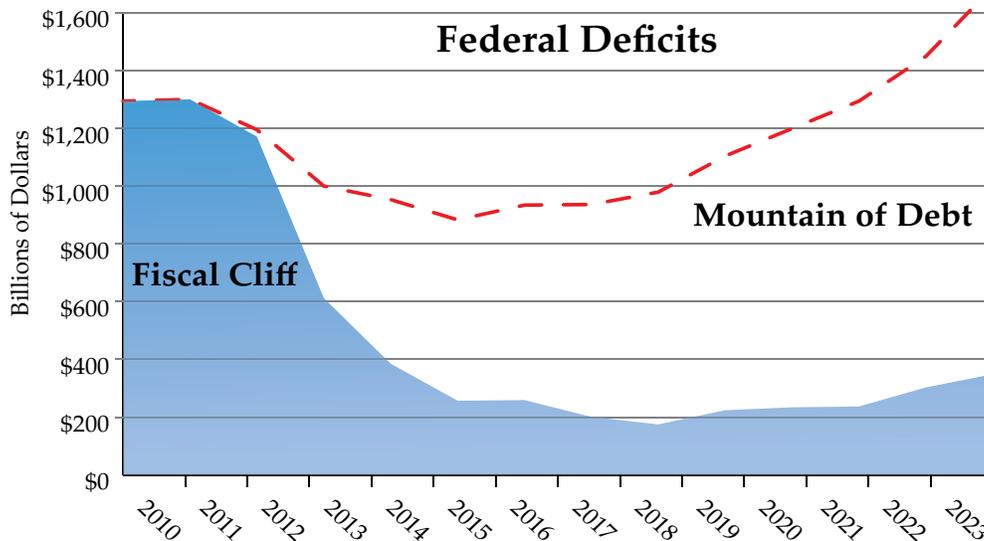




**THE COMMITTEE FOR A
RESPONSIBLE FEDERAL BUDGET**

Between a Mountain of Debt and a Fiscal Cliff

Finding a Smart Path Forward



Note: Graph reflects CBO current law and alternative fiscal scenario deficits.

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The Committee for a Responsible Federal Budget is a bipartisan, non-profit organization committed to educating the public about issues that have significant fiscal policy impact. The Committee is made up of some of the nation's leading budget experts including many of the past Chairmen and Directors of the Budget Committees, the Congressional Budget Office, the Office of Management and Budget, the Government Accountability Office, and the Federal Reserve Board.

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Between a Mountain of Debt and a Fiscal Cliff

Introduction

At the end of 2012 and the beginning of 2013, many major fiscal events are set to occur all at once. They include the expiration of the 2001/03/10 tax cuts, the winding down of certain jobs provisions, the activation of the \$1.2 trillion across-the-board “sequester,” an immediate and steep reduction in Medicare physician payments, the end of current Alternative Minimum Tax (AMT) patches, and the need to once again raise the country’s debt ceiling.

At the end of 2012, we face what Federal Reserve Chairman Ben Bernanke calls a “fiscal cliff.”¹ Taken together, these policies would reduce ten-year deficits by over \$6.8 trillion relative to realistic current policy projections – enough to put the debt on a sharp downward path but in an extremely disruptive and unwise manner.

Gradually phasing in well thought-out entitlement and tax reforms would be far preferable to large, blunt, and abrupt savings upfront. Policies set to take effect at the end of the year could seriously harm the short-term economy without making the changes necessary to address the drivers of our debt or strengthen the economy over the long-term.

However, the *worst-case scenario* would be for lawmakers to repeal the sequester and once again extend expiring debt-expanding policies without offsetting their costs.

If policymakers were to walk away from this potentially action-forcing moment to help them put the country’s debt on a sustainable path, it could lead to a loss of confidence in their ability to govern that could set off a dangerous chain reaction in markets. Statements from major credit rating agencies, especially Moody’s, have indicated that such action could result in downgrades of our debt. Downgrades aside, extending the policies currently in place would put our debt on an upward and ultimately unsustainable path.

The approaching fiscal cliff, therefore, represents both a challenge and an opportunity. The stakes are too high not to take advantage of it by enacting a thoughtful and gradual plan to stabilize the debt and put it on a downward path. Failure simply is not an option.

What We Face at Year's End

As Federal Reserve Chairman Ben Bernanke has explained, at the end of the year “there’s going to be a massive fiscal cliff of large spending cuts and tax increases.” Although some combination of spending cuts and new revenue are desperately needed to put the country on a sustainable path, Chairman Bernanke has rightly pointed out that “it is important to achieve sustainability over a longer period...one day is a pretty short time frame.”²

Instead, policymakers should enact a comprehensive plan to replace much of the approaching fiscal cliff with a combination of tax reform, entitlement reform, and spending reductions which could phase in gradually and thoughtfully to put the debt on a clear downward path.

