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MEMORANDUM

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November 20, 2012

TO: Interested Persons

FROM: Larson Silbaugh, Economist, (303) 866-4720

SUBJECT: Fiscal Constraint in Current Federal Law

Summary

Under current law, a number of federal fiscal policies are scheduled to take effect on January 1, 2013, that will reduce the deficit by an estimated $534 billion in 2013. The reduced deficit is achieved by raising $4.93 in taxes for every $1.00 in spending cuts. If Congress and the President do not act, then federal fiscal policy will be significantly tighter. The combination of rapidly tightening fiscal policy and slow economic growth will likely send the economy into recession in the first half of 2013.

Starting January 1, 2013, a number of federal fiscal policies will change under current law. These include the expiration of tax cuts and spending programs, new taxes, new spending cuts, and the United States reaching its statutory borrowing limit. This additional revenue and reduced spending will decrease the deficit, but the Congressional Budget Office has estimated that if these fiscal policies take effect, the economy will enter a recession in the first half of 2013.[1]

This memo is focused on what is known about the current law changes in federal fiscal policies; what *will* happen if Congress and the President do not act, rather than what *could* happen under different scenarios. The memo has three primary sections:

- a description of the changes to federal tax policies under current law;
- a description of changes to federal spending under current law; and

[1] *Economic Effects of Reducing the Fiscal Restraint That is Scheduled to Occur in 2013*, Congressional Budget Office, May 2012.

- a comparison with other deficit reduction plans that have been advocated and a description of the size of the fiscal restraint relative to the rest of the economy.

Changes To Federal Tax Policies Under Current Law

Several federal tax law provisions will increase revenue in 2013 over 2012 levels, if the law is not changed. These include: the expiration of the tax cuts passed in 2001, 2003, and extended in 2010; tax cuts passed as part of the stimulus package; changes to the estate tax; new taxes that are part of the Affordable Care Act; and tax policy changes that Congress passes nearly every year. Each policy change is described below and summarized in Figure 1 on page 7. Where federal tax policy changes flow through to Colorado revenue collections, is also noted.

Expiration of income tax cuts. In 2001 and 2003, a number of changes to the individual income tax were put in place and set to expire in 2010. These changes were extended for another two years, so they will expire on December 31, 2012. These tax policies include:

- a reduction in tax rates;
- an increase in the amount of itemized deductions and personal exemptions allowed;
- an increase in tax preferences for families with children;
- a reduction in the "marriage penalty";
- a reduction in tax rates on long-term capital gains; and
- a reduction in tax rates on qualified dividends.

If these tax cuts expire, individual income tax liabilities will increase for all taxpayers. Because individual income taxes for 2013 are due April 15, 2014, there is some time between the expiration of the tax cuts and when they will actually be paid.

The reduction in itemized deductions and exemptions will increase federal taxable income. This, in turn, will increase taxable income for Colorado individual income taxpayers.

Individual income tax changes in stimulus bill. Three individual income tax provisions changed as part of the economic stimulus bill passed in 2009. One expanded the earned income tax credit for larger families and married couples. Another increased the refundability of the child rare tax credit, and the third provision increased the amount of income tax credits available for paying for college. These tax credits are set to expire at the end of 2012.

Expiration of the payroll tax cut. In 2010, the employee's share of the social security payroll tax was reduced from 6.2 percent to 4.2 percent. This reduction is set to expire at the end of 2012.

Estate tax. A series of bills have reduced the federal estate tax since 2000. In 2012, the estate tax applies to estates over $5.12 million and is taxed at 35 percent. Current law will reduce the exemption to $1 million and increase the tax from 35 percent to 55 percent.

Colorado has an estate tax equal to the maximum credit amount allowed for federal estate taxes. This federal credit is scheduled to return in tax year 2013, which will increase Colorado estate tax revenue, although it will not increase the combined federal-state estate tax liability.

Alternative minimum tax. The alternative minimum tax (AMT) was established in 1969 to ensure that high-income individuals pay a minimum amount in taxes. Over the years, Congress has passed legislation to increase the income thresholds to which the AMT applies. In 2011, the AMT applied to income over $74,450 for couples and $48,450 for individual filers. If there is no change in current law, the AMT will apply to income over $45,000 for couples and $33,750 for individual filers in 2012. The AMT is calculated when individual income taxes are paid in April.

Extenders. There are a number of short term tax provisions that Congress routinely extends, known as "extenders." These tax policy changes impact individual and corporate income tax provisions and are scheduled to expire at the end of 2012. On the corporate side, these include the research and experimentation credit, work opportunity tax credit, and bonus depreciation of new investments. On the income tax side, tax policy changes that have been extended in previous years include the deductibility of state and local sales taxes and the child adoption credit. Some of these provisions reduce federal taxable income. If they expire, Colorado taxable income will increase, increasing Colorado corporate and individual income taxes.

