

US Economics Digest

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Fiscal Cliff and Federal Budget Chart Show

- We believe a deal on the fiscal cliff before year-end is the most likely outcome. But the answer to the question “How does this end?” remains difficult for financial markets to envision.
- What might a deal look like? Media reports suggest a two-stage framework. The first stage is a short-term stop gap solution which gets the system over the January 1 hump. Our Washington public policy team believes sequestration will be “switched off” and most of the Bush tax rates will be extended for a year. In addition, there could be some down payment on deficit reduction now. The short-term deal could involve some “revenue” raisers for upper-income taxpayers, and perhaps some modest spending cuts. The debt ceiling could also be lifted.
- The second stage would be a “grand bargain” on tax and entitlement spending reform - to be hammered out in 2013. Parameters would be set for negotiations now, perhaps involving targets for revenues and spending cuts. The Simpson-Bowles commission plan, or items from last year’s Obama-Boehner deficit negotiations, could be reference points for a deal. And a legislative “mechanism” could be put in place to force an agreement.
- Taxes remain the biggest obstacle to a deal. Republicans have signaled a willingness to accept new revenues. But they remain opposed to tax **rate** increases. Instead, they favor base broadening as opposed to higher rates, and demand spending cuts in return. The President says he is “open to new ideas,” but remains staunchly opposed to a deal without tax increases on the “wealthy.” Meanwhile, the depth of Democratic support for spending cuts, especially entitlements, is another unknown.
- In terms of timing, a deal is unlikely to occur until around mid-December.
- There is more to the fiscal cliff than just income tax rates and the sequester. Substantial fiscal drag is likely no matter what deal is struck on the larger issues. For example, the 2% payroll tax cut will probably lapse, which implies a \$126bn tax increase next year. “Obamacare” investor and Medicare payroll tax hikes are scheduled to begin on January 1. And other revenue and spending policies are likely to expire. Our baseline expectation assumes 1.5 ppt. of fiscal drag in 2013 from these sources - a significant, but absorbable hit to the economy, which we expect will grow by about 2% next year, with some acceleration in the second half versus the first.
- On the following pages, we review issues associated with the fiscal cliff and the federal budget outlook in a series of charts.

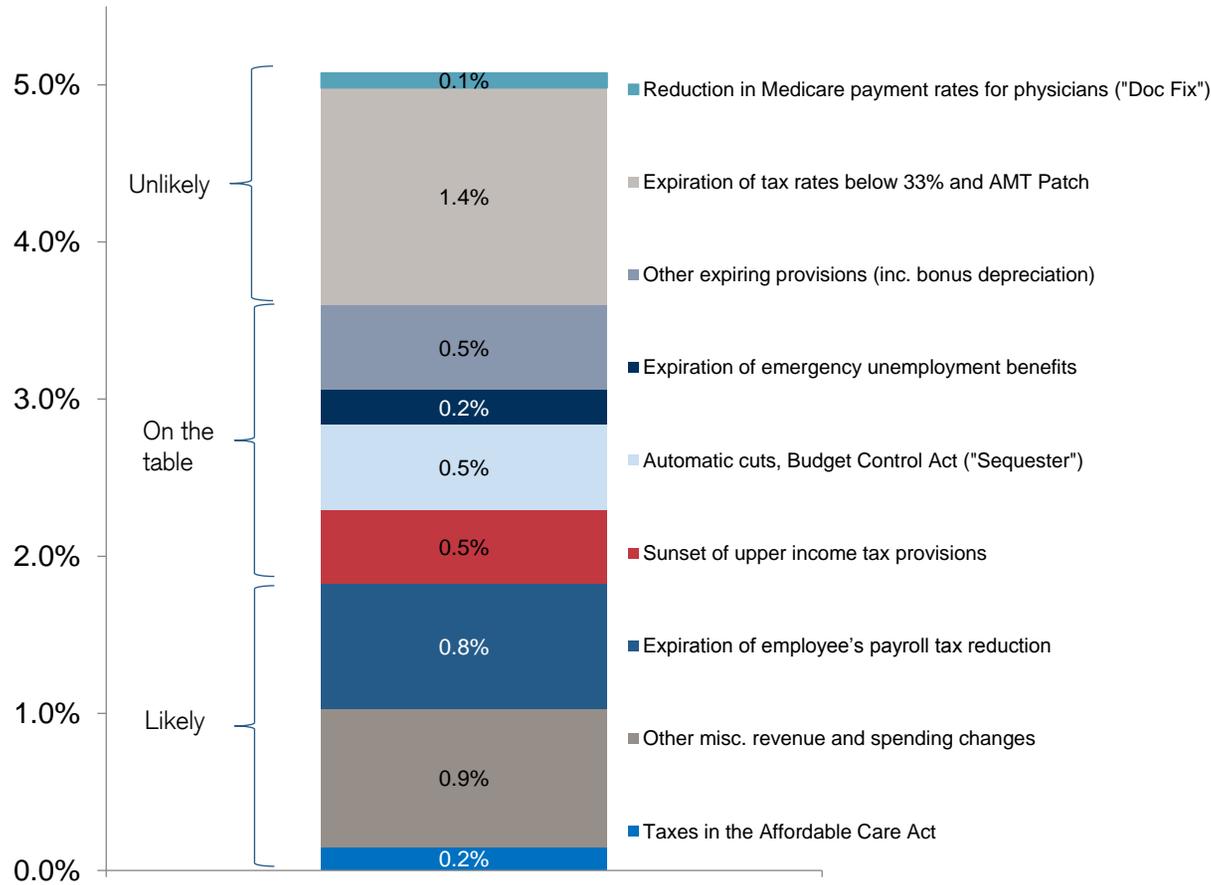
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Exhibit 1: Anatomy of the Fiscal Cliff

% of projected Q4:2012 nominal GDP, calendar year basis

Exhibit 1 shows the budgetary cost of tax and spending policies (as a share of GDP) that are scheduled to take effect on New Year's Day – the so-called “fiscal cliff.” All policies would reduce the federal budget deficit by almost 4% of GDP in fiscal year 2013, and more than 5% of GDP over a full calendar year (shown below).

Our baseline assumes roughly 1/3 of the cliff phases in (1.9% of GDP), including expiration of the 2% Social Security payroll tax cut, new taxes in the Affordable Care Act (“Obamacare”), and other miscellaneous spending and revenue measures likely to expire. With the President demanding higher taxes on upper-income individuals, and the Republicans demanding spending cuts in return, the risk is that the final fiscal adjustment could be larger than our baseline.



