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Goldman Sachs Global Economics, Commodities and Strategy Research

US Daily : The Election and the "Fiscal Cliff"(Phillips)

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- Market participants have begun to focus more on the fiscal "cliff" approaching at year end, when policies set to expire or take effect could impose roughly $600 billion (around 4% of GDP) in fiscal restraint absent congressional action, though we assume the actual amount of restraint will be much lower.
- While there is a great deal of uncertainty regarding how potential political scenarios could shape policy outcomes, it appears to us that the risk that these policies could temporarily lapse in Q1 2013 is greatest under a scenario where control of the House, Senate and/or White House changes hands, leading to unexpected fiscal restraint and policy uncertainty.
- By contrast, a status quo outcome that preserves a divided government would imply a lower likelihood of a temporary lapse, but could lead to somewhat greater fiscal restraint in 2013.

At the end of 2012, policies worth roughly $600 billion (compared to current policy) will set in, through the expiration of tax cuts and emergency benefits, and the phase-in of automatic spending cuts and new tax increases. The fiscal assumptions we incorporate into our economic forecast assume that most of this effect is neutralized by extension of the 2001/2003 tax cuts and delay of the automatic spending cuts. However, there is a good deal of uncertainty around these assumptions. Some of this is due to the complex interaction of interests regarding the spending cuts, tax cuts, and other expiring policies, along with the dynamics of the next debt limit increase that will come up around the same time.

However, part of the uncertainty also stems from the upcoming election. In our view, the impact of the election outcome on the amount of fiscal restraint in 2013 depends on which time frame is considered. In the short term, any result that deviates from the status quo would increase the amount of fiscal restraint likely in Q1, since the probability of a short-term lapse in tax cuts and the phase-in of spending cuts would increase. However, over the full year the opposite may be true, and a status quo outcome in which divided government is maintained probably means slightly more fiscal restraint in 2013 as a whole than other possible scenarios.

Short-term effects. The presidential and congressional elections on November 6 will play an important role in determining which policies will be phased in or out on schedule and which will be postponed. While the congressional election outcome does not take effect until January 3, 2013 and the presidential election outcome does not take effect until January 20, 2013 once the results become known in early November, they are apt to immediately influence deliberations on fiscal matters.

At the risk of oversimplifying, if Republicans win control of the Senate or the White House, the likelihood that Congress would enact a long-term extension of expiring tax cuts before year-end would decline, since Republicans would be in a better position to enact their preferred policies in early 2013. Democrats in Congress might also prefer to let them take responsibility for these issues, since an increase in the debt limit is likely to be necessary at around the same time, and lawmakers of both parties would rather avoid responsibility for increasing the debt limit if possible. Likewise, we assume that if Democrats were to win the House majority, a delay would also become more likely. In other words, a change in control towards either party could cause a temporary increase in fiscal restraint in early 2013, as policies that automatically phase in or out result in fiscal drag until a deal is reached.

By contrast, a status-quo election (i.e., President Obama is reelected with continued Democratic control of the Senate and Republican control of the House) would imply a higher likelihood that an agreement would be reached this year, before the various policies are set to phase in or phase out. However, since the two parties currently hold very different views whether tax increases should play a role in deficit reduction, even under this scenario an extension would be difficult to negotiate before year end. While a permanent extension of the middle-income rates is possible (perhaps with a higher threshold than the President proposes) this seems less likely than a shorter-term extension lasting one year or less, as discussed below.

The upshot is that an election result that deviates from the status quo would probably increase the amount of fiscal restraint in Q1 2013. While this would be a serious source of uncertainty for the market, businesses, and individual taxpayers, it is worth noting that the effect in Q1 would be less than the annual numbers imply, for three reasons. First, a lapse seems likely to be fairly short-lived if it does occur, probably lasting no longer than several weeks. Second, it is likely that if a lapse did occur, congressional leaders and the President would make their intentions clear in an effort to reduce the associated uncertainty.

