January 2, 2013

TD Economics

Data Release: U.S. Congress Avoids Fiscal Cliff but Leaves a Number of Questions Unanswered

- On January 1st, the U.S. House of Representatives joined the Senate in passing a bill that extends permanently income tax rates on 98% of American households and puts off $110 billion automatic spending cuts for another two months. The deal effectively avoids the fiscal cliff, but still leaves in place a fair degree of policy uncertainty, which we detail in the "implications" section below.

- The biggest single item in the bill is the permanent extension of income tax rates originally put in place in 2001 and 2003 for all income below $400,000. This takes off the table a potential economic drag of roughly 1.5 percentage points.

- For income above $400,000, tax rates rise to 39.6% from 35%. According to the Joint Committee on Taxation, this tax increase is expected to raise about $395 billion over the next 10 years and about $35 billion in 2013, equivalent to about 0.2% of GDP.

- Tax rates on capital gains and dividends will remain at 15% for income below $400,000, but will rise to 20% for income over $400,000. Within this income threshold, estate taxes also rise from 35% to 40% with an exemption of $5 million.

- The Alternative Minimum Tax (AMT) is patched permanently to avoid raising taxes on middle-income tax payers.

- The bill extends for another year unemployment benefits for people unemployed longer than 26 weeks at a cost of about $30 billion.

- The bill does not extend the payroll tax holiday. Payroll taxes will immediately rise from 4.2% to 6.2%. This represents an average tax increase of $700 on all U.S. households.

- There were a number of other numerous items, including an extension of tax breaks for low-income Americans including the Earned Income Tax Credit, and the Child Tax Credit, as well as for businesses through tax credits for R&D and a one year extension of 50% bonus depreciation – allowing businesses to write off 50% of the value of new investments.

Key Implications

- As expected, America avoided the fiscal cliff with an eleventh-hour deal. The basic structure was close to what we anticipated in our December forecast (link). In particular, the single biggest drag on near-term economic growth was expected to come from the expiration of the payroll tax cut. Its expiration was already embedded in our forecast, as was the preservation of middle-income tax cuts.

- However, the legislation veered from our expectations in one important area – the two month deferral in spending cuts. This, among other measures such as a higher income tax hike threshold, means Congress passed a weaker version of legislation relative to our expectations. In turn, this means less economic drag in the near term.

- TD Economics has revised up its real GDP growth forecast for the first half of the year from 2.1% to 2.3%. However, bear in mind that spending cuts remain on the front burner in Congress and will occur in some fashion after the two month grace period. Thus, modest upward revisions to the first half of the 2013 will likely be met with modest downward revisions to the second half and potentially even 2014, once details on the spending cut measures are known.

- For that reason, our 2013 real GDP forecast remains little changed at 2.5% (fourth quarter to fourth quarter), compared to 2.4% in our December forecast. In other words, the basic story for the US economy has not changed.

- On the surface, a little more economic relief in the near term via less fiscal contraction seems like a positive development. But, the current legislation leaves considerable economic and policy uncertainty:

  - First, it lessens, but does not remove uncertainty related to fiscal consolidation. The lack of clarity on spending cuts could result in a persistence of underinvestment by firms, particularly those still caught in the spider web of negotiated political outcomes (industries in defense, health care, those dependent on procurement contracts).

  - Second, negotiations related to the deferral of the $110 billion in spending cuts will coincide with when the debt ceiling limit is again maxed out, as the Treasury will have likely exhausted extraordinary measures by that time. This may turn into a déjà-vu of August 2011, when the lifting of the debt ceiling was used as the bargaining tool that ultimately created the fiscal cliff measures. Based on the 2011 experience, if these negotiations overlap and run down to the wire, it will likely inject another hefty dose of uncertainty into financial markets and restrain the economic recovery.

  - Third, until we know what measures will take place on spending cuts, the trajectory of the debt-to-GDP ratio will continue to worsen.

  - Fourth, whatever deal ultimately is made over the next two months on discretionary and defense spending cuts, reform still needs to occur with entitlements, which present to the largest source of cost pressures on US debt. Entitlement reform was not part of the near-term fiscal cliff measures, but the debt-to-GDP ratio cannot be stabilized in its absence unless draconian measures take place elsewhere.

  - So, Congress made a good first step yesterday, but many more still need to be taken. Stay tuned, we're just at the 100 meter mark of this relay race.

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