Understanding the fiscal cliff

What is the fiscal cliff?
The term fiscal cliff describes a host of significant tax increases and spending cuts that are scheduled to take effect beginning in January 2013. The scheduled tax increases include:

- The expiration of 2001 to 2003 individual income tax cuts and estate tax relief
- An additional 26 million taxpayers subject to the alternative minimum tax in 2012
- The implementation of an increase in the employee portion of the Hospital Insurance (HI) tax on wages over a certain amount ($250,000 for joint filers), and a new HI tax on net investment income over a certain amount ($250,000 for joint filers)
- The expiration of a temporary reduction in the employee payroll tax rate

The chart below summarizes scheduled tax rate increases.

<table>
<thead>
<tr>
<th></th>
<th>Wages</th>
<th>Interest Income</th>
<th>Dividends</th>
<th>Capital Gains</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012 Top Rate</td>
<td>36.45%</td>
<td>35.0%</td>
<td>15.0%</td>
<td>15.0%</td>
</tr>
<tr>
<td>2001/2003 Tax Cut Expiration</td>
<td>+4.6</td>
<td>+4.6</td>
<td>+24.6</td>
<td>+5.0</td>
</tr>
<tr>
<td>Phase-Out of Itemized Deductions</td>
<td>+1.2</td>
<td>+1.2</td>
<td>+1.2</td>
<td>+1.2</td>
</tr>
<tr>
<td>New HI Tax</td>
<td>+0.9</td>
<td>+3.8</td>
<td>+3.8</td>
<td>+3.8</td>
</tr>
<tr>
<td>Total Increase in Rate</td>
<td>+6.7</td>
<td>+9.6</td>
<td>+29.6</td>
<td>+10.0</td>
</tr>
<tr>
<td>2013 Top Rate</td>
<td>43.15%</td>
<td>44.6%</td>
<td>44.6%</td>
<td>25%</td>
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</tbody>
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The maximum federal estate tax rate is scheduled to revert to 55% with a $1 million per-person exemption amount (versus 35% with $5.12 million per-person exemption in 2012).

Who are the Key Players?
This is increasingly viewed as a negotiation between President Obama and Speaker of the House John Boehner, while the Senate is playing a supporting role. President Obama ran his campaign, and won re-election, on the promise that tax rates for upper income Americans would increase. Thus, the President and his congressional allies believe they have a mandate to increase tax rates and that a failure to avoid the fiscal cliff would be primarily blamed on Republicans. Speaker Boehner’s (R-OH) most recent negotiating proposal acknowledges that additional federal revenue will be part of a fiscal cliff deal. However, Speaker Boehner and congressional Republicans prefer that revenue come from tax reform that closes “tax deduction and loopholes,” rather than increasing rates.

Key Factors.

• **Key Dates.** Most obviously, any deal that successfully avoids the fiscal cliff must become effective on or before December 31, 2012. In addition, due to congressional parliamentary procedures and budget requirements, a deal that successfully avoids the fiscal cliff must begin to coalesce by the middle of the third week of December.

• **Two-step Process.** Both negotiating parties agree that there is not sufficient time to come to an agreement on a “grand bargain” that provides comprehensive tax and entitlement reform. Instead, it is likely that a deal to avoid the fiscal cliff will include a framework for comprehensive tax reform in 2013. To accomplish this goal, an agreement must include an expedited process for tax reform and some sort of triggering mechanism to force tough action next year.

What Might Happen.

• **A Deal is Reached.** It is more than likely that a modest compromise solution will be reached either before year-end or in the first half of January. However, it is difficult to know what the parameters of such an agreement would look like at this time. If a compromise solution is agreed to, the economy should continue to grow at a modest pace in 2013 (although current uncertainty with regard to the fiscal cliff will likely slow growth early in the year), allowing the unemployment rate to edge down slowly, keeping inflation contained, and ensuring that the Federal Reserve keeps monetary policy exceptionally accommodative. These things suggest that interest rates will remain very low, the demand for riskier assets will rise (reducing credit spreads), and equity prices should end 2013 above year-end 2012 levels.

Ultimately, we see Congress and the President reaching a deal as the most likely outcome. However, to avoid the fiscal cliff, the expiring tax and spending cuts must be temporarily extended, and the President is seeking at least $800 billion in new tax revenue. Despite Republican objections, that new revenue will likely come in the form of higher tax rates for some subset of Americans. A possible compromise that would allow both sides to claim some element of victory would be an increase in the top marginal tax rate above the current 35% rate but below the 39.6% threshold the President is seeking. Consequently a deal on tax rates could reasonably include a top rate increase to 37 or 38%. The threshold of those individuals subject to higher rates may also increase from the President’s proposed $200,000 ($250,000 joint-filer) limit, to somewhere closer to a $500,000 or $1 million dollar threshold.

Broad tax reform could be on the table, but in the past it has taken a couple of years for tax reform agreements to occur, so 2013 could be a year of tax reform discussion. We believe it is unlikely that any substantial changes in the tax code will go into effect before 2014, at the earliest. It is difficult to know what the parameters of broad tax reform would look like at this time.

• **Failure to Reach a Deal.** While perhaps less likely, it is still possible that the negotiating parties will fail to reach a deal, resulting in the U.S. economy potentially falling into a recession. In this unlikely scenario, we would expect the unemployment rate to climb toward double-digit levels, inflation to slow further, a drop in the dollar value, credit risk spreads to increase, and equity prices to fall sharply. The Federal Reserve would act to stem the downturn by purchasing Federal government debt more rapidly, pushing interest rates down more. The economy would begin to recover in 2013, with 2014 being a modest recovery year.

Should there be a failure to reach a deal, it remains unlikely that policymakers will allow the corresponding tax hikes and spending cuts to remain in place permanently. This significant negative market reaction provided the impetus for many members to ultimately vote in favor and pass the program. Likewise, should policymakers fail to reach an agreement on the fiscal cliff before December 31, a negative market reaction may be enough to force additional compromise from the negotiating parties.