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A Perfect Fiscal Storm is Brewing for the 2012 Lame Duck Session of Congress

Major Tax and Spending Events Could Throw the Economy Into Recession

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At the end of 2012, a number of major federal tax and spending events are set to occur all at once. They include the expiration of the Bush tax cuts, the end of certain jobs provisions, the activation of the $110 billion in automatic across-the-board spending cuts, and the need to once again raise the federal government's debt ceiling. Taken together, these policies would reduce real economic growth by 1.2 to 2.0 percent and potentially push the economy into another recession. However, the likelihood that Congress will let all these events to occur is slim to none. The most likely scenario is that Congress will cobble together some compromise, the parameters of which depend on the outcome of the November elections.

The Debt Ceiling

Last year's debt ceiling crisis ended with the enactment of the Budget Control Act of 2011, which raised the debt ceiling in a series of three steps from $14.3 trillion (on August 1, 2011) to $16.394 trillion (as of January 30, 2012), which is the current debt limit.

As of March 31, 2012 the amount of debt that is subject to the debt ceiling was $15.539 trillion. Currently, the Treasury Department has authority to borrow $855 billion more until it hits the debt ceiling again.

According to the Treasury Department, since November 1, 2011, the debt has been increasing by an average of $118 billion per month. This suggests that the U.S. will hit the current debt ceiling in about 8 months, or November 2012, and the federal government will have to address the issue during a lame-duck session of Congress after the election.

However, CBO estimates the debt will be $15.986 on September 30, 2012, which suggests it will increase by an average of just $74.5 billion between April and September 30, 2012. At this rate of increase, the U.S. won't hit the current debt ceiling for another 12 months, or March 2013, in which case the incoming President and Congress will have to address the issue in short-order.

On the other hand, OMB estimates the debt will be $16.334 on September 30, 2012, which suggests it will increase by an average of $132.5 billion between April and September 30, 2012. At this rate of increase, the U.S. would hit the current debt ceiling in about 7 months, or October 2012.

It all depends on how fast the economy grows and how fast the unemployment rate goes down over the next 6 months. One thing is certain; the next debt ceiling debate will be tied up in the budget battle that will occur at the end of this year.

Budget Control Act of 2011 and the January 2013 Sequestration

Last year's debt ceiling agreement also reduced spending in two ways.

1. By directly specifying $917 billion in spending cuts over 10 years, with $25 billion applied to Fiscal Year (FY) 2012 discretionary spending which ends September 30, 2012, and $46 billion in discretionary spending cuts for FY 20 13 which begins October 1, 2012.
2. Additionally, the legislation established the Joint Select Committee on Deficit Reduction, or "super-committee," to produce debt reduction legislation by November 23, 2011. The goal of the legislation was to cut at least $1.5 trillion over the coming 10 years. If the super-committee failed to produce a bill, which it did, the Budget Control Act includes a trigger mechanism that automatically cuts, or sequesters, spending by $984 billion over 10 years, beginning with $110 billion in January 2013 (for FY 2013).
   - $55 billion would be cut from defense spending (10.0%);
   - $39 billion would be cut from other discretionary spending programs (7.8%);
   - $11 billion would be cut from Medicare providers (2.0%); and
   - $5 billion would be cut from other mandatory spending (7.8%).
   - Social Security and Medicaid are exempt from any cuts.

Politically, the likelihood of spend cuts of this magnitude occurring next year is near zero. Cuts of this size would likely tip the economy into recession. Yet, President Obama has said that he will veto any attempt to roll-back the automatic cuts. The only questions are: who will blink first, what compromise will ultimately be struck or fudged together, and how much will tax increases be part of any deal that is made (see below).

Tax Increases and Other Year-end Issues

Besides the potential of another debt ceiling debate and the deep budget cuts scheduled for FY 2013 ($156 billion combined), on December 31, 2012, Congress will also be facing:

- A $93 billion personal income tax increase if all of the Bush tax rates are allowed to expire;
- A $125 billion payroll tax increase on employees if the payroll tax holiday expires;
- A $119 billion Alternative Minimum Tax increase if the "patch" is not extended;
- A $44 billion personal income tax increase if other components of the Bush tax cuts are not extended;
- A $29 billion tax increase on investment if the tax rate for capital gains is allowed to increase from 15 percent to 20 percent and dividends are taxed as normal income once again, instead of the current 15-percent rate;
- The expiration of the Medicare "Doc Fix" and a potential 27% cut in provider payments;
- PPACA's 2.3 percent medical device excise tax kicks in ($1.8 billion);
- PPACA increases the Medicare payroll tax by 0.9 percent on earned income above $200,000 for individuals and $250,000 for families, and imposes a 3.8% tax on investment income for taxpayers with adjusted gross income of $200,000/$250,000 or more ($20.5 billion);
- PPACA increases the threshold for deducting medical expenses for personal income taxes from 7.5 percent to 10.0 percent of adjusted gross income;

- PPACA limits flexible spending accounts for health care to $2,500; and
- Emergency unemployment benefits expire ($45 billion).
- Not to mention the likely uncertainty surrounding health care reform depending on what the Supreme Court decides in June 2012.

Potential Impact on the Economy

The Congressional Budget Office (CBO) projects that all of the fiscal events scheduled for the end of 2012 actually do occur, the unemployment rate would rise from an annual average of 8.8 percent in 2012 to 9.1 percent in 2013, and real economic growth would fall from 2.2 percent to 1.0 percent. In fact, economic growth would be negative in the first two quarters of 2013; the often cited definition of a recession.

Mark Zandi at Moody's estimates that without action, the "fiscal cliff'' could shrink next year's economy by 3.5 percent. Economist David Greenlaw at Morgan Stanley thinks the fiscal cliff could cut one percentage point off economic growth. On the other hand, a report issued by Goldman Sachs said the worst-case scenario would will cut almost 4 percentage points off the gross domestic product in the first half of 2013.

Conclusion

The likely outcome of all these fiscal events depends heavily on the election results — a clean win for President Obama portends a much different resolution than an Obama victory in which the GOP takes the Senate, or a GOP sweep. Regardless, this year's lame-duck session will likely go right down to the wire. Although the chances of a worst-case scenario actually happening are relatively low given the economic and political risks involved, a grand bargain that resolves all of the issues is even more unlikely. The most likely outcome is that Washington officials come up with a short-term compromise that would allow lawmakers to postpone the tough decisions until 2013. Needless to say, the economy hangs in the balance, both in the short-term, and long-term (think Greece).