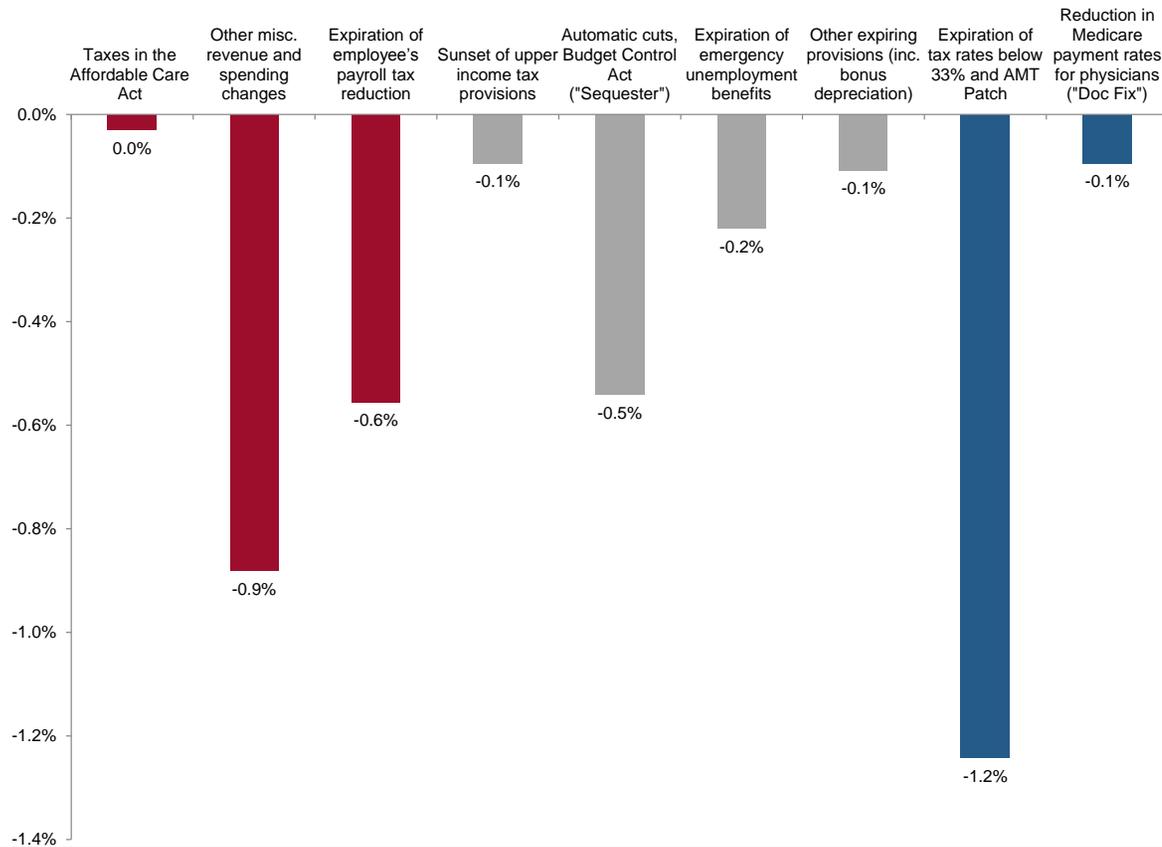
Source: Congressional Budget Office, Credit Suisse

Exhibit 2: 2013 GDP Impact from Fiscal Cliff Provisions

Impact on annual nominal GDP growth

Exhibit 2 shows scenarios for the GDP effect of individual fiscal cliff provisions, after applying fiscal “multipliers” for each component. Items shaded red are, in our judgment, likely to phase in; items shaded grey are “on the table;” and the blue bars cover provisions that are unlikely to kick in.

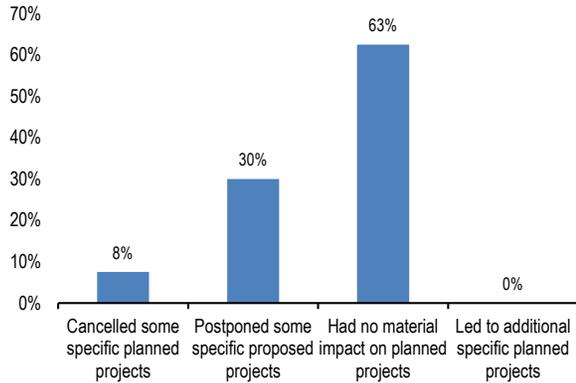
Multiplier size is the subject of a large degree of uncertainty, but the general consensus is that spending multipliers tend to be greater than tax multipliers in the short run. Given the skew in the fiscal cliff towards the tax side, we believe the scale of the cumulative multiplier is less than 1 for the entire cliff. Our current baseline assumes a 1.5% fiscal drag for next year.



Source: Congressional Budget Office, Credit Suisse

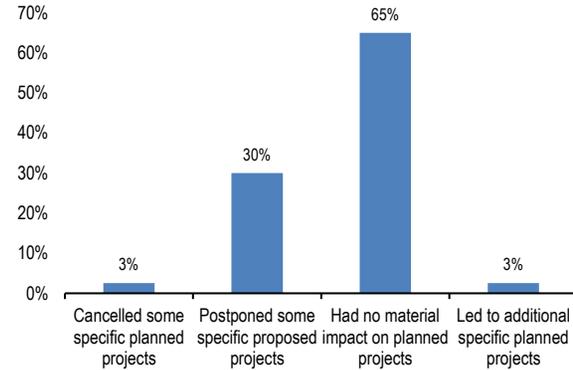
Our Credit Suisse Executive Panel survey (<https://plus.credit-suisse.com/u/LRgnMi>) polled 120 companies in the US and Europe about capital spending plans. In the US, 38% of US corporations either cancelled or postponed specific projects in response to fiscal cliff concerns. Interestingly, the threat caused by the Eurozone crisis was a slightly greater concern (41% cancelled or postponed projects). And the China slowdown factor was also significantly large.

Exhibit 3: US: How have your investment and spending decisions been impacted by the threat caused by the US Fiscal Cliff?



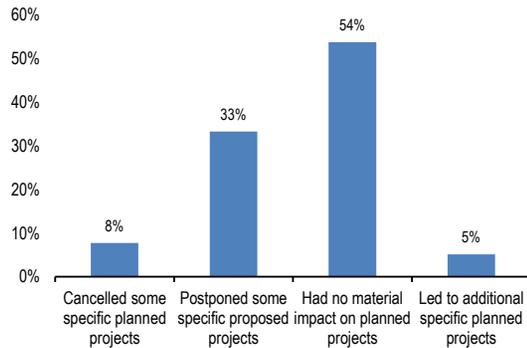
Source: Credit Suisse Executive Panel

Exhibit 4: US: How have your investment and spending decisions been impacted by the threat caused by a slowdown in China?



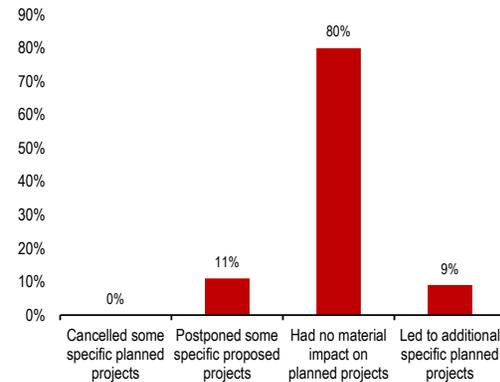
Source: Credit Suisse Executive Panel

Exhibit 5: US: How have your investment and spending decisions been impacted by the threat caused by the eurozone crisis?



Source: Credit Suisse Executive Panel

Exhibit 6: Europe: How have your investment and spending decisions been impacted by the threat caused by the US Fiscal Cliff?



Source: Credit Suisse Executive Panel

Taxes, particularly on “high-income” earners, are among the more contentious issues as we approach the cliff. Exhibit 7 shows a selection of marginal tax rate proposals. For comparison, we show “current policy” tax rates (today’s rates), “current law” tax rates (the rates that take effect in January 2013 if no action is taken to avoid the fiscal cliff), and proposals from President Obama’s previous budget proposal. The rates cover married couples filing their taxes jointly (for single filers, the rates are the same, but the bracket ranges are slightly lower). Broadening the base by curtailing the value of deductions and exemptions may extract more dollars of tax revenue from upper bracket taxpayers than raising tax rates.