Health care taxes. The Affordable Care Act increased taxes on individuals making more than $200,000 and couples making more than $250,000. Earnings above those thresholds will be subject to an additional 0.9 percent income tax. Investment earnings for taxpayers above the threshold will be taxed at an additional 3.8 percent. The Affordable Care Act also increased the threshold for deducting medical expenses for non elderly taxpayers from 7.5 percent of adjusted gross income to 10 percent.

Total revenue increase. In total, these expiring tax changes are estimated to increase federal revenues by $444 billion in 2013.[2]

Changes To Federal Spending Under Current Law

In addition to expiring tax provisions, spending reductions are scheduled to take effect January 1, 2013. These spending cuts are a result of historical budgetary measures, expiring provisions tied to the recession, and sequestration.

Expiring Spending Policies

Medicare reimbursement for doctors. In 1997, Congress passed legislation that included a formula to calculate how much medical providers would be reimbursed for caring for patients. This formula was designed to slow the growth in health care costs. Every year since 2002, Congress

[2] *An Update to the Budget and Economic Outlook: Fiscal Years 2012-2022*, Congressional Budget Office, August 2012.

has suspended the formula to keep physicians from getting a pay cut for caring for Medicare patients. In 2010, the formula was suspended for two years, and under current law is scheduled to go back into effect on January 1, 2013.

Emergency unemployment benefits. Emergency unemployment benefits expire at the end of 2012. In 2008, the federal government created a program to supplement state unemployment insurance, providing benefits once state unemployment compensation ran out. If Congress does not act, this unemployment compensation will expire at the end of 2012.

The expiration of the Medicare doctor's reimbursement and emergency unemployment benefits is estimated to reduce spending by $36 billion dollars starting in January 2013.[2,3]

Sequestration

Sequestration refers to the spending cuts that were enacted by Congress after the 2011 Deficit Reduction Super Committee did not act. In the summer of 2011, as part of the compromise to raise the nation's borrowing limit, a special committee was tasked with finding $1.2 trillion in spending reductions. Approximately $600 billion over a ten-year period is scheduled to be cut from both defense spending and domestic spending.

Defense spending. If Congress does not act, the spending authority of the Department of Defense budget will be reduced by $54.7 billion. This amount takes into account savings from interest payments over the ten-year budget window. This is equal to a 9.4 percent across the board reduction in their budget. The spending authority is reduced in federal fiscal year 2013 and will reduce direct military spending in federal fiscal years 2013 and 2014.

Domestic spending. If Congress does not act, domestic spending authority will also be reduced by $54.7 billion in fiscal year 2013. Within this amount, spending reductions to Medicare are capped at 2 percent, or $11.1 billion. The remaining $43.6 billion represents other domestic spending. This is equal to an 8.2 percent reduction in discretionary spending and a 10.0 percent reduction in nonexempt direct spending. Reductions to the spending authority of the programs for federal fiscal year 2013 will reduce domestic spending in federal fiscal years 2013 and 2014.

Discretionary spending is the spending that is appropriated annually. It includes appropriations to most government agencies and federal grants. Direct spending is spending that is determined by formula or eligibility requirements and is not subject to annual appropriation limits. Most direct spending programs like Social Security, Medicare, food stamps, and unemployment insurance are exempt from sequestration. Direct spending that is impacted by the automatic spending cuts are mainly subsidized student loans.

The automatic spending reductions resulting from sequestration equal $109 billion in spending authority in federal fiscal year 2013. The Congressional Budget Office estimates that

[3] *Economic Effects of Reducing the Fiscal Restraint that is Scheduled to Occur in 2013*, Congressional Budget Office, May 2012.

sequestration will reduce spending by $54 billion in calender year 2013.[4] The total reduction in spending due to expiring fiscal policies and automatic spending cuts between 2012 and 2013 equals $90 billion.

Debt Ceiling

In addition to the current law spending and revenue changes, the federal debt limit will need to be raised early in 2013. The current debt limit is set at $16.4 trillion and, as of October 31, 2012, the federal debt was $16.2 trillion.[5] The automatic spending cuts referred to as sequestration and a downgrade in the federal government's credit rating by Standard and Poor's resulted from the debate about the last increase in the debt-ceiling in 2011.[6]

Combined Effects

Figure 1 shows the estimated impact of the changes in tax and spending in current law. The Congressional Budget Office[7] estimates rely on estimates of economic activity to calculate the revenue increases associated with each policy. The estimates take into account the combined effects of certain policies. For example, letting the income tax provisions expire would increase federal revenue by $108 billion, and not indexing the AMT to inflation would increase federal revenue by $103 billion. Combined, the expiration of these two policies would increase federal tax revenue by $247 billion. The combined effect is larger because the higher alternative minimum tax would apply to more taxable income.