A third factor that should mitigate the effects of a temporary lapse is that the effect of these policies in Q1 is less than estimates of their annual effects would imply. The table below shows the quarterly effects of various policies set to expire or take effect at the start of 2013 (the amounts shown represent the change in fiscal impulse compared with policy in Q4 2012). To construct these estimates, we rely on estimates of the cost of extending expiring policies and on estimates of alternative policies from the Congressional Budget Office, the Office of Management and Budget, and the Treasury. Since these are made on a fiscal year basis (i.e., October to September) and do not provide quarterly detail, we estimate the quarterly path for each provision.

The spending provisions are reasonably straightforward. Absent another extension, emergency unemployment benefits will cut off January 2013 with essentially no phaseout. The automatic spending cuts under the "sequester" are likely to start with a small lag, though fiscal year estimates from CBO imply that most of the effect on spending should be in place by mid-2013.

On the tax side, the picture is more complicated mainly due to tax filing season. We assume that if Congress were to allow a lapse in the relief it normally provides from the alternative minimum tax, it would have little effect on tax payments in Q1, since a surprise increase in AMT liabilities for tax year 2012 would most likely not be recognized until taxpayers file their tax returns and pay any excess tax liabilities in April 2013. The other tax provisions related to the 2001 and 2003 tax cuts are more complicated since some of the tax increase would be reflected through increased tax withholding, particularly for lower- and middle-income taxpayers, while some of the effect would come through estimated tax payments and payments when tax returns are filed the following year. To disentangle these issues, we rely on IRS Statistics of Income data to allocate tax liabilities between withheld and non-withheld payments and among different income groups, and then develop a quarterly path based on seasonal patterns in total withheld and non-withheld receipts reported by the Treasury. The upshot is that fiscal restraint in Q1 would probably be limited to less than $450bn (annualized), or about 3% of GDP, due to flexibility in the timing of tax payments and, to a lesser extent, the phase in of spending cuts. As noted above, since a temporary lapse would probably be reversed well before the end of Q1, the dollar amount would be much lower, probably no more than a few tens of billions, and the economic effects of whatever unexpected restraint might come about would be less than an equal amount of restraint that consumers believed was permanent.

Full year effects. By contrast, fiscal restraint in 2013 as a whole would most likely be greater under a status-quo election outcome than under other potential scenarios, for three reasons:

1. **Difficulty in delaying the sequester.** While both parties have endorsed reversing the planned automatic spending cuts under the "sequester" for 2013, Republicans appear to have greater motivation to do so. This is because they have been very clear in their opposition to defense cuts that would take place under the automatic cuts. While we would also expect congressional Democrats and the White House to support an effort to replace these cuts with equivalent savings over ten years, it is not yet clear how the two parties will be able to agree to do this; Republicans have proposed replacing defense cuts with domestic cuts, which many Democrats are unlikely to accept. The President's budget omits the automatic cuts and proposes spending cuts and tax increases, which nearly all Republicans oppose. Thus, under a status-quo election outcome the probability that the sequester would be allowed to take place in 2013 is higher than under other scenarios.
2. **Greater potential for a tax increase.** If Republicans win the White House, the Senate majority, or both, the likelihood of a full extension of the 2001/2003 tax cuts would increase (the likelihood would clearly increase more if Republicans win both). By contrast, under a status quo election outcome, a compromise on the expiring tax cuts will be necessary. This could involve allowing some of the top rates to expire for 2013 (either rates on income over $250,000, as the President proposes, or more likely rates on incomes over $1 million, as some congressional Democrats have suggested). It could also involve an agreement to extend the 2001/2003 tax cuts, in return for enacting some of the more targeted corporate tax increases the President has proposed (e.g., carried interest, oil and gas tax preferences, etc). A third possibility would be a temporary extension, perhaps lasting one year, designed to give lawmakers the opportunity to address more fundamental tax reforms that go beyond the binary question of whether or not to extend the upper income rates, and instead restructure the tax code to raise revenue versus current policy without necessarily raising rates. It is too early to speculate on what form such a compromise on income taxes would take under a status quo election outcome, but it is clearly possible that it would involve an increase in tax revenues. While neither the President nor Republican leaders have proposed further extension of the 2 percentage point payroll tax cut that was recently extended to the end of 2012, further extension appears less likely in a divided government scenario and seems likely only in a scenario in which Democrats gain control of the House while maintaining control of the Senate and the White House.
3. **Lower likelihood of additional fiscal stimulus.** If the status quo is maintained, it is less likely that any additional stimulus will be enacted assuming the economic outlook remains similar to our forecast. President Obama's most recent budget proposed $160 billion in additional job creation measures in fiscal years 2013 and 2014, but there is little support among congressional Republicans for the proposals. If Democrats were to gain the majority in the House and retain control elsewhere, hiring incentives and infrastructure spending, among other items, might gain traction. While most Republicans have expressed little enthusiasm for further extensions of the payroll tax cut, they have shown interest in a tax cut for small businesses and profit repatriation, among other proposals.