Exhibit 7: Selected Tax Rates for 2013: Current Policy, Current Law (Fiscal Cliff), and Obama Administration Budget Proposal

Taxable Income	Current Policy	Current Law ("Fiscal Cliff" scenario)	President's 2013 Budget Proposal
\$0-\$17,500	10%	15%	10%
\$17,500-\$59,300	15%	15%	15%
\$59,300-\$71,000	15%	28%	15%
\$71,000-\$143,350	25%	28%	25%
\$143,350-\$218,450	28%	31%	28%
\$218,450-\$241,900	33%	36%	33%
\$241,900-\$390,050	33%	36%	36%
\$390,050-and over	35%	39.6%	39.6%
Top dividend tax rate	15%	*43.4%	*43.4%
Top capital gains tax rate	15%	*23.8%	*23.8%

Source: Tax Policy Center, Credit Suisse. *includes the 3.8% investment tax under the Affordable Care Act

Exhibit 8 shows the budgetary impact of previous White House proposals to raise individual and investor taxes at the upper end. The President is reportedly using these proposals as part of a starting point for negotiations.

Exhibit 8: Menu of “Upper Income” tax options from previous Obama Administration proposals

(\$bn)

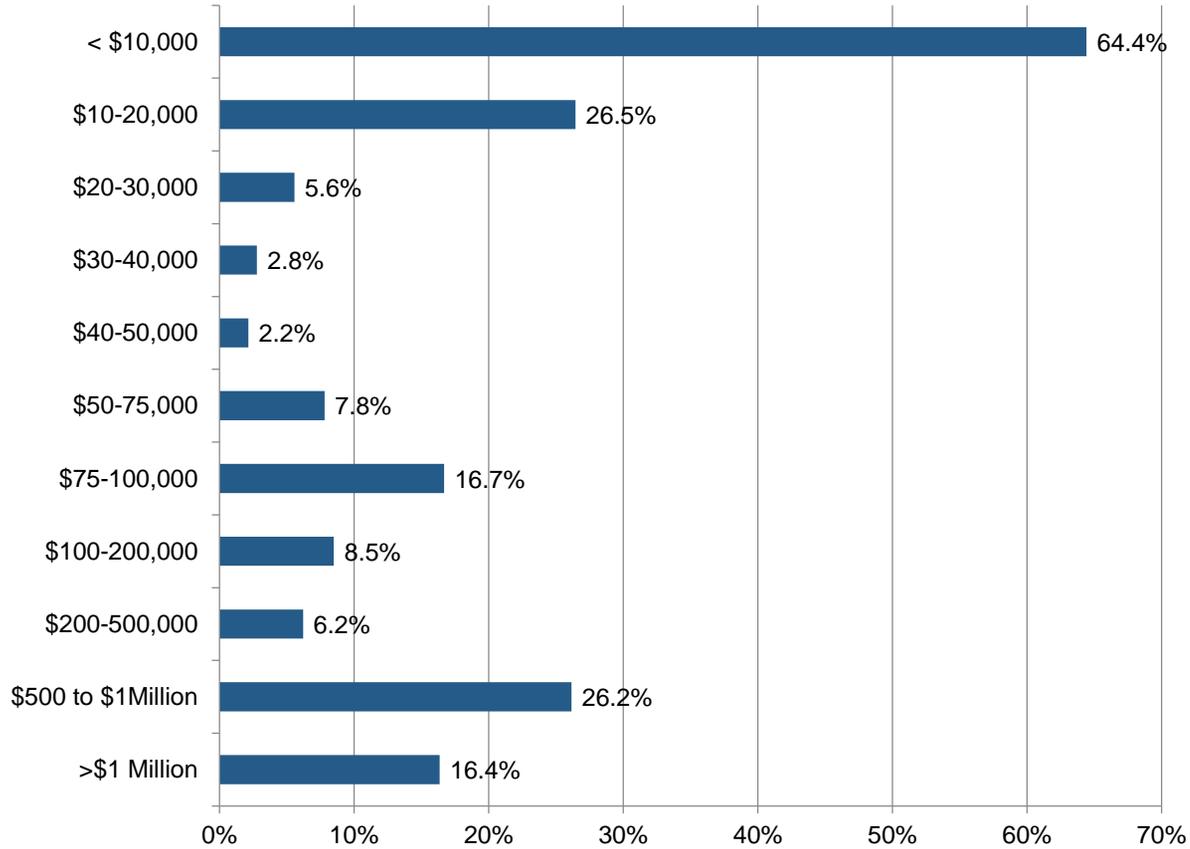
	Fiscal Year 2013	Calendar Year 13	10-year Impact
Reinstate the limitation of itemized deductions	4	6	124
Reinstate the personal exemption phase-out	2	2	42
Reinstate the 36% and 39.6% tax rates	23	31	442
Tax qualified dividends at ordinary income	22	29	206
Tax net long-term capital gains at 20%	6	8	36
Reduce value of certain tax expenditures	27	36	584
"Buffet Rule" (30% minimum tax on AGI over \$1mn)	5	7	47
Total	88	118	1481

Source: Office of Management and Budget, Congressional Joint Committee on Taxation, Credit Suisse

Exhibit 9: Marginal tax rate increase under fiscal cliff scenario by income bracket

% change

Marginal tax rates would rise for all taxpayers under a full fiscal cliff stalemate. In percentage terms, taxpayers at the lower end of the income distribution would be hit the hardest.



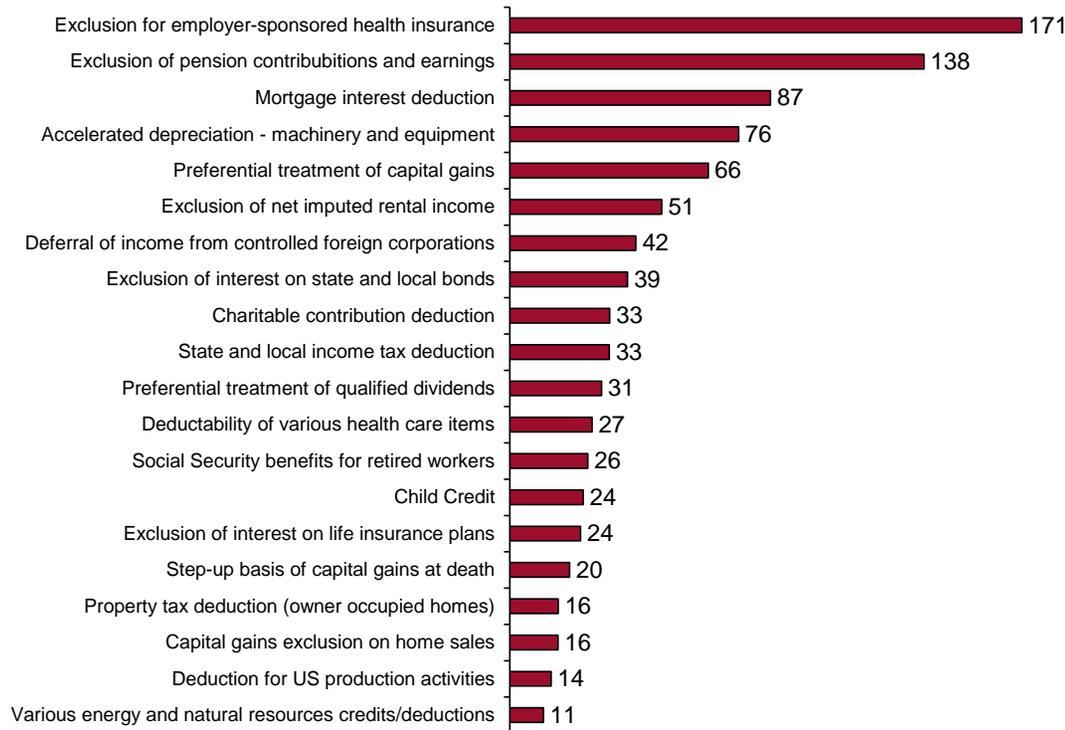
Sources: Urban-Brookings Tax Policy Center Microsimulation Model, Credit Suisse

Exhibit 10: 20 Largest Tax Expenditures

\$bn, FY2012 estimate

Republicans have emphasized the idea of “base broadening”— paring back the panoply of tax expenditures in the tax code – instead of raising tax rates. The largest tax expenditures enjoy sacrosanct status, which is why tax reform efforts almost always fail (the 1986 Reagan tax reform, which ended many breaks and lowered the top marginal rate from 50% to 28%, looks like a happy historical anomaly).

