

# Economic Insights

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## The Fiscal Debate Continues

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The fiscal debate has dramatically changed character and emphasis in just the past few months. Whereas last January President Obama only hinted at tax reform and spending cuts, they now have taken over the fiscal agenda. True, Republicans and the president remain far apart, and Washington is nowhere near a grand compromise, but it now looks as though the parties could agree on some bits and pieces, significant enough for markets to begin, but only just begin, to gain some confidence in progress on the deficit issue.

This is the fourth in Lord Abbett's occasional series in fiscal issues. The first took up the president's initial budget proposals. The second investigated the proposals for corporate tax reform that began to emerge after President Obama made his vague remarks in January's State of the Union address. The third reviewed the Republican budget proposals and how they differed dramatically from the president's. This discussion takes up President Obama's response to the Republicans. Though it remains distinct from the Republican proposals, the response is much closer than the president's initial proposals. The fiscal goal posts have moved.

Clearest in this movement is the president's responsiveness to spending cuts. Obama's original budget offered what can only be described as perfunctory efforts at spending restraint, concentrating exclusively on defense and the small section of the budget referred to as non-defense discretionary spending, mostly obscure programs. Now he proposes to cut a cumulative \$3 trillion from federal spending over the next 12 years. Combined with \$1 trillion in revenue increases from tax hikes, he now speaks of deficit reductions of a cumulative \$4 trillion over this time. The figure still falls far short of the Republican proposals, which would cut almost \$6 trillion cumulatively off the deficit during the next 10 years—two years faster than the president's proposal and derived exclusively from spending. But the president's proposals have changed significantly—and in a remarkably short time.

Aside from this general move, the following points contrast the major elements of the president's latest proposals with the Republican equivalent and the president's original budget, beginning with the areas of greatest difference between the parties:

- On *Medicaid*, the president rejected out of hand the Republican plan to fund the program with block grants to the states that would allow them discretion on how to administer the program. Cost control under the president's plans would come not from the state's efforts but from the commission designated in last year's healthcare reform law. In this, President Obama remained true to his original proposals.
- On *Medicare*, the president also rejected Republican proposals to change the government-run program gradually to one that, by 2022, subsidizes private insurance premiums for retirees. Whereas the Republicans look to competition between private insurers to hold down costs, the president would strengthen the commission authorized by last year's healthcare reform.
- On *personal income taxes*, President Obama has moved quite a bit from his original proposals. He had mentioned reform and simplification in his State of the Union address, but his budget offered nothing substantive except, of course, his plan to raise the maximum rate on higher-income Americans. In his latest proposals, he has moved toward the Republican plan to reduce statutory tax rates generally and eliminate deductions, though he seems to reject the Republican proposal to collapse the number of brackets and remains committed to exacting greater tax levies from higher-income Americans.

- On *corporate taxes*, the gap between the president and the Republicans is even narrower. The president would lower the statutory rate and eliminate some deductions and credits, as the Republicans have also proposed and as Obama outlined in his State of the Union message, but largely left out of his original budget proposal. Whereas he would like to raise tax collections from corporations, the Republicans look for neutrality or possibly a cut.
- On *defense* and *Social Security*, the sides are almost identical. Both would cut defense spending \$78 billion over 10 years according to the program outlined by Defense Secretary Robert Gates. On Social Security, neither the Republicans nor the president has proposed anything except general, bipartisan ways to put the system on a sounder financial footing. Neither of these points, however, differs in any way from the president's original budget proposals.

This latest set of Obama proposals did offer something not previously mentioned, by either the Republicans or the president himself. He would now seek what he referred to as a “debt failsafe” or “trigger” that would impose across-the-board spending cuts and tax increases if the nation’s debt relative to its gross domestic product failed to stabilize by 2014. The White House message’s use of the expression “across the board,” was, however, an overstatement. The president would excuse from these strictures particular entitlements—Social Security, Medicare, Medicaid, and other programs aimed at lower-income Americans—which are by far the largest part of the budget.

Even though the president has moved a long way toward the Republicans, the differences remain wide, too wide to look for any general or easy compromise anytime soon. The president clearly cannot accept any of the Republican proposals on Medicare or Medicaid. The Republicans cannot accept the tax increases on high-income Americans on which President Obama insists. Neither would they accept his proposed “debt failsafe,” because it includes tax increases and because it exempts entitlements. But positions on corporate tax reform are not that far apart and there is no difference to speak of on defense and Social Security. The president’s general movement alone speaks to the possibilities of future compromise, if not the nature of the compromise itself. Even the tax hike issue looks surmountable, if the president were to raise the cut off significantly and perhaps yield more on collapsing the number of brackets. There is nothing concrete yet, but there is more hope on this fiscal front than in a long time.

Milton Ezrati, Partner and Senior Economist and Market Strategist, has been widely published in a wide variety of magazines, scholarly journals, and newspapers, including *The New York Times*, *Financial Times*, *The Wall Street Journal*, *The Christian Science Monitor*, and *Foreign Affairs*, on a broad spectrum of investment management topics. Prior to joining Lord Abbett, Mr. Ezrati was Senior Vice President and head of investing in the Americas for Nomura Asset Management, where he helped direct investment strategies for both equity and fixed-income investment management.

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