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Will the "Cliff" Steal Christmas?

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Now that the political lines for the next couple of years are clear, the so-called "fiscal cliff" stands first on the agenda for President Obama and the existing Congress. The matter is urgent. Unless something is done between now and year-end, some $660 billion in automatic spending cuts (sequestration) and tax hikes will almost certainly toss the economy into recession.

Avoiding it probably would have been easier if Mitt Romney had won the election, because by offering Congress an excuse to wait for the new administration to work out its budget, a new person in the White House would have offered both sides of the aisle a way to sidestep this difficult issue. But with the election results as they are, avoiding the cliff will now involve hard negotiations. The next few weeks doubtless will see much give and take and, despite any initial spirit of compromise, recriminations, too. Because neither side can concede until the last minute, little will likely become clear until late December. But probabilities suggest nonetheless that Washington will in the end steer clear of the cliff (or most of it), offering a kind of last-minute holiday gift to the economy and its markets.

During this coming period of negotiation and uncertainty, investors and businesspeople will need to keep in mind that no one in Washington wants to go off this cliff. Even before the election, Congress had voted to fund the government through March 2013, indicating a clear willingness to at least kick the proverbial can down the proverbial road. What is more, a bipartisan group of eight senators (calling itself the "Gang of Eight") had formed well before the election to devise at least a minimum down payment on the deficit that would forestall all the sequestration of discretionary spending, mostly on defense, something on which the 2011 debt-ceiling compromise otherwise would have insisted. House Speaker John Boehner (R-OH) had already outlined the basis of a compromise on the Bush tax cuts. So this process had already begun weeks ago. Still, some pieces of the cliff will be easier to avoid than others.

The easiest aspects to fix are the scheduled imposition of a broader-based alternative minimum tax (AMT) and the scheduled cutbacks in fees paid to doctors under Medicare and Medicaid. These issues amount to some $90 billion, or about 14% of the cliff. Congress already has the legislation in place to avoid both. Every year, for years now, Congress has passed special legislation to stop each aspect from imposing fiscal restraint. The "ATM patch," as it is familiarly called, regularly blocks the spread of this tax burden to 32 million taxpayers from the four million who now suffer under it. Its passage has become an annual event. A repeat should be easy to pass quickly in the closing weeks of the year. Similarly, Congress has so frequently sidestepped the otherwise mandated cut in doctors' fees that the legislation is familiarly referred to as the "doc fix." Another round on this front should impose little problem.

The tax increases implicit in the Patient Protection and Affordable Care Act stand on the other side of the difficulty scale, and may be almost impossible to avoid. After all, such an effort could involve dismantling that huge piece of complex legislation. These taxes include special premium Medicare levies on wealthier taxpayers and an extension of Medicare taxes to investment income. But while those burdens may irritate investors, they amount to only $25 billion, less than 4% of the fiscal cliff.[1]

Two other aspects of the cliff—the end of extended unemployment benefits and the end of the partial payroll tax holiday—will see some tough negotiations. Should Congress fail, these would amount to $162 billion in fiscal restraint. To be sure, the sides today seem far apart. Democrats, as per earlier statements, want to continue both. Republicans want to end them. Much of the handicapping in Washington now suggests that Democrats will prevail, which would relieve this aspect of the cliff entirely. A compromise, already raised from both sides of the aisle, might allow for a gradual adjustment back to the original law. If that adjustment occurs over a year, the economy will avoid half this fiscal restraint in 2013 and still more of it, if the adjustment is set to take longer. On this basis, a conservative

calculation would indicate relief of at least another $81 billion, or 12.3%, reduction in the cliff's size, and possibly more.[2]

If the proposals of the Gang of Eight prevail, the economy will avoid the entire spending cuts of the sequestration. That would amount to about $90 billion, mostly in defense, or 13.6% of the cliff.[3] But even if this particular approach fails, Congress still would have other ways to relieve much of the strain. After all, the sequestration does not change the budgeted amount, but only blocks the spending of what law has already appropriated. Given the precarious state of the economy and the clear desire in Washington to steer away from the cliff, it would seem likely, then, that even without Gang of Eight action on the deficit, lawmakers will find a way to spare the economy this restraint or delay it to later quarters or perhaps even to 2014.

The expiring Bush tax cuts are the most complex matter. If they lapse entirely, they will amount to fully one-third of the fiscal cliff. The negotiation positions are long-standing. Republicans want to continue them for all taxpayers. Democrats want to continue the cuts only for those individuals who make less than $200,000 a year and for those couples with joint incomes of less than $250,000 a year. Two years ago, when the current rates were set to expire, the Republicans prevailed and Congress extended the cuts until the end of this year. Congress is not likely to repeat that action. Two lines of compromise are open, however. One follows proposals from the 2010 debate that would raise annual income limits for a tax hike, including on capital gains and dividends, possibly to $1 million in annual income. In that case, the economic effect would be slight indeed. An alternative, offered by House Speaker Boehner, would avoid these hard negotiating positions by pursuing more fundamental tax reform. Proposals to reduce statutory tax rates and limit deductions have gained favor on both sides of the aisle and with the White House. These could remain revenue neutral or, as indicated recently, raise revenues. However the disputants eventually work this out, it does seem likely that the economy will avoid all or most of this aspect of the cliff as well.

To be sure, the exact nature of this debate and ultimate compromises remain obscure. But the probabilities still suggest that the economy and markets will avoid the bulk of the cliff. At most, it looks as though the economy will have to bear $150–200 billion of fiscal restraint in 2013. That is a significant number, but it is still barely more than 1% of gross domestic product. It is not enough to create the severe recession of which the Congressional Budget Office warned when accessing the entire cliff. It is likely not enough even to drive this slow-growing economy into a mild recession. It will, however, help ensure that growth remains sluggish at best.

[1, 2, 3] Data from the Congressional Budget Office.

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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