Exhibit 10 shows the top 20 tax expenditure categories, totaling an estimated \$946bn for the current fiscal year (2012). The total estimated revenue losses from all tax expenditures exceed more than \$1 trillion annually, close to what the government collects from individual and corporate income taxes combined, and almost as much as it spends on discretionary programs.



Source: Office of Management and Budget, Credit Suisse

Exhibit 11: Capping Deductions - Illustrative Proposals

\$bn

Capping the overall amount of itemized deductions, as opposed to targeting specific ones, is another approach under discussion (and perhaps one avenue for compromise). Exhibit 11 shows estimates of various proposals, ranging from over \$1.3 trillion to as low as \$473bn. The President's own budget capped certain deductions at 28%, which save \$584bn over ten years.

Proposal and Baseline	Fiscal Year										Total 2013-22
	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	
Option 1a: Cap itemized deductions at \$25,000											
Current Law	67	90	98	108	117	124	132	139	147	155	1,177
Current Policy	70	95	104	116	126	136	146	155	164	175	1,286
Option 1b: Cap itemized deductions except for charitable contributions at \$25,000											
Current Law	45	61	66	73	79	85	91	96	101	107	804
Current Policy	47	64	70	79	87	94	101	107	114	122	885
Option 2a: Cap itemized deductions at \$50,000											
Current Law	39	53	58	65	71	76	83	88	94	101	727
Current Policy	39	54	59	66	72	78	86	91	98	106	749
Option 2b: Cap itemized deductions except for charitable contributions at \$50,000											
Current Law	25	34	37	42	46	49	54	58	62	66	473
Current Policy	25	34	38	43	47	51	56	60	65	70	490

Sources: Urban-Brookings Tax Policy Center Microsimulation Model, Credit Suisse

Personal Income and Taxes

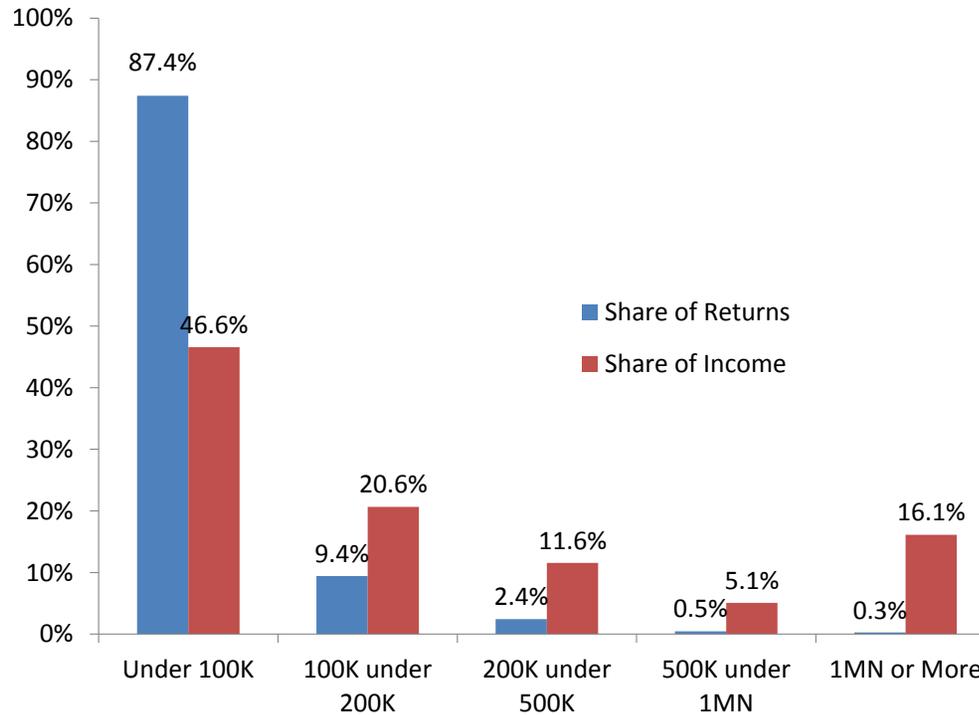
Exhibit 12 shows the distribution of adjusted gross income (AGI), essentially all gross income from whatever source – wages, capital gains, interest, dividends, etc. – minus certain deductions. Data are from 2007 (the last relatively clean year for tax returns not distorted by the recession).

87% of returns show earnings of \$100K or less, which account for 47% of all AGI. 9% of returns are between \$100K and \$200K, generating 21% of all income. 3.2% of returns show income above \$200K, and just 0.3% of returns – about 392,220 earners in the entire country – show income at \$1 million or more. This relatively small group of taxpayers in the \$1 million+ category takes in 16% of all the adjusted gross income. The average income within the \$1 million+ bracket is 59 times the average for all brackets.

Not shown in the charts (because the scale would render the rest of the bars imperceptible), earners taking in \$10 million or more, about .01% of returns, or about 18,394 tax return filers, account for 6.5% of income.