Absent such action, however, this deficit reduction would occur all at once in a blunt and ultimately anti-growth manner. The following is set to take place at the end of 2012:

The Expiration of the 2001/2003/2010 Tax Cuts

On December 31st, the set of tax cuts enacted in 2001, expanded in 2003, and extended in 2010 will expire. As a result, the top rate will rise from 35 percent to 39.6 percent and other rates will rise in kind. The 10 percent bracket will disappear, and the child tax credit will be cut in half and no longer be refundable. The estate tax will return to the 2001 parameters of a \$1 million exemption and a 55 percent top rate. Capital gains will be taxed at a top rate of 20 percent and dividends will be taxed as ordinary income. Finally, marriage penalties will increase, and various tax benefits for education, retirement savings, and low-income individuals will disappear.

The End of AMT Patches

Congress generally “patches” the AMT every year to help it keep pace with inflation. As a result, just over four million tax returns currently pay the AMT. If a new patch is not enacted retroactively for 2012, that number will increase to above 30 million for that year and would exceed 40 million by the end of the decade.³

The End of Jobs Measures

In February, the President signed an extension of a two percent payroll tax holiday and extended unemployment benefits through year’s end. Under current law, both will disappear at the end of the year, causing employee payroll taxes to increase from 4.2 percent to 6.2 percent, and reducing the number of weeks individuals can collect unemployment insurance.

The End of Doc Fixes

The Sustainable Growth Rate formula calls for a substantial reduction in Medicare payments to physicians – a reduction lawmakers have deferred through continued “doc fixes” since the early 2000s. At the end of the year, the current doc fix will end, leading to a nearly 30 percent immediate reduction in Medicare physician payments.

The Activation of the Sequester

Beginning on January 1, 2013, an across-the-board \$1.2 trillion spending sequester over ten years will go into effect as a result of the failure of the Super Committee. The sequester will immediately cut defense spending across the board by about ten percent, will cut non-defense discretionary spending by about

eight percent, and will reduce Medicare provider payments by two percent. In total, this will result in an immediate \$110 billion single-year reduction in budget authority.⁴

The Expiration of Various “Tax Extenders”

Various normal “extenders,” such as the research and experimentation tax credit and the state and local sales tax deduction, expired at the end of 2011. Some of these extenders are likely to be reinstated retroactively at the end of this year, but will disappear under current law.

The Implementation of New Taxes from PPACA

The Patient Protection and Affordable Care Act (PPACA) included several revenue measures set to go into effect in 2013. The largest of these measures is a 0.9 percent increase in the Medicare HI (hospital insurance) payroll tax for higher earners and an effective 3.8 percent tax increase on investment income. The law also calls for an increase in the floor for unreimbursed medical expense deduction, a 2.3 percent excise tax on medical devices, limits on annual contributions to Flexible Spending Accounts (FSAs), and elimination of the employer deduction for Medicare Part D retiree subsidy payments.

Reaching the Debt Ceiling

The debt ceiling agreement reached last summer is likely to allow continued borrowing through the 2012 election – particularly given that the Treasury Department has a number of “extraordinary measures” at their disposal to delay hitting the ceiling. However, the debt ceiling may need to be increased again at year’s end in order to avoid a potential default.

* * * *

Allowing some of the policies to occur at the end of the year would not necessarily be problematic, and could indeed improve our fiscal credibility and sustainability going forward. Some of the broad-based changes set to occur could help lawmakers further control discretionary spending, Medicare, and other programs while raising new revenues if they were all implemented in a targeted and gradual way. However, allowing all of the policies to occur at once would be such a large and abrupt change that they would be economically damaging. Moreover, policymakers should not abdicate their responsibilities for determining the nation’s priorities and how to pay for them by turning over budget decisions to blunt tools and the sun-setting of existing policies. Instead, they should replace the dangerous fiscal cliff with a gradual, targeted, and credible plan to fix the debt.

The Fiscal Impact of the Cliff

The changes set to occur at the end of the year are likely to create a large fiscal cliff if they occur all at once, but would add substantially to the deficit (relative to current law) if lawmakers continue them indefinitely. Relative to current law, which assumes many expiring provisions actually will expire, the 2013-2014 two-year cost of extending these policies is about \$1 trillion (roughly 3.5 percent of GDP over the relevant period). Relative to where we are today, letting them expire would lead to a “fiscal shock” of similar magnitude.⁵

Extending these policies permanently could increase the debt in 2022 by about \$7.5 trillion above current law. This means debt would rise from 70 percent of GDP today to 88 percent by 2022 if lawmakers continued current policies, compared to current law where debt is scheduled to fall to 61 percent. Continuing all the expiring provisions and cancelling the sequester without a plan in place would be a dramatic move in the wrong direction and should be considered a non-starter.

