

ECONOMICS: US PERSPECTIVES—DECEMBER 10, 2010

# Contentious Fiscal Policy Debate to Follow Initial Tax Deal

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After Congress approves the tax package that was negotiated this week, attention will turn towards long-term fiscal sustainability and tax reform. Reaching a political consensus will be challenging, but we think the new proposals from the Fiscal Responsibility panel provides a framework for an agreement.

When the Republicans won majority control of the House of Representatives in elections on November 2, it looked increasingly likely that an agreement would be reached to extend the Bush tax cuts, which are due to expire at the end of 2010. In fact, the new tax package negotiated this week between congressional Republicans and President Barack Obama was a big surprise.

### Tax Package Is Good for Growth

Tax negotiators exceeded the expectations of optimistic observers by agreeing to a package that is undeniably bullish for investment and economic growth. As a result, we're raising our above-consensus 2011 real GDP growth forecast by 0.5 percentage points from 3.3% to 3.8%, with all the incremental growth stemming from stronger business investment.

Had the tax cuts expired, all US taxpayers would have faced an increased tax burden in 2011 that would have weighed heavily on economic activity. The Republican victory meant that even if the outgoing

Congress does not approve a full extension of the tax cuts before year-end, the 112th Congress will almost certainly do so as soon as it convenes in January.

### Cuts Extended for Two Years

The key details of this week's deal (**Display**) include a full extension of the Bush tax cuts for the next two years. It also maintains the current 15% tax rate for capital gains and dividends, and allows companies to expense 100% of equipment purchases for 2011 and 50% for 2012.

The employee share of the payroll tax was reduced for one year by two percentage points from 6.2% to 4.25%. A new 35% estate tax rate will be levied on estates worth at least \$5 million. (The estate tax was repealed for 2010 and was scheduled to be reinstated in 2011 at 55% for estates over \$3 million.) In addition, according to the agreement, the alternative minimum tax will be extended, while unemployment compensation benefits will remain at their current level through the end of 2011.

#### Display Pro-Growth Tax Deal

Outlines of White House / Congress Tax Deal

1. Tax Rates:  
Extend Bush-era tax rates for two years
2. Payroll Tax:  
Reduces employee tax by two points for one year
3. Alternative Minimum Tax:  
Two-year extension
4. Bonus Depreciation:  
Full expensing in 2011 and 50% in 2012
5. Estate Tax:  
A two-year tax rate of 35% for estates over \$5 million
6. Unemployment Compensation:  
13-month extension
7. R & D Tax Credit:  
Two-year extension
8. Child and Earned Income Tax Credit:  
Two-year extension

Source: Washington Research, White House and AllianceBernstein

The main surprises in the proposed agreement are a continuation of a favorable treatment of dividend and capital gain income. These tax rates were widely expected to increase to at least 20%, as Obama's administration had suggested earlier. Two additional features of the package were designed to spur economic growth: the full expensing of investment in new equipment as well as the inclusion of

the payroll tax reduction for workers, which should increase cash flow and hopefully prompt more spending.

Approval of the package is highly likely, since it already has secured the President's endorsement, while Republicans were the key architects of many items in the bill. Democratic representatives may object to some components, which could temporarily delay approval of the package in the House. But when the Republicans assume majority control in January, they're likely to bring up the legislation in the first few days and make all the tax laws retroactive to January 1.

### **Fiscal Commission Submits Proposals**

Talks on the tax package overshadowed another important milestone for US fiscal policy. Last week, the National Commission on Fiscal Responsibility and Reform, chaired by Erskine Bowles (former Chief of Staff to President Bill Clinton) and Alan Simpson (former Republican senator from Wyoming), completed its list of recommendations to Congress on achieving long-term fiscal sustainability for the US economy.

This Commission was created earlier in 2010 by Obama as a bipartisan panel of 18 members, and its final proposed package was an ambitious attempt to achieve a substantial deficit reduction of \$4 trillion through 2020. It also aims to ensure lasting solvency of Social Security by extending the retirement age and raising taxes on wealthier taxpayers. The third goal of the commission is to achieve comprehensive tax reform, by reducing marginal tax rates for individuals and businesses and eliminating or scaling back many itemized deductions such as mortgage interest payments.

For the final list of recommendations to be sent to Congress as legislation, it required

the approval of at least 14 of the commission's 18 members. In the end, 11 of the 18 members voted for the bipartisan package. The commission's failure to secure the 14 votes required to advance the package may have created the impression that the recommendation would carry less weight in upcoming congressional hearings.

### **Proposals Offer Hope of Change**

But we think achieving a modest majority in a bipartisan panel is a huge accomplishment since many historic pieces of legislation often pass with the slimmest of margins. Moreover, one of the supporters of the package was Kent Conrad (Democrat, North Dakota), Chairman of the Senate Budget Committee, who will lead the debate in the Senate on deficit reduction. Incoming House Budget Committee Chairman Paul Ryan (Republican, Wisconsin) voted against the proposal. However, Ryan's commitment to fiscal responsibility is evident in his recent legislative proposal "A Roadmap for America's Future," which aims to eliminate the federal deficit through substantial reductions in government spending.

### **Tax Reform Is Good Strategy**

In addition to broad and large cuts in federal government spending, the commission's plans also include recommendations for comprehensive tax reform, something that has been widely embraced both inside and outside Washington. By eliminating or scaling back many so-called tax expenditures (i.e. deductions) the commission has proposed much lower marginal tax rates. In our view, this is a good strategy to help improve the allocation of capital in the US and make the country's corporate tax system more competitive in the global economy.

Both the tax package negotiated this week and the Fiscal Responsibility proposals are crucial components of the short and long-term rehabilitation of the US economy. The extension of tax cuts is especially important in the short run to help the US economic recovery gain speed and breadth. In the long term, the second fiscal package is critical for fiscal sustainability and the vitality of the US economy.

### **Is Fiscal Consensus Possible?**

Although agreement on the tax package was achieved relatively quickly, reaching a politically viable consensus on the long-term fiscal proposals will be much more challenging. The current proposals are clearly just the first draft, which will be rewritten repeatedly as the debate heats up.

Investors should not ignore the panel's recommendations as they will form the basis for spending and tax law changes. History clearly demonstrates that real and financial asset prices are often influenced by incentives and disincentives in the tax code. Altering the tax code, even at the margin, would foster a fundamental change in investor behavior because it would profoundly affect the returns of real and financial assets.

In our view, fiscal policymakers must focus on reducing America's deficit while simultaneously encouraging a shift toward productive investment over the traditional domestic economic growth drivers of consumption and housing, as we have argued during 2010 in our *New Mix* thesis. We are optimistic that the 112th Congress will be up to the challenge, especially as the initial draft from the panel provides a solid foundation for the budget and tax discussions that will take place next year. ■

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