Exhibit 12: Adjusted Gross Income

%, 2007

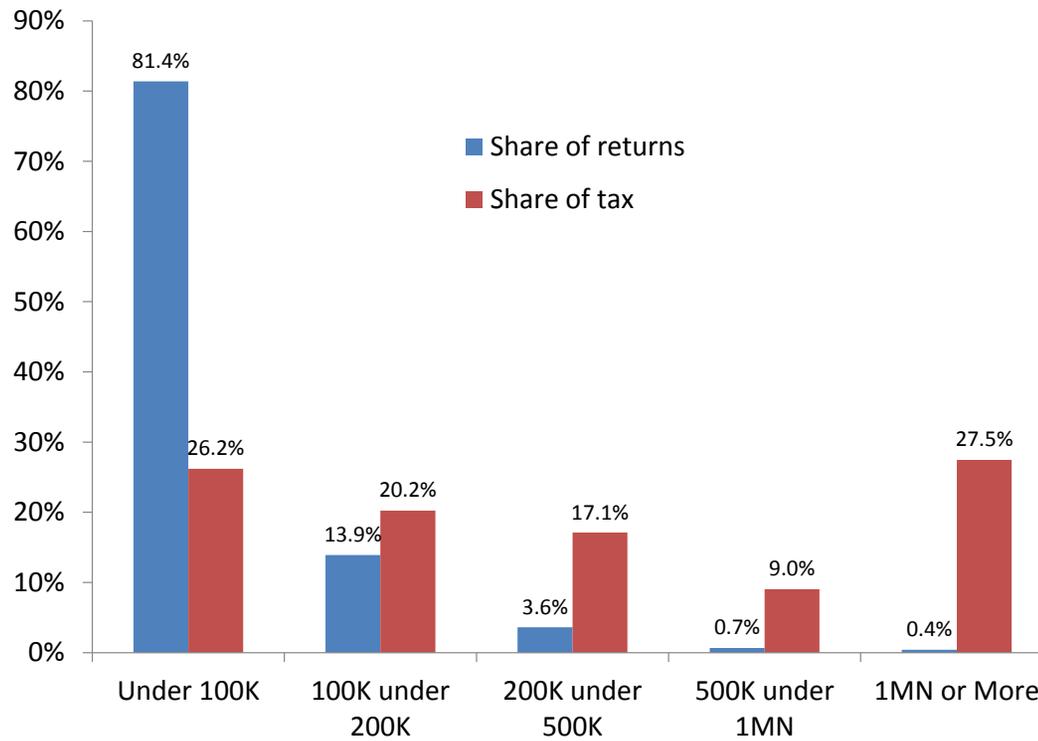


Source: IRS, Credit Suisse

Exhibit 13: Total Income Tax

%, 2007

While the income distribution is heavily skewed to the top end, the income **tax** distribution is even more so. The 4.7% of taxpayers that make more than 200K (ostensibly the ones that would be paying higher taxes under the President’s plan) paid 53.6% of federal income tax in 2007 – while earning pre-tax 35% of aggregate adjusted gross income.



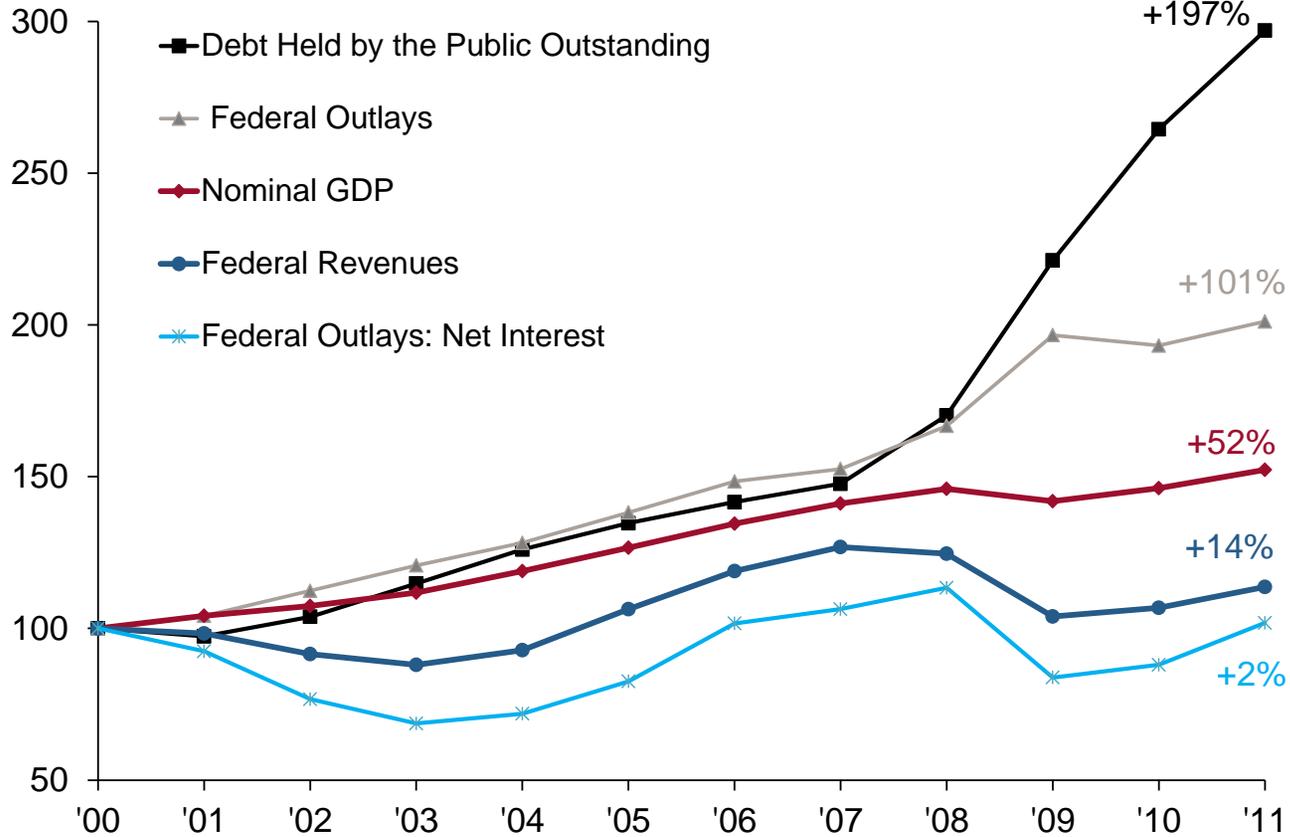
Source: IRS, Credit Suisse

Federal Budget

Exhibit 14: Federal Outlays, Revenues, Debt, and Debt Service vs Nominal GDP (Since 2000)

2000 = 100

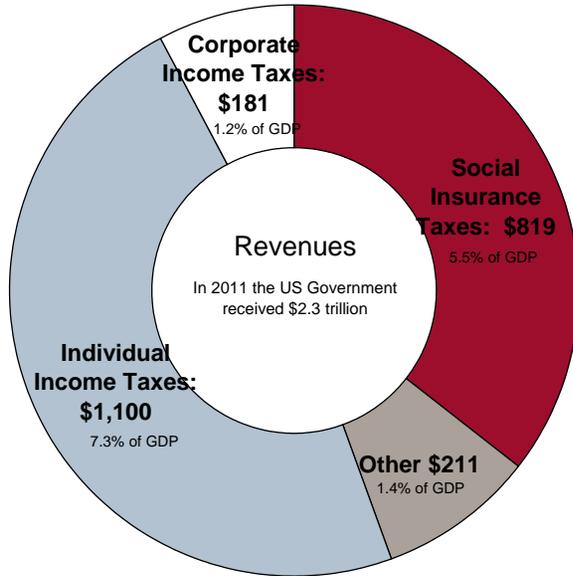
Exhibit 14 shows how both spending and revenues became seriously unhinged relative to the underlying pace of economic expansion. From 2000 through 2011, federal outlays grew about 101%, double the 52% expansion in nominal GDP. Federal revenues increased marginally, rising just 14% over the same period. Federal government debt has tripled since 2000, while debt service costs have hardly risen at all. The problem going forward – interest rates are effectively at irreducible minimums, and so the incremental beneficial effect on debt service from lower rates disappears.