The election won't be the only factor determining whether these policies are addressed at year end. First and foremost, changes in the economic outlook could force lawmakers to shift their positions. As noted above, the statutory debt limit is also likely to require another increase around the end of the year, which will necessitate legislation. If the binding deadline to enact debt limit legislation falls before the end of 2012, this could very easily become a vehicle to address--even if only on a temporary basis--some of the issues noted above. Pressure from the rating agencies could also influence which policies are extended, though we would note that in the last fiscal debate the views of the rating agencies were generally not a major factor.

It is also worth noting that while the outcome of policy decisions in late 2012 and/or early 2013 is becoming an important focus for market participants, the fiscal debate will clearly extend beyond this. We expect that debate on reducing long-term fiscal imbalances will restart in earnest again in 2013, potentially intersecting with extensions of some of the policies noted above (for instance, if one final temporary extension of expiring tax cuts at the end of 2012 sets the stage for a debate on tax and/or entitlement reform at some point in 2013, when tax cuts would be once again due to expire). The longer term debate is beyond the scope of this article, but is also very relevant and will also clearly be influenced by the election outcome.

Alec Phillips

Fiscal Effecf of Policies Set to Expire or Take Effect Under Current Law (Billions of Dollars vs. Q4 2012, Annualized)

	Q1 2013	**Q2 2013**	**Q3 2013**	**Q4 2013**	**CY 2013**	**GS Assumption**	**Republican Position***	**Democratic Position***
"Sequester" Automatic Cuts (Discretionary Spending)	-60	-68	-76	-76	**-70**	Delayed past 2013, with equivalent savings spread over 2013-2022	House Budget Resolution assumes 85% of discretionary cuts, at a cost of $78bn/10yrs, financed w/ $116bn/10yrs in savings	President's budget assumes sequester does not take effect; also proposes deficit reduction, but not directly linked to sequester repeal
"Sequester" Automatic Cuts (Mandatory Spending)	-16	-16	-16	-17	**-16**			
2001/2003 Tax Cuts (250k+ Incomes, Estate Tax)	-38	-58	-58	-65	**-55**	Extension	Extension	No extension
2001/2003 Tax Cuts (Middle Income)	-164	-156	-137	-172	**-157**	Extension	Extension	Extension
Alternative Minimum Tax (Incl. Interaction w/ Tax Cuts)	0	-374	-125	-29	**-132**	Extension	Extension	Extension
Payroll Tax Cut	-94	-114	-114	-114	**-109**	No Extension	Supported previous extensions, but many view as ineffective means of stimulus	Supported previous extensions; President's budget does not propose extension for 2013
Emergency Unemployment Compensation	-34	-34	-34	-34	**-34**	No Extension		
Affordable Care Act (3.8%/0.9% tax on passive/ wage income 250k+)	-27	-27	-27	-27	**-27**	Implemented on schedule	Repeal	Implemented on schedule
Total (All Provisions)	**-433**	**-847**	**-587**	**-534**	**-600**			
Total (GS Assumption)**	**-155**	**-175**	**-175**	**-175**	**-170**			

*Our estimates, based on budget proposals where possible.

** For ease of exposition, this table excludes several smaller policies set to expire at year end, as well as fiscal restraint imposed by fading stimulus and other spending cuts already underway.

Source: GS Global ECS Research. Congressional Budget Office. Office of Management and Budget. House Budget Committee. Treasury Dept.

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