FIG 1. THE FISCAL IMPACT OF POLICIES THAT EXPIRE OR ACTIVATE IN OR AFTER 2012

	Cost of Renewal (Fiscal Years)		
	2013	2013-2014	2013-2022
2001/2003/2010 Tax Cuts	\$110 billion	\$340 billion	\$2.8 trillion
Expiration of American Opportunity Tax Credit	\$3 billion	\$15 billion	\$125 billion
Reduction of Child Tax Credit from \$1,000 to \$500 per child	\$7 billion	\$40 billion	\$350 billion
Expiration of Child Tax Credit enhanced refundability	\$0 billion	\$10 billion	\$90 billion
Expiration of EITC expansion	\$0 billion	\$10 billion	\$95 billion
Elimination of 10% Bracket	\$30 billion	\$80 billion	\$450 billion
Increase in rates from 25 28 33 35 to 28 31 36 39.6	\$40 billion	\$95 billion	\$730 billion
Restoration of phased outs for itemized deductions and personal exemptions (Pease and PEP)	\$6 billion	\$20 billion	\$165 billion
Expiration of reductions in marriage penalties	\$5 billion	\$10 billion	\$55 billion
Increase in capital gains taxes from 15% to 20% and dividends taxes from 15% to being taxed as ordinary income	\$15 billion	\$25 billion	\$315 billion
Expiration of various education and other tax benefits	\$1 billion	\$5 billion	\$20 billion
Increase in estate tax from 35% over \$5 million to 55% over \$1 million	\$5 billion	\$35 billion	\$430 billion
AMT Patches	\$125 billion	\$225 billion	\$1.7 trillion
Cost relative to current law	\$90 billion	\$130 billion	\$805 billion
Interaction with extension of 2001/2003/2010 tax cuts	\$35 billion	\$100 billion	\$920 billion
Jobs Measures	\$115 billion	\$150 billion	\$150 billion
Expiration of 2% payroll tax holiday*	\$90 billion	~\$120 billion	~\$120 billion
Expiration of expanded unemployment benefits*	\$25 billion	~\$30 billion	~\$30 billion
Doc Fixes	\$10 billion	\$30 billion	\$270 billion
The BCA Sequester	\$65 billion	\$160 billion	\$980 billion
2% reduction to Medicare providers	\$5 billion	\$10 billion	\$90 billion
Other mandatory reductions	\$5 billion	\$10 billion	\$45 billion
10% reduction in defense spending (down to 8.5% by 2021)	\$30 billion	\$80 billion	\$510 billion
8% reduction in non-defense discretionary spending (5.5% by 2021)	\$25 billion	\$55 billion	\$335 billion
"Tax Extenders"^^	\$30 billion	\$60 billion	\$455 billion
Subpart F for active financing income	\$5 billion	\$10 billion	\$80 billion
R&E tax credit	\$5 billion	\$10 billion	\$65 billion
Alcohol fuel tax credit	\$10 billion	\$10 billion	\$60 billion
Other extenders	\$10 billion	\$30 billion	\$250 billion
Health Care Reform Taxes	\$25 billion	\$50 billion	\$420 billion
Increase HI tax by 0.9% for high earners and apply full tax to investment income	\$20 billion	\$40 billion	\$335 billion
FSA limit, medical device tax, and other measures	\$5 billion	\$10 billion	\$85 billion
Net Interest	n/a	n/a	\$1.2 trillion
TOTAL (without Jobs Measures)	~\$400 billion	~\$900 billion	\$7.9 trillion
TOTAL (with Jobs Measures)	~\$500 billion	~\$1 trillion	\$8.1 trillion

Note: Cost estimates of policies calculating off of a current law baseline. Numbers are rounded.

*Assumes one-year extension only.

^^Measures exclude expiration of bonus depreciation and expensing rules.

The Economic Consequences of the Fiscal Cliff

Avoiding the fiscal cliff altogether would cost about \$500 billion in fiscal year 2013 and \$1 trillion through FY 2014, the equivalent of nearly 4 percent of GDP over the relevant time periods. In other words, there would be about 4 percent of GDP less in deficits than if we continue to do what we are doing today (including upholding the Budget Control Act caps and continuing to draw down the wars abroad).

At any time, such a change could cause an abrupt shock to the economy and a temporary spike in unemployment along with a fall in economic activity. This is even truer in the midst of a fragile economy which has yet to fully recover from a deep economic recession. According to the Congressional Budget Office (CBO), allowing the fiscal cliff to occur would shrink the size of the economy by about 3 percent in the first half of 2013, relative to continuing current policy, and it would reduce employment by one to two million.

Importantly, CBO found that over the long-run the opposite would be true if the fiscal cliff is waived – the economy would be notably smaller due to the substantial debt accumulation we face if lawmakers continue to enact deficit-increasing policies.

FIG 2. EFFECT OF CONTINUING CURRENT POLICY (I.E. AVOIDING A FISCAL CLIFF)

Economic Measure	Effect in 2013	Effect in 2022
Change in Real GDP Growth (Q4 to Q4)	+1.6%	-0.2%
Change in Real GDP Level	+2.1%	-1.0%
Change in Unemployment Rate (Q4)	-1.1%	n/a
<i>Memorandum: Change in Real GNP Level from More Gradual Illustrative \$2.4 Trillion Debt Reduction Plan*</i>	-0.4%	1.0%

*Estimates from the Congressional Budget Office, and reflect effect in first year and tenth year.

Looking at growth trends, CBO finds the economy would contract by 1.3 percent in the first half of 2013 and grow by only 2.3 percent in the second half, for total yearly growth of only 0.5 percent. This contraction would almost certainly be substantial enough to constitute a double-dip recession. Even these estimates may underestimate the pain associated with the fiscal cliff since they do not fully account for the continued market uncertainty or the potential “hysteresis” associated with continued long-term unemployment.