The spending cuts are also reported by the Congressional Budget Office. The Congressional Budget Office reported only a single number for the automatic spending cuts, but the defense, Medicaid, and discretionary spending amounts reported were determined using information from the Office of Management and Budget.[8]

Figure 1 shows the difference between 2012 and 2013 for each of the fiscal policies. The longer the graph, the longer the policy has been in place. For changes that will occur for the first time in 2013, like the health care taxes and sequestration, they are shown starting in 2013. The height of the graph shows the estimated impact on federal revenue or spending. The taller the graph, the larger the dollar amount that is involved.

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[4] *An Update to the Budget and Economic Outlook: Fiscal Years 2012-2022*, Congressional Budget Office, August 2012.

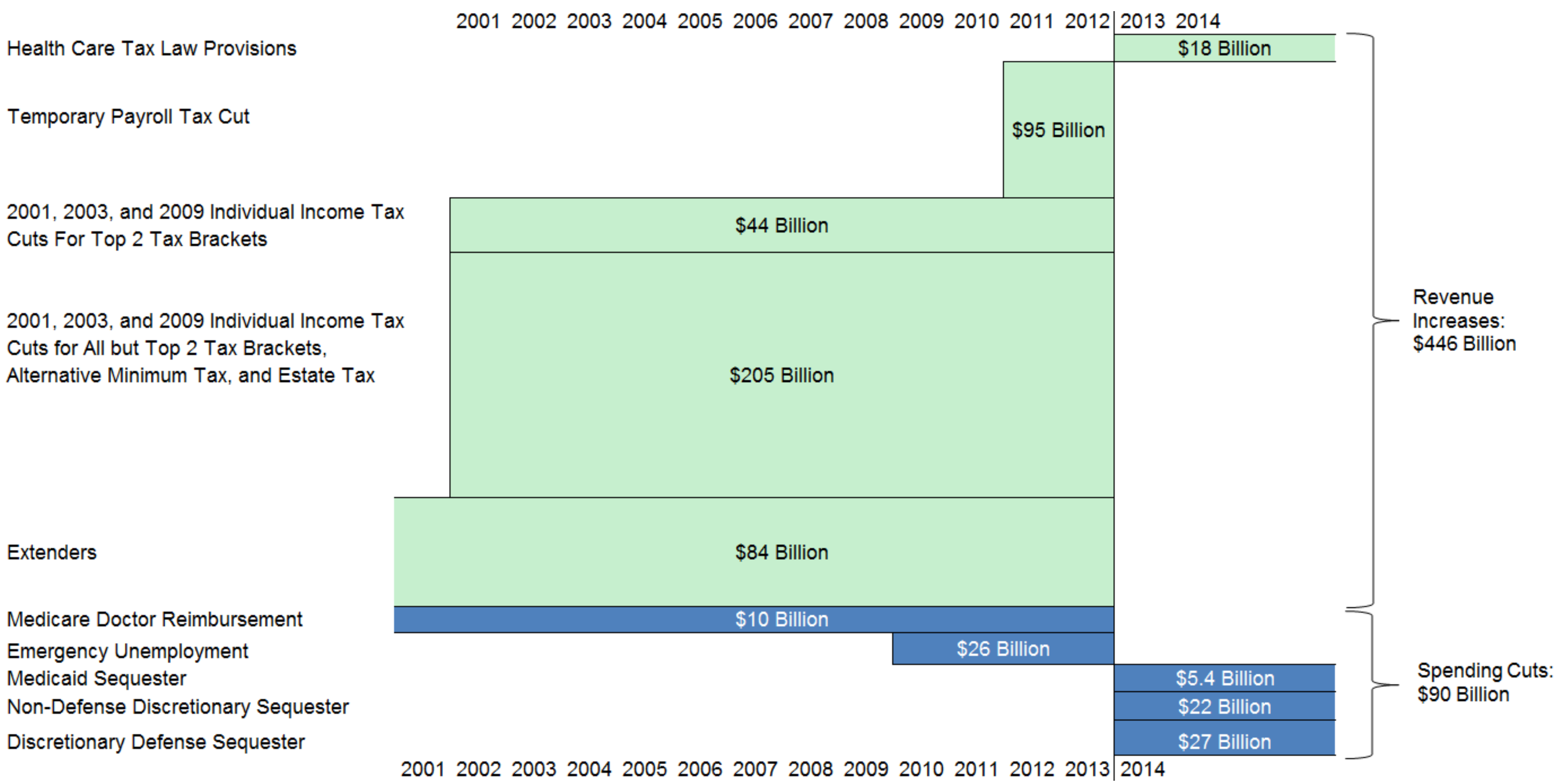
[5] United State Treasury Department Website, accessed October 31, 2012.

[6] *United States of America Long-Term Rating Lowered to 'AA+' on Political Risks and Rising Debt Burden*, Standard and Poor's, August 5, 2011.

