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November 14, 2012

What is the So-Called Fiscal Cliff?

> **Defining the "fiscal cliff"**
> - Bush-era tax cuts expire
> - Spending is cut under sequestration
> - Medicare physician payments are cut
> - Temporary assistance expires
> - Routinely extended tax cuts expire
>
> **First year fiscal impact (FY 2013): $503 billion**

The federal budget is approaching what has been commonly called a "fiscal cliff" at the end of the year. It is when a number of tax cuts and temporary assistance measures expire, deep spending cuts are triggered across government services and even deeper cuts are scheduled in Medicare doctor payments, all near the time when the nation will reach its debt limit. The non-partisan Congressional Budget Office (CBO) and others have forecast that the economic effects of a net $503 billion increase in revenues and decrease in outlays in fiscal year (FY) 2013 could trigger another recession next year.

Federal Reserve Chairman Ben Bernanke and two bipartisan fiscal commissions have warned to take pains not to disrupt economic growth in the short term while pursuing a necessary longer-term deficit reduction package. Therefore, any successful proposal will need to create jobs in the short term while also addressing the need for deficit reduction in the long term. President Obama laid out a plan in his American Jobs Act, which was released more than a year ago, but the House of Representatives failed to even schedule a vote on many of the components that would directly create jobs. For instance, that package provides a payroll tax credit for employers who hire new workers, and includes billions of dollars for school modernization, infrastructure investment, and hiring and retaining teachers and first responders in our communities. Enacting these types of job-creation proposals would strengthen the economy while we also pursue long-term deficit reduction.

Last week, CBO released a report estimating the budgetary and economic impacts associated with preventing different parts of the scheduled spending cuts and tax increases. The following analysis from the House Budget Committee Democratic staff describes the looming budgetary changes, briefly summarizes their effects, and describes some of the alternatives proposed by Democrats and Republicans.

Expiring Tax Cuts

The 2001-10 Tax Cuts

The 2001-10 tax cuts (the Bush-era tax cuts) are set to expire at the end of the year. The key expiring provisions include:

- Top tax rates of 35% and 33%, which would revert to 39.6% and 36%
- Elimination of the phase-out of personal exemptions and itemized deductions at high incomes (instead of a return of these phase-outs)
- The 15% tax rate on capital gains and dividends (instead of a 20% rate on capital gains and ordinary tax rates applied to dividends)
- The 10% income tax bracket
- Several provisions benefiting married couples, including a larger standard deduction, a 15% tax bracket that ends at a higher income level, and an EITC benefit that begins phasing out at a higher income level
- The $1,000 child tax credit refundable above $3,000 of earnings (that reverts to a $500 child tax credit that is not refundable and thus only offsets taxes owed)
- Enhanced credits for child care and adoption
- Several tax incentives for higher education
- A per-spouse estate tax exemption of $5 million and tax rate of 35% (which will revert to an exemption of $1 million per spouse and a 55% tax rate)
- A "patch" for the alternative minimum tax (AMT) such that only 4 million high-income taxpayers have to pay it (as opposed to 30 million taxpayers, including many who are upper middle class, who would owe AMT otherwise)

As part of their deficit reduction proposals, Democrats and the President have proposed to save $1 trillion by allowing the tax cuts on income over $250,000 for couples (over $200,000 for singles) to expire while extending all the rest of the "middle class" portions of the tax cuts, including estate tax relief and an AMT patch. Specifically, the President has proposed to:

- Extend all lower tax rates while allowing the 35% and 33% tax rates to revert to 39.6% and 36% respectively – the same top tax rates in effect under President Clinton, when the economy created 23 million jobs
- Reinstate (but harmonize) the phase-outs of personal exemptions and itemized deductions to apply to upper-income households only
- Extend the 15% rate on capital gains and dividends to families with incomes below $250,000 ($200,000 if single) while applying a 20% tax rate to capital gains and ordinary tax rates to dividends for upper-income households
- Extend the tax relief provisions for married couples, including the enhanced EITC benefit
- Extend the $1,000 child tax credit refundable above $3,000 of earnings
- Extend the enhanced credits for child care and adoption

- Extend several tax incentives for higher education
- Reinstate 2009 law regarding the estate tax: a per-spouse estate tax exemption of $3.5 million and tax rate of 45%
- Patch the AMT such that only around 4 million high-income taxpayers have to pay it

The Extenders

A number of key business and individual tax relief provisions have either already expired or are due to expire at the end of the year, ending $73 billion of tax relief. The top four "extender" provisions are:

- The research and development tax credit – $14.3 billion
- Tax credits for renewable energy production – $12.2 billion
- Subpart F active financing exception – $11.2 billion
- Deduction for state and local general sales taxes – $4.4 billion

There is generally broad bipartisan support for the tax extenders, although Republicans tend not to support extending the tax credits for renewable energy. House Republicans have vowed to trim down the number of tax extenders, but it is likely that Democrats and Republicans would mostly agree on what to continue.