Moreover, because of the composition of policies in the fiscal cliff, there is only a weak case for short term pain leading to long-term gain. True, there will be medium and long-term benefits as a result of lower deficit and debt levels. However, both the spending cuts and revenue increases come in ways which are generally anti-growth, thereby partially offsetting these gains.

The spending cuts take place across-the-board, exempting most transfers and entitlement programs. This means substantial cuts to potentially pro-growth investments such as education, infrastructure, and

research and development. The revenue increases, meanwhile, come mainly from increasing rates across-the-board on earned income as well as capital gains and dividends.

To be sure, the positive effects of the deficit reduction still outweigh the negative effects of its sources over the medium and long-term. However, a better approach would be to focus spending cuts on low-priority spending and on changes which can help to encourage growth and generate new revenue through comprehensive tax reform which broadens the base – ideally by enough to also lower tax rates.

The Policy Consequences of the Fiscal Cliff

Not only are there economic considerations associated with the fiscal cliff, but there are also important policy issues raised as a result of the policies which would go into effect at year's end.

While further spending reductions are certainly warranted, it would be much more effective for lawmakers to make calculated decisions about where to spend less instead of across-the-board reductions to almost all spending not exempt from the sequester. The sequester's blunt savings offer limited flexibility on how best to achieve savings, which would result in serious strategic challenges on the defense side as well as in many non-defense programs.

Additionally, on the tax side, the fiscal cliff would lead to abrupt increases in taxes for nearly every person without making strategic choices about how to best improve the tax code. While policymakers must not extend expiring tax cuts without offsets or a comprehensive fiscal plan, it would be far better policy to raise revenue by simplifying and cleaning out tax breaks from the tax code rather than adding higher rates on top of a code that is in many ways broken.

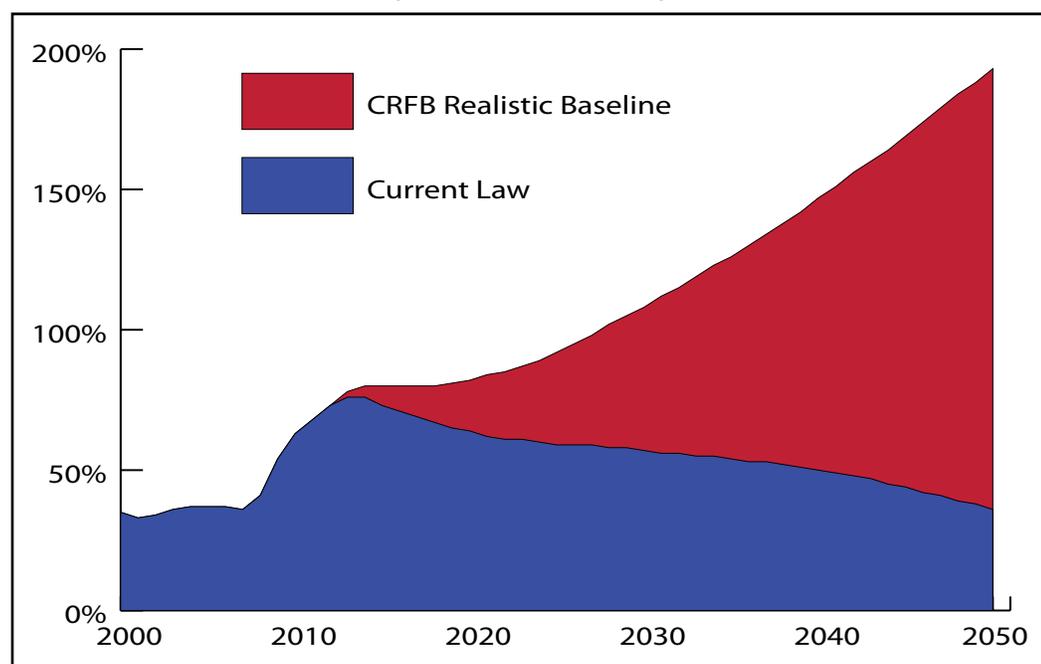
Finally, the policies in the fiscal cliff would do little to address the root of the country's fiscal problems – the unsustainable growth of health and retirement programs. The sequester, for the most part, exempts these programs.

The Consequences of a Mountain of Debt

On our current path, debt has already risen from 40 percent only a few years ago to 70 percent today, and under CRFB's Realistic Baseline it will rise to more than 85 percent by 2022, 130 percent by 2035, and nearly 200 percent by 2050.

This accumulation of debt is unsustainable and allowing it to occur is unacceptable. Failure to make the hard but necessary choices now on our own terms will lead to much harder and more severe choices later to control rising debt in the future. In the meantime, the strength of the economy will begin to suffer, as will confidence in the economy's future path and the ability of elected officials to address it.

FIG 3. DEBT PROJECTIONS (PERCENT OF GDP)



Note: For more details on the CRFB Realistic Baseline, see <http://crfb.org/document/analysis-cbos-budget-and-economic-projections-and-crfb-realistic-baseline>.