Source: Bureau of Economic Analysis, Congressional Budget Office, Credit Suisse

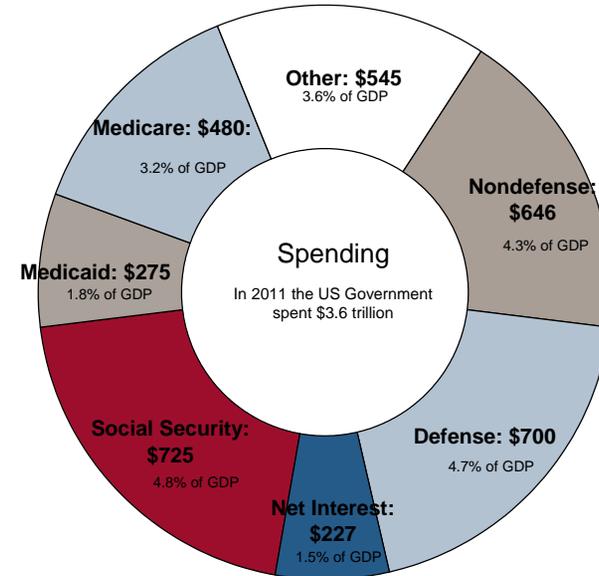
Distribution of federal revenues and outlays

Exhibit 15: Federal Revenue Snapshot



Source: Congressional Budget Office, Credit Suisse

Exhibit 16: Federal Outlays Snapshot

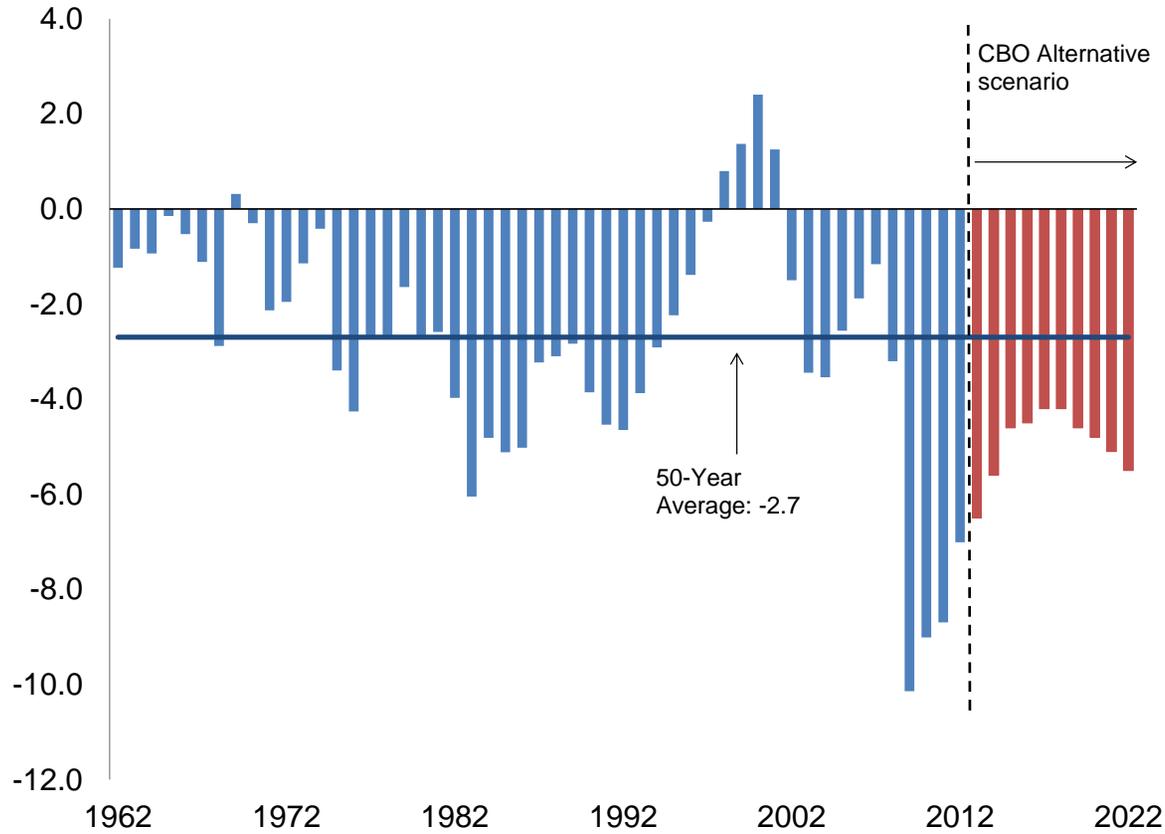


Source: Congressional Budget Office, Credit Suisse

Exhibit 17: Federal Budget Balance

% of Nominal GDP

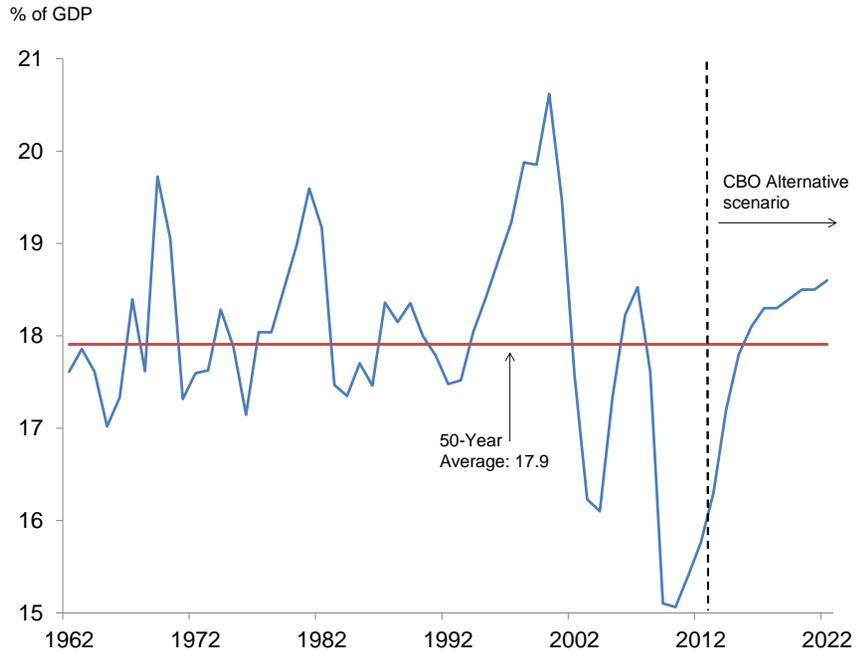
Exhibit 17 shows the recent history of the federal budget balance and a projected path over the coming decade as formulated by the CBO's "alternative scenario" (widely believed to be a more realistic forecast than the official current law "baseline"). The deficit is likely to shrink somewhat as the economy recovers and major foreign operations wind down. Following 2018, the trajectory begins to deteriorate further under the weight of increasing demographic pressures (aging baby-boomers) and the associated rise in entitlement spending.