[7] *An Update to the Budget and Economic Outlook: Fiscal Years 2012-2022*, Congressional Budget Office, August 2012

[8] *OMB Report Pursuant to the Sequestration Transparency Act of 2012*, White House Office of Management and Budget.

Figure 1
Components of the Fiscal Cliff: Difference Between CY 2012 and CY 2013



Source: Congressional Budget Office, Office of Management and Budget.

Fiscal Restraint In Context

The next section of this memo puts the changes in federal fiscal policies in context by comparing them to other deficit reduction plans that have been advocated and the size of the fiscal restraint relative to the size of the economy.

Ratio of Revenue Increases to Spending Cuts

If current law is not changed, the budget deficit will be reduced by about $536 billion dollars between 2012 and 2013. This is made up of $90 billion in spending cuts and $446 billion in tax increases, a ratio of $1.00 in spending cuts to $4.95 in tax increases.

Table 1 is included to illustrate the share of deficit reduction attributable to tax increases and spending reductions between current law and other plans that have been proposed. About 16.8 percent of the reduction in debt in 2013 is from current law changes is from spending cuts; 69.0 percent of deficit reduction under the Simpson-Bowles Commission is from spending cuts.

Table 1
Ratio of Spending Cuts to Revenue Increases in Selected Deficit Reduction Plans

Proposal	Spending Cuts to Tax Increases
House Republican Budget[9]	$1.00 to $0.00
White House Budget[10]	$2.50 to $1.00
Simpson-Bowles[11]	$2.23 to $1.00
Current Law	$1.00 to $4.93

Sources: House Budget Committee, White House Office of Management and Budget, The National Commission on Fiscal Responsibility and Reform.

Size of the Fiscal Restraint Relative to the Economy

Using the estimates above for tax years and federal fiscal year spending authority, total fiscal constraint will be $534 billion dollars. According to the Bureau of Economic Analysis, the U.S. Gross Domestic Product (GDP) was $15.775 trillion in the third quarter of 2012, and increased at an annualized rate of 2.0 percent between the second and third quarter of 2012.[12] Current law

[9] *The Path to Prosperity, Fiscal Year 2013 House Budget Resolution*, House Budget Committee.

[10] *2013 Budget Overview*, White House Office of Management and Budget.

[11] *The Moment of Truth*, The National Commission on Fiscal Responsibility and Reform, December 2010.

[12] Gross Domestic Product: Advance Estimate Third Quarter 2012, U.S. Bureau of Economic Analysis, October 26, 2012.

fiscal constraint scheduled to take effect in early 2013 equals 3.4 percent of the most recent estimate of GDP.

The Congressional Budget Office has forecast that the combination of weak economic trends and federal fiscal constraint will lead to a recession.[13] If taxing and spending policies in 2013 are the same as 2012, the Congressional Budget Office estimates GDP would grow 5.3 percent between the fourth quarter of 2012 and the second quarter of 2013. Under current federal law the Congressional Budget Office forecasts that GDP will decrease 1.3 percent between the fourth quarter of 2012 and second quarter of 2013. This estimate accounts for the timing of tax changes, federal fiscal year spending, and secondary impacts in the broader economy. It does not take into account any impact if the federal debt ceiling is not raised.

Summary

It is not clear what federal fiscal policy will actually be in 2013. This memo has described the changes to tax and spending policy that are scheduled to occur under current law, which can be changed at any time.

A variety of revenue changes are scheduled to increase taxes, and they have a variety of origins. Some of the policies are a result of the Affordable Care Act and some are related to the federal stimulus. Tax cuts that were first enacted in 2001 and 2003 are set to expire, as are the estate tax changes that were passed in the 2000s. In addition, the alternative minimum tax and various other tax policy changes that have been regularly extended are set to expire. All of these changes are set to occur at the same time, January 1, 2013, and how or if they will be extended is not clear.

There are several changes on the spending side that will reduce federal spending starting January 1, 2013. Like the revenue changes, the spending policies have different origins. Unemployment benefits are related to stimulus spending. The Medicare payment for physicians is related to a spending formula passed in the 1990s and has been postponed for the past 10 years. The largest spending cuts are related to the sequester and the debt limit increase in 2011. Each of these spending reductions will start impacting federal spending in January 2013.

In addition to federal spending and revenue policies, the U.S. debt will reach its statutory limit in late 2012 or early 2013.

The impact of these policy changes is not clear, but with a slowly growing economy the changes will likely send the United States into a recession. The federal fiscal policy changes set to occur in 2013 include more tax increases and fewer spending reductions than other deficit reduction plans that have been advocated.

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[13] *Economic Effects of Reducing the Fiscal Restraint that is Scheduled to Occur in 2013*, Congressional Budget Office, May 2012.