At some point, we may face a binary choice between a fiscal crisis and a sharp deficit reduction plan of similar magnitude to the fiscal cliff we face at year's end. This is an unappealing choice, and one that could easily be avoided by acting sooner rather than later.

Conclusion

At the end of the year, Congress and the President will face what appears to be a daunting choice: either allow the country to go off of a recessionary fiscal cliff all at once, or doom the country to large deficits that will permanently slow economic growth and increase the likelihood of a fiscal crisis.

Allowing the country to hit the fiscal cliff at year's end would be a dangerous mistake, but adding \$7.5 trillion to our debt by extending the expiring policies and repealing the sequester, without putting the budget on a more sustainable path, would be a travesty.

But the end of the year provides the opportunity for a third option – one which avoids many (though not necessarily all) of the abrupt changes at year's end and replaces them with a gradual and thoughtful plan to stabilize and then reduce the debt. As Chairman Bernanke has argued, Congress should “figure out ways to achieve the same long-run fiscal improvement [as the fiscal cliff] without having it all happen at one date.”⁶ A comprehensive deficit reduction plan can offer a win-win by giving the economy space to recover in the short-term while enacting long-term reforms to strengthen the economy and put the country's finances in order. Policymakers should avoid the fiscal cliff and take this course instead.

Appendix A: The Economic Effect of the Fiscal Cliff

Most experts agree that allowing the fiscal cliff to occur would lead to a substantial economic contraction and most likely a double-dip recession. However, various firms have reached different conclusions with regards to the size of the economic hit. For calendar year 2013, estimates of the impact on GDP range from 0.3 percent to 7.5 percent. Looking only at the first half of the year, the hit could be even more substantial.

Generally speaking, differences in estimates occur for one of two reasons. First, there is the question of what the cliff is being compared to – or what policies are considered “cliff policies” rather than “baseline policies.” Second, there is a question of multipliers and how much does the economy shrink with each dollar of deficit reduction.

FIG 4. ESTIMATES OF THE FISCAL CLIFF (CALENDAR YEAR 2013)

	Budgetary Impact (% of GDP)	Economic Impact (% of GDP)	Policies Included
CBO	3.3%*	0.3% to 2.9%	Tax cuts, AMT patch, jobs measures, sequester
CRFB	4.2%*	2.2%	Tax cuts, AMT patch, sequester, doc fix, ACA taxes, jobs measures
Mark Zandi	4.2% - 4.5%*	3.6%	Tax cuts, AMT patch, sequester, doc fix, ACA taxes, jobs measures, and bonus depreciation
Morgan Stanley	5%	2.5% to 7.5%*	Tax cuts, jobs measures, sequester, BCA caps, war drawdown, ACA taxes
Goldman Sachs	4%	4%	At least tax cuts, sequester, jobs measures
Bank of America Merrill Lynch	4.6%	N/A	Tax cuts, AMT patch, jobs measures, sequester, doc fix, BCA caps, tax extenders, ACA taxes, expensing, "other" programs

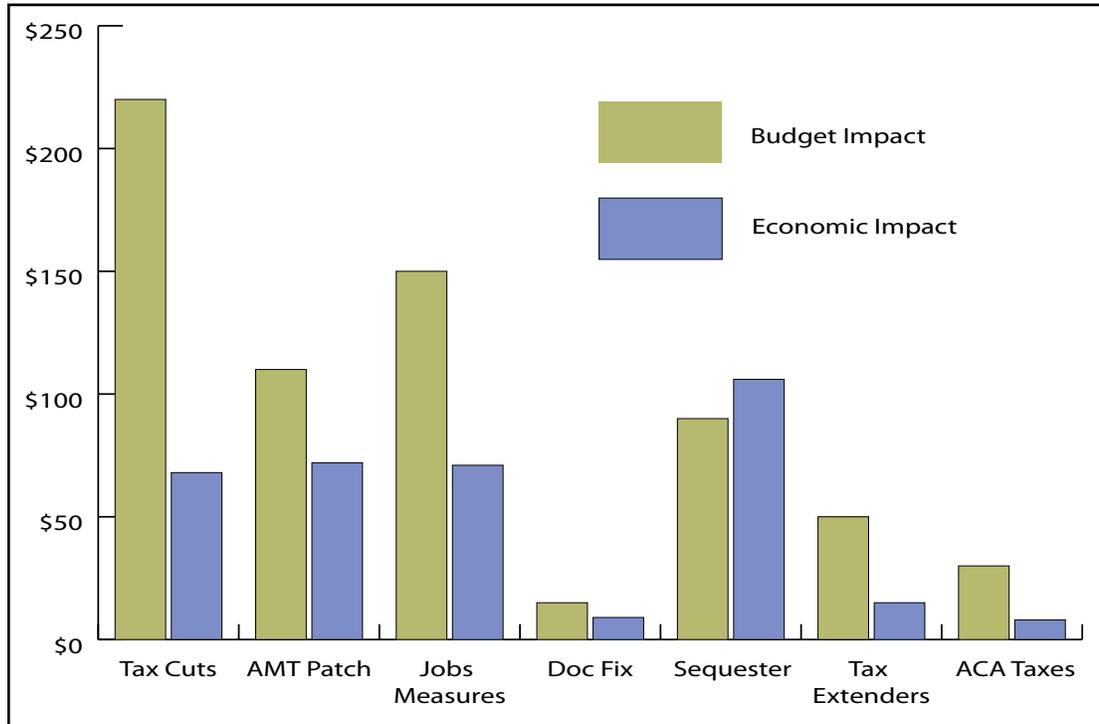
*Adjusted from fiscal year to calendar year estimates by CRFB. Mark Zandi estimates include the same policies as the CRFB scenario except for bonus depreciation, but details are not available for the form of the depreciation assumption and are thus reflected in the budgetary range.

