U.S. Flash

New Year Brings Partial Resolve to Fiscal Cliff

- **Congress finally settles on fiscal agreement, but a lot left up in the air**
- **Among the various issues addressed, the Bush tax cuts will expire for the wealthy**
- **Automatic spending cuts will be delayed two months pending further negotitations**

After months of uncertainty and struggle to reach a compromise in Congress, lawmakers finally voted on a deal to avoid falling completely off of the fiscal cliff. The agreement, voted on early New Year's Day by the Senate, was finally passed by the House late at night, just days before the new Congress is sworn in.

Tax reform dominated much of the heated debate in recent weeks, but the Democrats and Republicans finally reached an agreement in order to avoid a significant impact on economic activity, at least in the short-term. The deal will extend the Bush tax cuts for individuals making less than $400,000 (families less than $450,000) and will also maintain existing policy on long-term unemployment benefits for 2 million people through 2013. Furthermore, the agreement does limit some deductions for those making $250,000 (married couples making $300,000), partially helping Obama to keep his campaign promise to raise taxes on the "wealthiest Americans." Under the deal, tax rates on capital gains and dividends will increase from 15% to 20%, remaining lower than the pre-2001 rates. Obama's stimulus tax credits will be extended for five more years, and the alternative minimum tax (AMT) will be permanently adjusted for inflation. Doctors who take Medicare patients will continue to receive reimbursements, but outside of Obama's healthcare law. Initial estimates suggest that the deal would result in approximately $600bn in new tax revenues throughout the next 10 years. The deal does not address the expiring payroll tax cuts, so consumers will see a dip in disposable personal income.

Despite the compromise on taxes, a solution to the automatic spending cuts defined in the Budget Control Act of August 2011 was postponed. These cuts to federal spending, referred to as the sequester, will total $110bn per year across both defense and non-defense programs. Given the severity of these spending cuts to economic growth, Congress decided to delay the sequester for two months, ultimately kicking the can further down the road as we have expected all along. In addition, the deal does not address the debt ceiling which will need to be increased in order for the Treasury to continue borrowing. With this, we have come full circle back to where we were in August 2011 when Congress voted to address tax reform and spending cuts by 2013 in order to approve the debt limit increase. Republicans will likely try to use the incoming debt ceiling debate as a way to push further spending cuts. Negotiations will continue through the next few months with the hopes of preventing another credit ratings downgrade as in summer 2011.

Bottom Line: The Drama Never Ends in Congress

For both parties, the political cost of the fiscal cliff was too high to leave it unresolved; this is why they were able to find at least a partial solution to the problem, focusing on tax increases, where effects would have been felt immediately by the population. Although the New Year's deal will prevent the economy from going into another severe recession, the outcome is still far from the Grand Bargain needed to achieve fiscal sustainability in the long-term. The President hopes that Congress will be able to "put a package like this together with a little bit less drama, a little less brinksmanship (and) not scare the heck out of folks quite as much", but the facts suggest that polarization is still the common denominator in Washington and the outlook for a more cooperative political environment is still grim. In fact, the new Congress may provide little relief to the brinkmanship for upcoming negotiations on spending cuts and the debt ceiling. The following months will be plagued with bitter and resentful discussions that will add uncertainty to the economic outlook and increase the risk of another downgrade of the U.S. debt.

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