ISSUE BRIEF

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What's in the Fiscal Cliff?

Romina Boccia, James Sherk, and Katie Tubb

The nation is now firmly on track to go over the fiscal cliff in January 2013 unless Washington takes action. The uncertainty leading up to the fiscal cliff—especially Taxmageddon—is already hurting the economy today and, according to projections by the Congressional Budget Office, could send the country back into recession in 2013.[1]

Individuals, families, businesses, and the military would all be hit hard by the fiscal cliff, but Congress and the President have yet to act to avoid this economic and defense disaster. Here are specific recommendations for how to avoid the four main parts of the fiscal cliff.

1. Taxmageddon. Seven different categories of tax policy expire on January 1, causing a $494 billion tax increase in just one year. This is uncharted territory: Never has there been such a steep tax increase in a single year.

Most of this massive tax increase stems from the expiration of the 2001 and 2003 tax cuts implemented under President George W. Bush. There is also the payroll tax cut, the alternative minimum tax patch, and a host of other policies that expire at year's end.[2] In addition, five of the 18 tax increases built into Obamacare are scheduled to go into effect. Families will bear the brunt of this tax increase among American households, with an average increase of over $4,100 in taxes.[3]

Uncertainty created by the prospect of Taxmageddon is continuing to hurt the economy today. Businesses are increasingly concerned about a jump in their own tax burdens and, given the economy's poor outlook into next year, are reluctant to hire or invest. In 2010, President Obama reversed course and extended all expiring tax policies, arguing that the economy was too weak to sustain a major tax hike.[4] This is just as true today as it was then, with this year's third-quarter GDP growth of 2 percent being lower than fourth-quarter 2010 growth of 2.4 percent.

Recommendation: Free businesses, investors, and families from uncertainty by extending current policy for *all* Americans permanently or for at least two years. This will provide time and momentum for pro-growth, revenue-neutral tax reform, which is overdue. Also, stop new Obamacare taxes, especially the tax on non-wage income.

2. Sequestration. The Budget Control Act of 2011 (BCA), a product of last summer's debt-ceiling deal, increased the debt limit by $2.1 trillion in exchange for spending cuts. The BCA first established caps on discretionary spending to accomplish $900 billion[5] in savings over 10 years and then tasked a "super committee" with finding at least $1.2 trillion more in savings. The super committee's failure to reach agreement triggered sequestration—automatic budget cuts—totaling $1.2 trillion (including interest savings) over nine years. Sequestration cuts begin on January 2, 2013.

The Department of Defense would bear the greatest burden—49.5 percent of total cuts in 2013—even though it accounts for only 16.8 percent of total spending. About $55 billion of those cuts will hit in January 2013.

This would be a mistake. The world is still a hostile place, and such massive cuts directly affect the

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The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002
(202) 546-4400 | heritage.org

readiness of the military and supporting industries and personnel to respond to future threats with next-generation equipment and training. The military should be ready before these threats require direct military action, which requires maintenance of American forces.

Recommendation: Prevent cuts in defense from sequestration for 2013 at a minimum, preferably with cuts in other spending.[6]

3. The "Doc Fix." Medicare is set for another crisis point come December 31, when Congress's latest "doc fix" agreement expires. As part of the Balanced Budget Act of 1997, Congress adopted the Sustainable Growth Rate (SGR) formula to pay doctors for treating Medicare patients. The SGR's formula led Congress to choose between paying doctors less and patching together short-term fixes to keep reimbursing doctors.

Unless Congress patches together another doc fix agreement before December 31, physicians will see a 27 percent decrease in pay, a situation that will make it unaffordable for many doctors to continue accepting Medicare patients. This could leave millions of seniors without care. These doc fix agreements, which Congress has renewed almost annually since 2003, do not solve the growing problem of unsustainable Medicare costs; they only delay a real solution.

Recommendation: Prevent the immediate cuts to Medicare providers, preferably by choosing alternative savings. Then, in the new Congress, end the SGR formula, thus eliminating the need for the annual doc fix, and fix Medicare for the long term with a premium-support model that benefits from competition and provides consumer choice.

4. Emergency Unemployment Benefits. Involuntarily unemployed workers receive income support through the joint state–federal Unemployment Insurance (UI) program. Normally, states provide benefits for up to 26 weeks and an additional 13 weeks in states with high unemployment. In 2010, Congress created temporary additional federal UI benefits, extending the maximum length of benefits to 99 weeks (two years). Last February, Congress gradually reduced the maximum benefit duration to 73 weeks.

The federal government currently provides 100 percent of funding for these additional benefits, which expire at the end of the year. The additional federal benefits will cost $26 billion for the remainder of fiscal year 2013.

Providing UI benefits for a longer time during a deep recession can make sense, because it can take longer to find new work. However, extending UI also increases unemployment and can hurt those it is meant to help.[7] Extending benefits for too long encourages the unemployed to postpone job searches or hold out for something that may not be attainable.

Even with the difficult job market, the current duration of benefits is excessive. Today, the average duration of unemployment is 40 weeks (nine months).[8] Providing 60 weeks of UI payments would increase benefits proportionately to the detriment of the labor market.

Recommendation: Make any decision to extend UI benefits on humanitarian grounds, understanding that this spending will not boost the economy. If Congress chooses to maintain extended UI benefits beyond six months, it should reduce them to 52 or 60 weeks and pay for it by reducing spending on less

1. See J. D. Foster, "Obama Could Prevent a Made-in-Washington Recession," Heritage Foundation *Issue Brief* No. 3742, September 26, 2012, http://www.heritage.org/research/reports/2012/09/recession-2013-washington-policies-and-cbo-s-recession-forecast.
2. See Curtis S. Dubay, "Taxmageddon: Massive Tax Increase Coming in 2013," Heritage Foundation *Issue Brief* No. 3558, http://www.heritage.org/research/reports/2012/04/taxmageddon-massive-tax-increase-coming-in-2013.
3. The Heritage Foundation, "How Will Taxmageddon Impact You?," June 11, 2012, http://www.heritage.org/multimedia/infographic/2012/06/how-will-taxmageddon-impact-you.
4. See Foster, "Obama Could Prevent a Made-in-Washington Recession."
5. The Heritage Foundation, "Sizing Up the Budget Control Act and Sequestration," October 16, 2012, http://www.heritage.org/multimedia/infographic/2012/10/federal-spending-by-the-numbers-2012/sizing-up-the-budget-control-act-and-sequestration.
6. See Patrick Louis Knudsen, "$150 Billion in Spending Cuts to Offset Defense Sequestration," Heritage Foundation *Backgrounder* No. 2744, November 15, 2012, http://www.heritage.org/research/reports/2012/11/150-billion-in-spending-cuts-to-offset-defense-sequestration.
7. See Bhashkar Mazumder, "How Did Unemployment Insurance Extensions Affect the Unemployment Rate in 2008–10," Federal Reserve Bank of Chicago *Essays on Issues* No. 285, April 2011; Jesse Rothstein, "Unemployment Insurance and Job Search in the Great Recession," National Bureau of Economic Research *Working Paper* No. 17534, October 2011; and Rob Valletta and Katherine Kuang, "Extended Unemployment and UI Benefits," Federal Reserve Bank of San Francisco *Economic Letter* No. 2010–12, April 19, 2010.
8. