permanently the same (15%) for everyone else.

The **estate tax** will rise to 40% with a $5 million exemption (which will now be indexed to inflation).

Spending cuts (the sequester) will be delayed for two months.

Tax breaks for low-income earners (the Earned Income Tax Credit, the Child Tax Credit, and the American Opportunity Tax Credit) will be extended for five years.

Temporary tax breaks for businesses will be extended for another year.

The **Alternative Minimum Tax** will be permanently patched (no more annual fixes).

Limits on tax exemptions and deductions for upper income earners will be re-imposed: Personal Exemption Phaseout (PEP) and the itemized deduction limitation (Pease) starts at $250,000 for individuals and $300,000 for families. Note that these provisions do not alter the municipal bond exemption.

Scheduled cuts to doctors under Medicare will be postponed for a year, to be paid for by unspecified cuts to spending.

Federal unemployment insurance benefits will be extended for another year.

The individual **payroll tax** rate rises from 4.2% TO 6.2%. For someone making $60,000 per year, this would amount to a reduction in take-home pay of $100 per month.

A nine-month farm bill was attached to the deal (avoiding the "milk cliff").

Analysis:

The Senate deal has its detractors. The far right opposes any increase in taxes and felt that there weren't enough cuts in spending. The far left believes that too much was given away and the White House "squandered" a clear negotiating advantage. In the House, Democrats voted 172- 16 to approve the plan, while Republicans voted 85-151, signaling a troubled leadership (this was already evident in the House's failure to vote on the leadership's package in mid-December).

The biggest economic impact will come through the increase in payroll taxes, which is expected to shave about a full percentage point from consumer spending growth in 1Q13. The failure to extend the 2% payroll tax reduction was not a surprise, as there was little support from either party. Payroll taxes are there to support Social Security, so the 2% reduction generated some strains in the long-term outlook for the program. Tax increases for upper income households should have only a minor impact on consumer spending and overall economic activity.

The package does relatively little to address the long-term budget shortfall, reducing the projected 10-year deficit by only $600 billion (vs. $4.5 trillion if the full fiscal cliff had hit), not counting added interest expense. The U.S. is still lacking a plan to reduce the budget deficit over the long term.

The passage of the budget deal removes major uncertainties about tax policy, which is helpful for the stock market. Equity futures are higher on the news. However, deficit reduction in the plan was less than anticipated, a negative for the bond market (higher bond yields) and the dollar. S&P downgraded the credit rating of the U.S. in 2011, citing the inability of the two parties to come together to deal with the long-term budget outlook. The current budget package should be enough to prevent another possible downgrade, but not by much.

The package also sets up a mini-cliff in two months. Large spending cuts (the sequestration) are now set for March 1. In addition, Treasury has bumped up against the debt ceiling. Treasury can take evasive action to fund the government for another two or three months, but Congress must act to raise the ceiling over the next several weeks. Many House members are furious about the budget package and will be looking for more spending cuts and reforms to entitlement programs in exchange for raising the debt ceiling. At some point, after the near-term euphoria subsides, market participants are likely to turn their focus to Washington's unfinished business.