The expiration of all of the 2001-10 tax cuts (including the AMT patch) and the tax extenders will increase revenues by $330 billion in FY 2013. CBO estimates that allowing all of these tax cuts to lapse will subtract 1.4 percentage points from economic growth next year.

Sequestration

The Budget Control Act required Congress to develop a bipartisan plan to achieve long-term deficit reduction, and provided an impetus by setting up automatic, indiscriminate budget cuts under sequestration as the deficit-reduction mechanism of last resort. Every bipartisan group that has examined the budget challenge has recommended a balanced approach to deficit reduction that includes a mix of targeted spending reductions and revenue increases. Because Republicans have resisted such a balanced approach – up until now refusing to consider reducing the deficit by even one penny from increased taxes – Congress has not enacted the required deficit reduction, so sequestration will go into effect on January 2. The sequester will cut nearly $110 billion in spending for FY 2013, half from defense and half from non-defense spending.

In a September report to Congress, the Office of Management and Budget listed which accounts would be exempt and which would be cut, as well as a rough estimate of how large a cut each category would face at that time. Many entitlement programs – including

the Supplemental Nutrition Assistance Program (SNAP), Medicaid, and Social Security – are exempt from sequestration, and Medicare is generally subject only to a 2 percent cut in payments to providers.

Republicans propose only damaging spending cuts to replace the FY 2013 sequester

House Republicans used the fast-track procedures provided under budget reconciliation to push their budget resolution's harmful priorities as a replacement for next year's sequester savings. Their reconciliation bill makes permanent mandatory spending cuts and lowers the FY 2013 discretionary spending cap by $19 billion below the level set in the Budget Control Act, but leaves in place the sequester of non-defense mandatory programs, which will cut programs such as Medicare. This Republican plan targets programs that help the vulnerable – including reducing food assistance to everyone who receives SNAP benefits, and eliminating health care coverage for at least 300,000 low-income children – while protecting the tax breaks of powerful special interests. In fact, the reconciliation package makes deep cuts to food and nutrition programs for low-income families and Medicaid, both of which are entirely exempt from any sequestration cuts.

House Republicans subsequently passed a similar bill supporting a cancellation of the FY 2013 sequester if Congress first enacted other legislation – either the Republican reconciliation bill described above or another bill that cuts spending by the same amount. This bill explicitly rejects any revenue increases to cut the deficit.

Republican long-term plan relies on deep spending cuts year after year

The Republican budget resolution is a long-term plan that relies on deep, unspecified spending cuts on non-defense spending for all of its deficit reduction. Its total discretionary spending levels assume that sequestration takes effect after FY 2013, but it takes all of the required cuts on the non-defense side of the budget. The Republican budget hides the impact of these draconian cuts by including almost $1 trillion in unallocated non-defense spending cuts – cuts that could fall on any and all non-defense services, such as education, public health and safety, veterans' health care, law enforcement, or transportation and infrastructure, to name just a few. At the same time the Republican budget accepts these post-sequester discretionary spending levels, it extends tax cuts for the wealthy and special interests, again rejecting any deficit reduction from revenue increases.

Democratic proposals for a balanced approach to prevent sequestration

In contrast to the Republican plans that rely solely on cuts to non-defense spending, Democrats have proposed various short- and long-term alternatives to reduce the deficit through a balanced approach from a combination of targeted spending cuts and cuts to tax breaks for the wealthy and powerful special interests. First, the President provided Congress with specific policies for long-term deficit reduction both last fall and in his FY 2013 budget. This spring, the House Democratic budget proposed to replace the deficit

reduction from ten years of meat-ax spending cuts under sequestration with a combination of mandatory spending cuts aimed at improving efficiency and reducing waste, as well as revenues from eliminating tax loopholes and asking millionaires to return to the same top tax rate they paid during the Clinton Administration, a time of strong economic growth and fiscal responsibility.

House Democrats also proposed a short-term substitute to the Republican reconciliation bill's savings. It proposed a mix of spending cuts to agriculture subsidies and increased revenues from ending taxpayer subsidies for big oil companies and asking millionaires to share greater responsibility in reducing the deficit. House Republicans refused to hold a vote on this balanced approach to deficit reduction.

Medicare Physician Payments

Current law requires a 27 percent cut in Medicare payment rates to physicians in calendar year 2013. This requirement stems from the Sustainable Growth Rate (SGR) formula, which was created in 1997 to control federal costs by attempting to limit total growth in spending on Medicare payments to physicians. The SGR sets annual and cumulative spending targets that accommodate growth in Medicare fee-for-service enrollment, inflation, real per capita Gross Domestic Product, and changes in law or regulation that have the effect of increasing spending on Medicare physician payments. Actual spending, however, has often grown at a faster rate than allowed under the formula, largely due to increases in the volume and intensity of medical services supplied per enrollee. The SGR formula requires that when actual spending exceeds the targets, payment rates for physician services must be adjusted downward. Congress enacted short-term fixes for 2003 through 2012 to prevent the payment rate reductions that otherwise would have taken place under the SGR formula. The latest "doc fix" runs through December 31.