The Congressional Budget Office estimates that allowing the fiscal cliff to take effect would reduce GDP by between 0.3 and 2.9 percent in 2013 compared to their Alternative Fiscal Scenario, with a central estimate of 1.6 percent.⁷ Adding the effects of the expiration of the payroll tax holiday, unemployment benefit expansions, and the new taxes from PPACA into the cliff, we estimate that number would increase to 2.2 percent.

Note that this compares to a fiscal impact of 4.2 percent by CRFB’s account. The difference between the fiscal and economic impact is the result of policy changes affecting the economy by more or less than they affect the budget using a ratio referred to as a “multiplier.”

Different policies can have very different economic multipliers. Although there are limits to the level of precision with which one can make these estimates, various multipliers provided by CBO allow us to categorize most policies into types of fiscal changes, and then apply multipliers to each.

FIG 5. ECONOMIC IMPACT OF THE FISCAL CLIFF (CBO MULTIPLIERS, CALENDAR YEAR 2013)



Note: CBO published overall multipliers for the tax cuts and AMT patches, but the remaining multipliers were constructed by CRFB staff based on CBO data to equal the overall economic effect of the fiscal cliff as estimated by CBO.

Using this methodology, we estimate very roughly that the expiration of the 2001/2003/2010 tax cuts, along with AMT patches, would reduce the size of the economy by about \$135 billion through the end of calendar year 2013 and the activation of the “sequester” would reduce it by a slightly smaller amount.

Of course, these numbers focus only on the short-term demand-side effects and do not look at the potential medium and long-term consequences (both positive and negative) of continuing current law. They also, importantly, do not show the serious negative consequences associated with continuing to kick the can down the road if lawmakers significantly add to the debt by waiving or not replacing the scheduled savings. Extending the fiscal cliff policies without a medium-term fiscal plan would substantially worsen market uncertainty and leave our debt on an unsustainable growth path which could ultimately lead to a fiscal crisis.

Appendix B: The Effect of the Fiscal Cliff on Defense Spending

In January 2013, the automatic sequester is set to reduce defense spending by \$492 billion over the 2013-2021 period, which would require an immediate reduction in defense spending of \$55 billion in 2013 off of projected levels. This would equate to a 10 percent abrupt reduction in defense spending over the full year, and could amount to a 15 percent cut in non-military personnel budgets when accounting for the fact that the cuts would begin three months into the fiscal year and could exempt military personnel.⁸ Moreover, these cuts would apply across the board to each “program, project, and activity,” and there is lack of clarity as to exactly how much discretion there is in determining what those terms mean.

In a letter to the Joint Select Committee on Deficit Reduction (Super Committee) in 2011, Secretary of Defense Leon Panetta outlined the types of changes the sequester would require from the Department of Defense.⁹ Assuming the President would exempt military personnel costs from sequestration, the potential impacts include:

- Furloughs for civilian personnel
- Reductions in contractor employees
- A 23 percent reduction in spending on major weapons programs which would increase unit costs, including the Joint Strike Fighter, P-8 aircraft, and ground combat vehicles
- A 23 percent reduction in ship and military construction, which would render them unusable
- Steep reductions in investment accounts, including research, development, testing, and evaluation
- War effort disruptions due to reductions in base budgets

Other independent analyses by experts at the Bipartisan Policy Center and the Center for American Progress have also noted the difficulty of reductions to programs, projects, and activities that include large procurement projects.¹⁰ Large reductions to such programs could force entire projects to be terminated, scheduling delays, and higher per unit costs by scaling back quantities.

Defense contractors and their employees could also be significantly affected by scheduled cuts. The Worker Adjustment and Retraining Notification Act enacted in 1988 requires companies to notify employees at least 60 days in advance of expected mass layoffs – a likely scenario in the event sequestration cuts go into effect. Some of the largest defense contractors, including Lockheed Martin, have announced plans to notify employees of the risk of such layoffs later in the fall, while many contractors have already begun scaling back operations in preparation for the sequester.