Sources: Congressional Budget Office, Credit Suisse

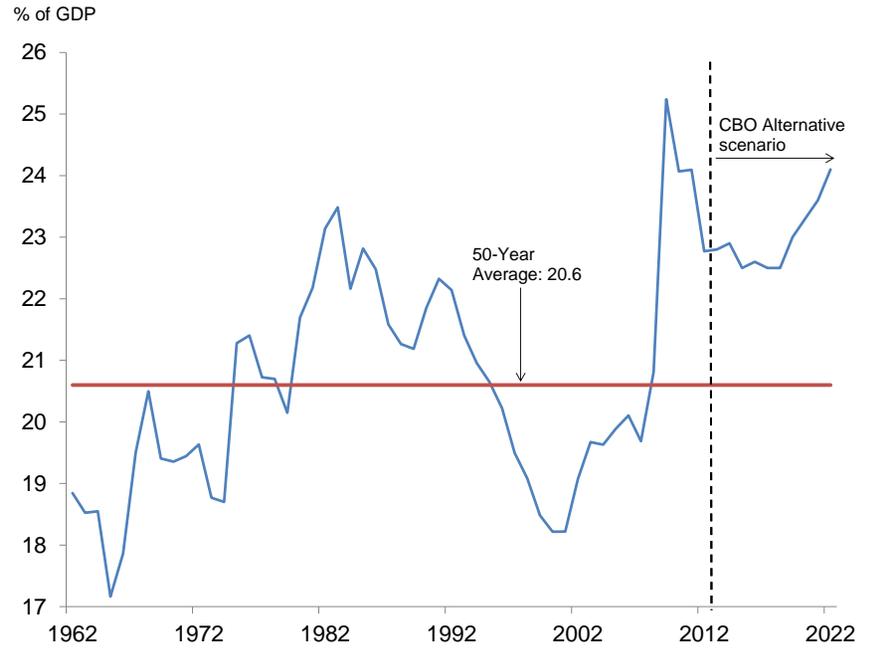
Revenues and Outlays: Revenues collapsed and outlays surged during the Great Recession as a share of GDP. In the alternative scenario, revenues move back towards their long-run average of 18% by 2015, assuming continued economic expansion. But outlays never get back to their pre-Great Recession average of about 21%.

Exhibit 18: Federal Revenues



Source: Credit Suisse

Exhibit 19: Federal Outlays



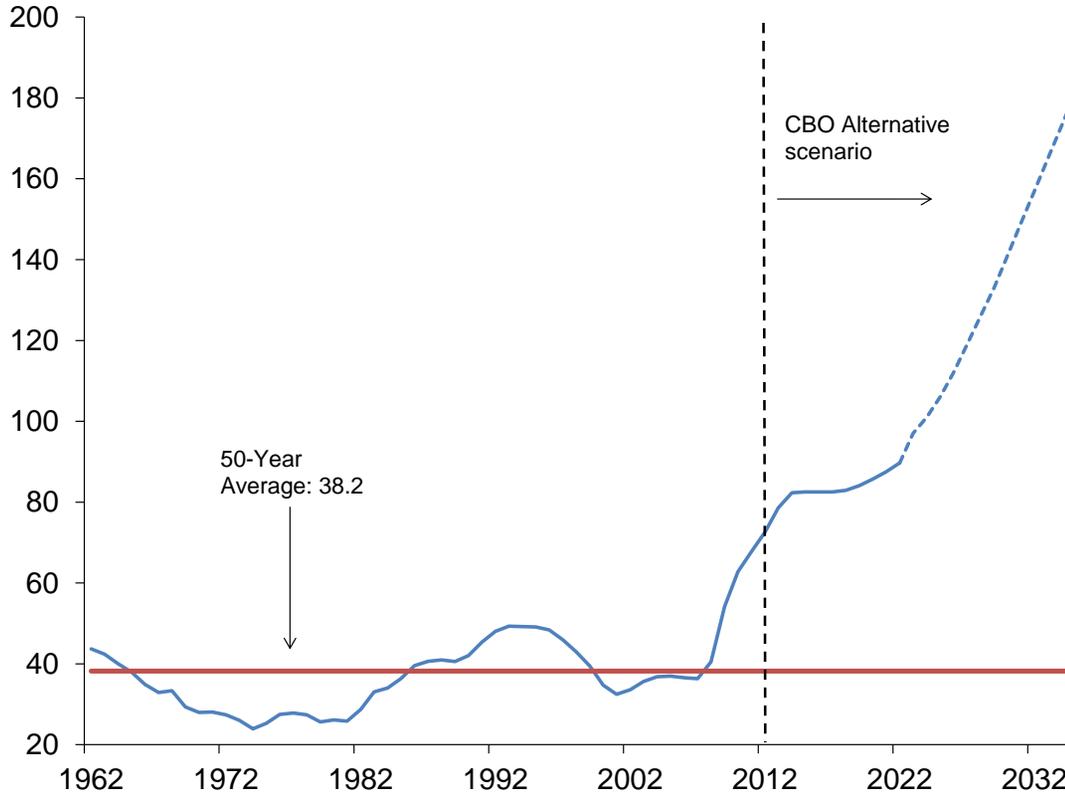
Source: Credit Suisse

Exhibit 20: Debt-to-GDP Ratio

Debt held by the public % GDP

For the period 1972-2011, the average debt-to-GDP ratio was 38%. On the eve of the Great Recession, federal debt held by the public as a share of GDP was about 36%. In fiscal year 2012, debt was 73% of GDP. Even with deficits projected to subside somewhat over the next decade, debt in the CBO alternative scenario does not stabilize as a share of GDP over the forecast horizon – moving up to 90% by 2022.

After that, the debt ratio is projected to skyrocket.

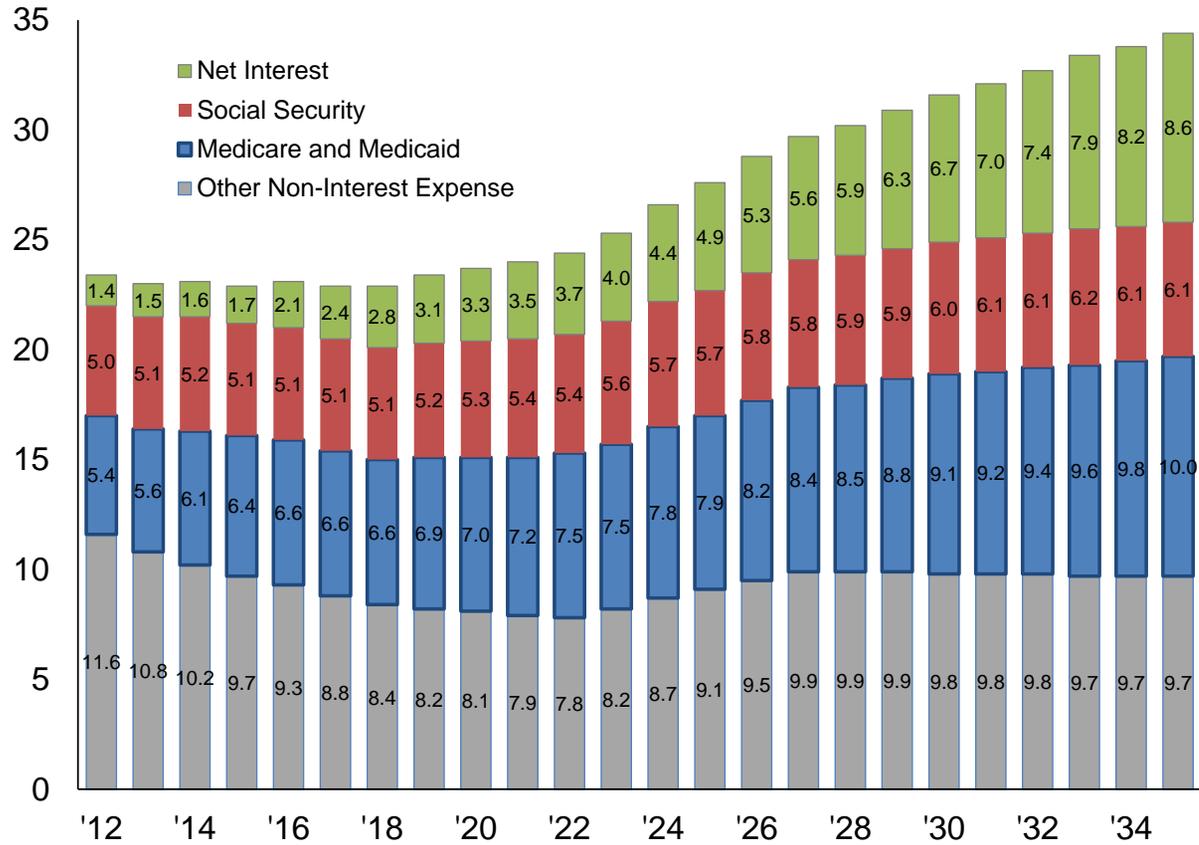


Source: Congressional Budget Office, Credit Suisse

Exhibit 21: Sources of Long Run Outlays Pressure

% of GDP

As a share of the economy, federal outlays are projected to rise towards levels that dwarf recent historical experience. The main source of upward pressure: 1) entitlement spending, especially Medicare and Medicaid, and 2) interest costs (this assumes interest rates eventually “normalize”).

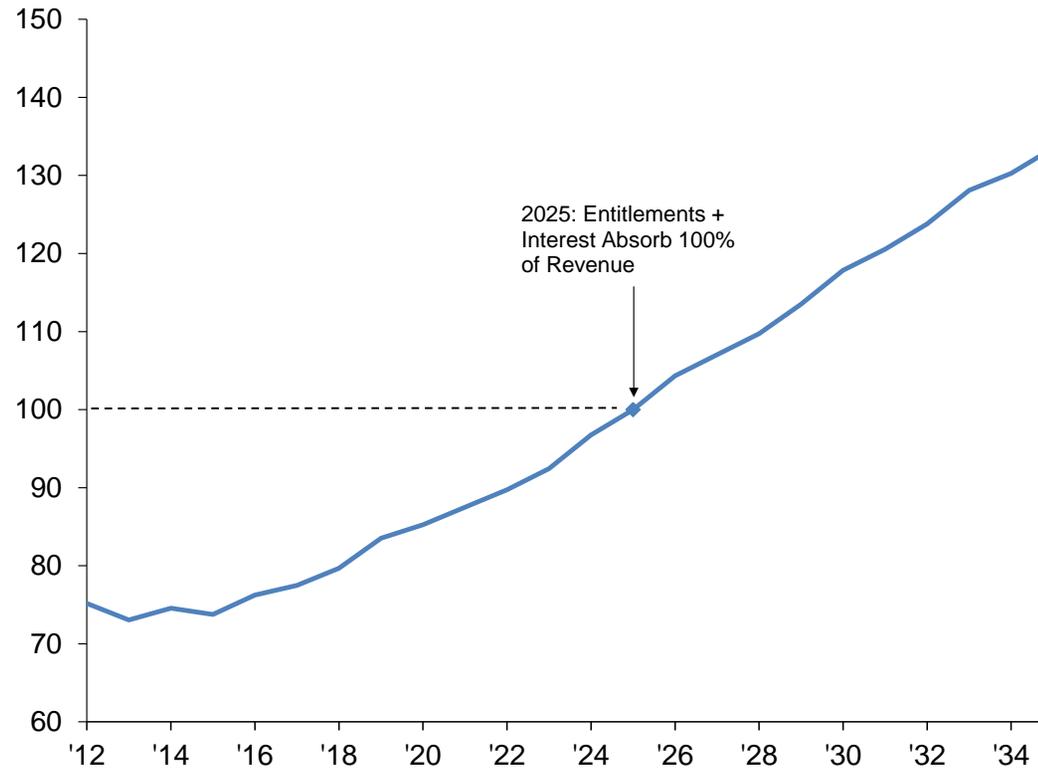


Source: Congressional Budget Office, Credit Suisse

Exhibit 22: Entitlements and interest expense will absorb all federal revenues by 2025

Ratio: Entitlements + Interest to Revenues

By 2025, Social Security, health care programs and interest costs (in other words, the most uncontrollable part of the budget) will gobble up an estimated 100% of all federal revenues.



Source: Congressional Budget Office, Credit Suisse

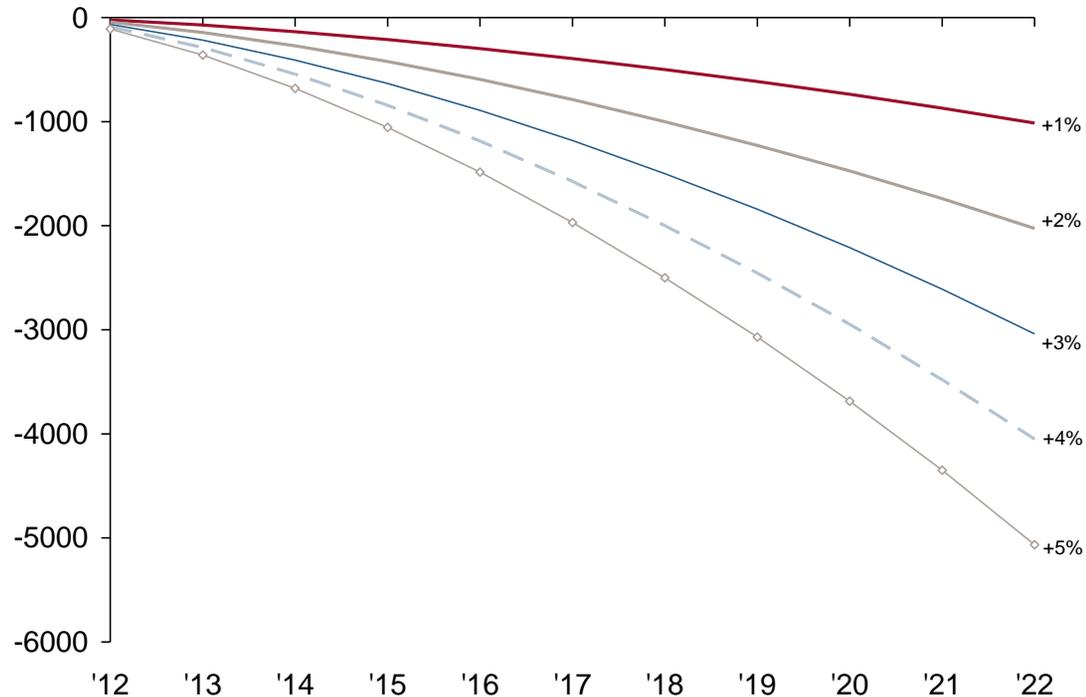
Exhibit 23: Change in the 10-year Debt Baseline at Different Interest Rate Paths

\$bn. Interest rate levels are versus the CBO baseline

A one percentage point rise in interest rates across the curve leads to another roughly \$1 trillion more in debt cumulated over a ten-year horizon as higher rates force debt service costs up. That's a claim on tax revenue or programmatic spending priorities that would complicate the effort to establish a sustainable fiscal trajectory.

Before the financial crisis, many Taylor-rule type models assumed a 4%-5% nominal fed funds rate to be "equilibrium." The Federal Reserve's "long-run" projections are in this range, and CBO uses only slightly lower figures in constructing its scenarios. Avoiding these interest rates would make the management of the budgetary future much more tractable, while returning to those interest rate levels would impart an enormous additional burden on already strained federal finances. Nor should we neglect the financial stability strains of a bear market of that magnitude.

If there is any lesson from the financial crisis, it's that financial stability is paramount in meeting broader policy objectives. Raising rates too much or too soon could expose a key vulnerability in the financial system. This is yet another argument for expecting interest rates to remain at very low levels for a very long time.



Source: Congressional Budget Office, Credit Suisse

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Disclosure Appendix

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