There is bipartisan agreement that the SGR formula is unworkable and needs to be replaced with a more realistic payment system that includes appropriate incentives for providing high-quality, efficient care. The cost of replacing the SGR has so far proved a major barrier to reform. As an illustrative example, simply preventing further rate cuts for the next ten years would cost $271 billion. It is possible that some of the costs of replacing the SGR can be offset through substantive reforms to the physician payment system, but there will likely be a need for further offsets. House Democrats have called for using some of the savings from winding down the wars in Iraq and Afghanistan to pay for SGR reform.

Expiring Short-term Provisions

Extending emergency Unemployment Insurance (UI) benefits

Emergency UI benefits delivered by the Emergency Unemployment Compensation (EUC) program currently provide about 2 million people an average of $300 per week, according to the Center on Budget and Policy Priorities. The expiration of these expanded benefits at year's end will deprive the economy of high bang-for-the-buck spending, as UI recipients typically spend most of the benefits they receive. While the EUC program normally allows people to receive their full allotment of weeks of unemployment benefits, Congress's most recent extension of the program called for a "hard" cut-off that would abruptly end benefits for all recipients at the end of the year.

Policymakers have instituted a federal emergency UI program in every major recession since 1958 and have never allowed benefits to expire while the unemployment rate was above 7.2 percent.

The Payroll Tax Cut

The 2 percent cut in employees' share of the payroll tax that has been in effect since 2011 expires on December 31. CBO estimates that extending the payroll tax cut and emergency unemployment benefits for two years would boost the economy by 0.7 percentage points and save or create 800,000 jobs. By comparison, CBO also projects that the economy will shrink by 0.5% in calendar year 2013 (and that unemployment will rise to 9.1%) if all the scheduled budgetary changes take effect permanently. Therefore, extending the payroll tax cut and emergency unemployment benefits for another year (at a cost of $108 billion) has the potential to avert a recession. Extending these two provisions also delivers more "bang-for-the-buck" in terms of what they contribute to economic growth and job creation than extending the upper-income tax cuts.

Other Must-address Item: The Debt Ceiling

Although not considered to be part of the fiscal cliff, discussion about increasing the government's ability to borrow is likely to part of lame duck negotiations. There is a statutory limit on the overall level of federal borrowing, which is commonly referred to as the debt ceiling. The Department of the Treasury has indicated that the current debt ceiling of $16.394 trillion is likely to be reached before the end of the calendar year. However, Treasury has authority to take certain extraordinary measures that will provide additional time for Congress to act to increase the debt ceiling. Treasury believes those measures will push off the need for a debt ceiling increase until early calendar year 2013. If the debt ceiling is not increased by that time, the government would default on its obligations.

Failure to act on the debt ceiling would be irresponsible

A debt ceiling increase will be an essential element of any new fiscal framework to avoid significant disruptions in capital markets and the broader economy, and to maintain the government's ability to reliably borrow in capital markets. Playing brinksmanship with the government's ability to meet its obligations, as Republicans did in 2011, disrupts markets and ultimately can lead to higher interest rates faced by the government in the future. Markets would consider all of the government's transactions in evaluating the nation's fiscal soundness. It is not possible, for example, to pay bondholders but ignore other creditors, or to delay program benefits and suggest that a default has not occurred.

> **Catastrophic Costs of Default: Job Losses, Tax Increases**
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> "Default would effectively impose a significant and long-lasting tax on all Americans and all American businesses and could lead to the loss of millions of American jobs. Even a very short-term or limited default would have catastrophic economic consequences that would last for decades."
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> — Treasury Secretary Geithner letter to Senator Harry Reid, January 6, 2011

Debt ceiling increases reflect past decisions

An increase in the debt ceiling does not change the government's legal obligations or increase funding for any federal program. Increased borrowing merely allows the government to finance existing legal obligations. It is nearly impossible for Congressional decisions made in the next few months to significantly delay the time when an increase in the debt ceiling will be needed; that timing is based on hundreds of past funding and financing decisions already made by Congresses and Presidents of both parties.

Decisions on fiscal framework will impact need for future debt ceiling increases

As decisions are made on how to deal with the fiscal cliff and to develop a framework for the future, one goal will be to achieve a sustainable fiscal outlook. Sustainability is widely viewed as a set of policies that stabilize debt relative to the size of our economy. The more successfully that challenge is met, the smaller the need for increased borrowing will be in the future. However, even a successful fiscal framework that reduces spending and raises revenue will take a number of years to implement, only gradually narrowing the gap between the amount of the government's commitments and the amount of revenues to pay for those commitments. Therefore, additional increases in the debt ceiling will need to be made from time to time, as the absolute dollar value of borrowing rises (even while the increase in borrowing as a fraction of the economy diminishes). As an example, the House Republican budget called for raising the debt ceiling by some $5 trillion over the next ten years, even if the full Republican agenda – which slashed spending – was implemented.