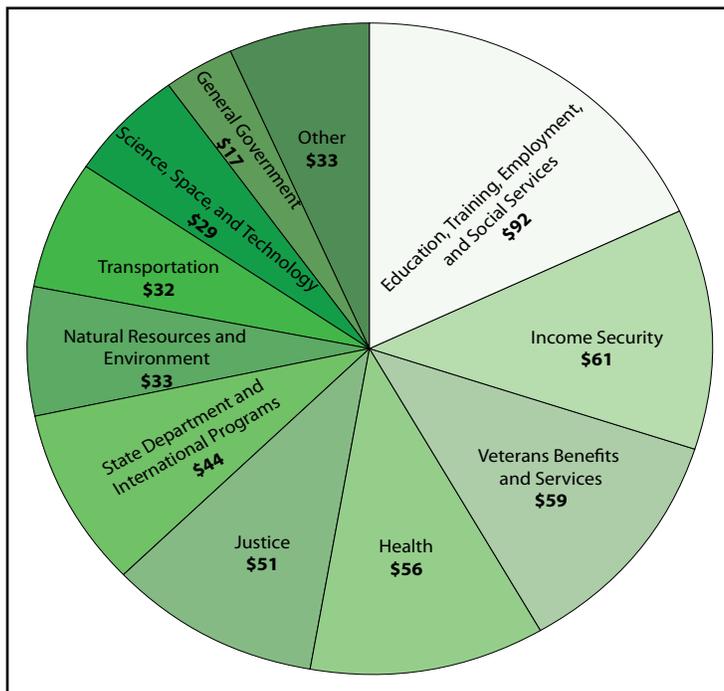
Appendix C: The Effect of the Fiscal Cliff on Non-Defense Discretionary Spending

Beginning in January 2013, automatic cuts to spending programs would also apply to non-defense funds annually appropriated by Congress, requiring a \$43 billion cut off of whatever level of funding lawmakers enacted for the year.

A cut of that size would equate to nearly an 8 percent reduction off of levels enacted in the BCA. Similar to the automatic defense cuts, the non-defense cuts would apply over the remaining 9 months of FY 2013 and could increase the effective percent reductions to roughly 10 percent. This cut is on top of substantial reductions enacted or scheduled in the past two years. Compared to CBO baseline levels from August 2009, for example, discretionary spending would be about 16 percent lower in FY 2013 – or closer to 22 percent when the cuts are applied over three quarters of the fiscal year.

With thousands programs throughout the non-defense discretionary budget, the sequester would likely affect the large majority of programs and services that the government provides. The sequester to non-defense programs would still apply at the same “program, project, and activity” level as would the defense sequester, although no guidance has been given on how that would be interpreted.

FIG 6. ELEMENTS OF THE NON-DEFENSE DISCRETIONARY BUDGET (BILLIONS OF DOLLARS)



Source: Congressional Budget Office, budget functions.

Included in non-defense discretionary programs are most Department of Education spending, including grants to states; transportation funds for highway repairs and new construction; Department of State diplomatic and consular efforts; homeland security initiatives, including customs and border protection; food safety, inspection, and evaluation programs; National Institutes of Health (NIH) research grants; the Federal Aviation Administration; and hundreds of others. Many programs within these efforts or departments would be slowed or cancelled.

Appendix D: The Effect of the Fiscal Cliff on Taxes

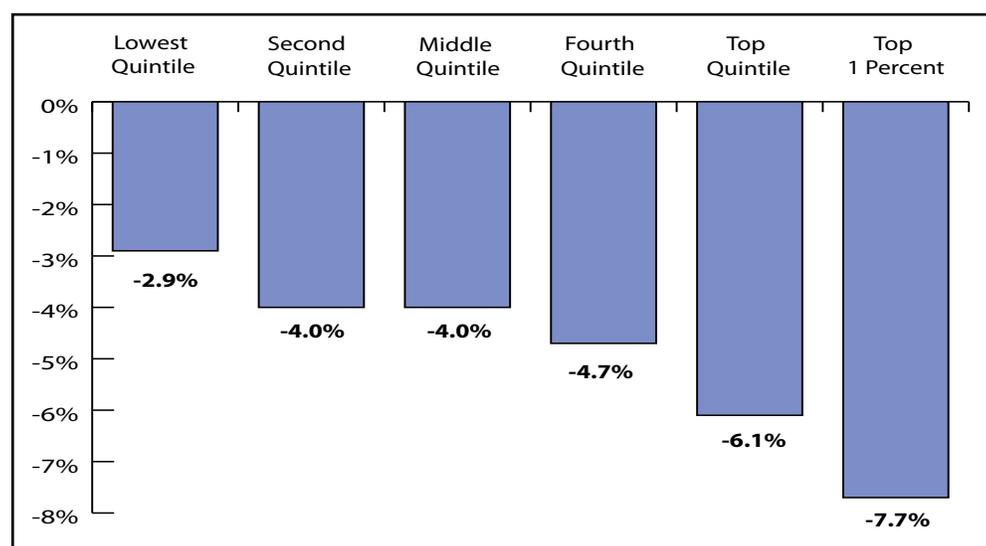
Many changes to the tax code are set to occur at the end of the year, including expirations of large income tax cuts and the implementation of several new tax measures. In terms of expirations, all of the 2001/2003/2010 tax cuts are scheduled to sunset – including the lower rates, larger credits, greater capital gains and dividends preferences, and smaller estate and gift taxes.

