Quick update on what a US fiscal cliff deal may look like; NYT

It looks like a deal is emerging to avoid the fiscal cliff from hitting with full force in 2013. As expected, legislated austerity may be cut from 4.3% of GDP to ~1.5% of GDP. The apparent compromises have not been "scored" by the Congressional Budget Office yet, but from prior iterations, we can make a good estimate of their impact. As shown in the table, an agreement may shelve a variety of tax hikes and spending cuts, leaving the expiration of the payroll tax holiday and increased income and healthcare taxes on the wealthy (e.g., > $1mm in adjusted gross income) as the only major tax changes that will still take place. The drag on the economy is not necessarily 1:1; the multiplier effect of these tax changes on spending is less than 1.0, in the same way that the growth benefit was less than 1:1 when they were introduced in the first place (tax relief was saved, or used to pay down debt).

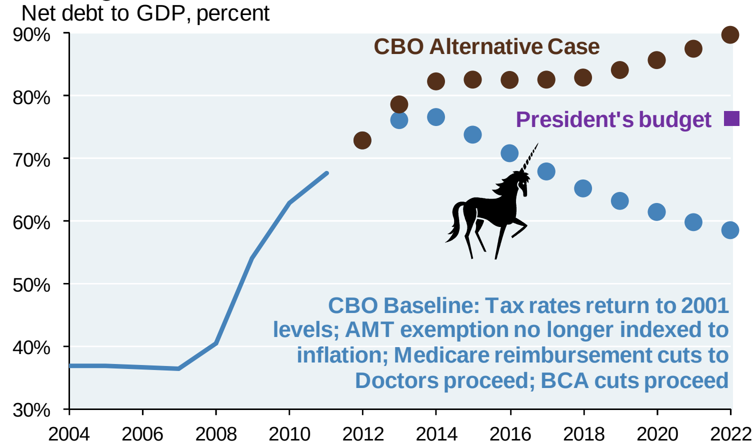
Fiscal cliff options, in billions and percentage of GDP

Increased Revenues from:	Legislated	Est.
Expiring payroll tax holiday	115	115
Expiring personal tax provisions	27	9
Expiring business tax provisions	75	25
New healthcare taxes	24	24
Alternative Minimum Tax	40	0
Expiring 2001/2003 Upper Income tax relief	83	42
Capital gain and dividend tax	8	4
Ordinary income and deductions	44	22
Estate tax	31	16
Expiring 2001/2003 remaining tax relief	171	0
Total increase in revenues	**535**	**215**
Reduced Expenditures from:		
Lower Medicare physician reimbursement	14	0
Ending extension of unemployment benefits	33	17
BCA spending reductions (Sequester)	85	0
Total expenditure reductions	**132**	**17**
Total fiscal adjustment	667	231
Total fiscal adjustment (%GDP)	**4.3%**	**1.5%**

Source: Tax Policy Center, CBO, J.P. Morgan Asset Management.

US long-term debt scenarios

Net debt to GDP, percent



CBO Alt: All tax cuts and subsidies extended, AMT and medicare patches continue, no BCA sequester

President's budget: all taxes return to 2001 levels for AGI>$250k, substantial deduction limitations, new taxes on municipal income and health insurance premiums

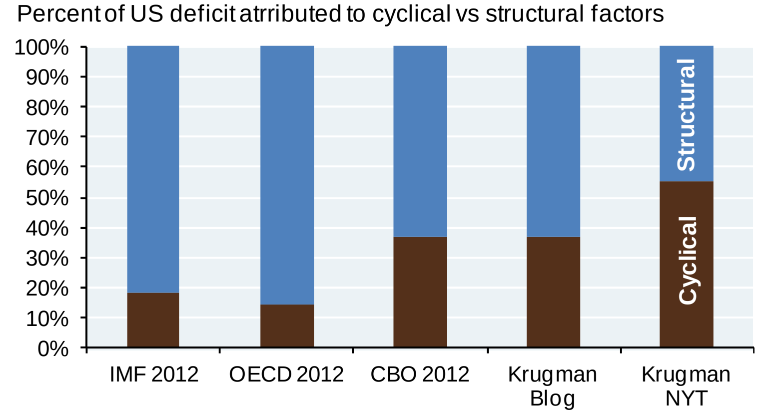
Source: CBO, JPMAM. AGI is adjusted gross income. Data as of August 2012.

Such a deal will be welcomed by markets, which until now have had to factor in a non-zero probability of more austere fiscal conditions in 2013. There are other issues in play, most notably the debt ceiling which will be reached shortly, but we do not expect them to derail the fiscal cliff negotiations. The White House appears ready to accept the idea of linking social security payments to chain-weighted inflation (instead of regular inflation), but this affects budgets in the future rather than 2013**.** An initial deal may only address personal income taxes, but we expect a final deal before the end of January on the other tax and spending provisions. **However, over the next few months, markets and rating agencies may start to focus on the longer-term fiscal picture, which is only made worse by deferring the fiscal cliff**. The chart is a reminder of the long-term debt outlook. The CBO Baseline Case is once again shown with a unicorn, indicating the likelihood of Congress adhering to the tax and spending changes assumed. The President's budget proposal is shown for context; it raises as much revenue from the top brackets via deduction limitation and a broader definition of income as from higher tax rates. These are the chips in the "grand bargain" debate around sustainable debt, which involves more difficult political decisions than just deferring the fiscal cliff.

The deficit was 7% of GDP in 2012; where will it be once the economy recovers? The debate about how much belt-tightening the US needs depends on your view of how much of the trillion dollar deficit is "cyclical" (the part that goes away when growth resumes, tax collections rise and unemployment benefits fall), and how much is "structural" (the rest). **Most estimates show US structural deficits being the larger of the two, so a recovery is not projected on its own to create a sustainable deficit of ~3%**. Paul Krugman appears to agree on his blog, albeit with higher estimates for the cyclical deficit than the IMF or OECD. However, in a NYT op-ed yesterday, he asserted that the cyclical deficit is *higher* than the structural one, and that we shouldn't worry about the deficit now since growth will solve the deficit problem. All the news that's fit to print?

Varying estimates of how the cycle is impacting US deficits

Percent of US deficit atrributed to cyclical vs structural factors



Source: IMF, OECD, CBO, New York Times (NYT) 12/17/2012, JPMAM.

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