The expiration of the most recent AMT patch, which technically occurred at the end of last year, will also take effect -- increasing the number of affected tax returns from 4 million to above 30 million. On top of this, various temporary tax measures referred to as “tax extenders,” which lawmakers often extend, have already expired or are set to expire at the end of the year. These include the research and experimentation tax credit, the alcohol fuel tax credit, subpart F exemption for active financing income, educational expenses deduction, and many others. Finally, the temporary two percentage point payroll tax reduction (the “payroll tax holiday”) will expire.

Along with these expiring provisions, some taxpayers will be faced with new taxes from the PPACA set to go into effect on January 1, 2013. This includes increasing the Medicare HI payroll tax by 0.9 percent for people making over \$250,000 and extending the full 3.8 percent tax to net investment income for those high-earners; increasing the floor for the unreimbursed medical expense deduction from 7.5 percent to 10 percent of adjusted gross income; imposing a 2.3 percent excise tax on medical devices; limiting annual contributions to Flexible Spending Accounts (FSAs) to \$2,500; and eliminating the employer deduction for Part D retiree subsidy payments.

As a result of the impending tax changes, the Tax Policy Center finds that 83 percent of tax units will see their taxes go up – including more than 90 percent of every income group making above \$30,000 per year. On average, after-tax income will decrease by about 5 percent, with the bottom quintile seeing a roughly 3 percent reduction and the top quintile facing a 6 percent reduction.

FIG 7. PERCENT CHANGE IN INCOME FROM TAX MEASURES SET TO GO INTO EFFECT



Source: Tax Policy Center.

Appendix E: The Effect of the Fiscal Cliff on Medicare Spending

In January 2013, Medicare providers will be hit in two ways under the fiscal cliff – through the sequester, which will cut payments to most providers by two percent, and through the Sustainable Growth Rate (SGR), which will cut physician payments by 27 percent. These cuts total \$15 billion in 2013, \$26 billion in 2014, and \$312 billion through 2021.

The sequester exempts most entitlement spending from any reduction, but it does allow Medicare payments to providers to be cut – with a 2 percent limit on the size of that cut. By comparison, other non-defense discretionary and mandatory spending faces nearly an 8 percent cut in the first year of the sequester. However, some Medicare spending, such as subsidies for low-income earners, is completely exempt from the sequester. Another two percent of Medicare spending – mainly administrative costs – is not exempt and reduced by the same rate as other non-defense spending.

While most Medicare providers will see a two percent cut, physicians will face a much larger 27 percent cut in their payments. This is because of a formula known as the Sustainable Growth Rate (SGR), which was designed to control Medicare costs but has been waived time and again through doc fixes. The scheduled cuts can only be avoided through further waivers.

In addition to the budgetary pressures on providers, allowing the SGR to take effect could have significant impacts on Medicare beneficiaries' access to physician services. The Medicare Payment Advisory Commission has noted an increased concern that declines in physician payment rates and the uncertainty surrounding reimbursement levels could potentially jeopardize beneficiaries' access to health care services.¹¹

Endnotes

¹ Ben Bernanke, testimony before House Financial Services Committee, February 29, 2012. <http://www.reuters.com/article/2012/02/29/us-usa-fed-bernanke-idUSTRE81S1DO20120229>.

² Ben Bernanke, testimony before House Oversight Committee, March 21, 2012. <http://thehill.com/blogs/on-the-money/801-economy/217317-geithner-and-bernanke-were-not-greece>.

³ Technically, AMT patches have already expired – but they can be retroactively reinstated through the end of 2012.

⁴ Through 2021, the sequester will put in place cuts totaling \$455 billion in defense beyond the current limits set in the Budget Control Act, an additional \$295 billion in non-defense discretionary, \$90 billion in Medicare, and \$50 billion in other programs.

⁵ Many current policy projections, such as the CRFB Realistic Baseline, do not incorporate the costs of possible new job measures or various tax extenders. Incorporating those costs could increase the magnitude of a fiscal shock.

⁶ Ben Bernanke, testimony before House Financial Services Committee, February 29, 2012. <http://thehill.com/blogs/on-the-money/801-economy/213351-fed-boss-warns-of-massive-fiscal-cliff>.

⁷ Congressional Budget Office. “Economic Effects of Reducing the Fiscal Restraint Scheduled to Occur in 2013.” May 2012. http://www.cbo.gov/sites/default/files/cbofiles/attachments/FiscalRestraint_0.pdf.

⁸ See Scott Lilly, “How Sequestration Would Work.” Center for American Progress. June 18, 2012. http://www.americanprogress.org/issues/2012/06/sequestration_effects.html; Bipartisan Policy Center. “Indefensible: The Sequester’s Mechanics and Adverse Effects on National and Economic Security.” June 2012. <http://bipartisanpolicy.org/library/report/sequester>.

⁹ Letter from Secretary Panetta to Joint Select Committee, November 14, 2011. <http://security.blogs.cnn.com/2011/11/14/panetta-details-impact-of-potentially-devastating-defense-cuts/>

¹⁰ See endnote 9 for Center for American Progress and Bipartisan Policy Center analyses.

¹¹ Medicare Payment Advisory Commission, “Report to Congress: Medicare Payment Policy,” May 2012. http://www.medpac.gov/documents/Mar12_EntireReport.pdf.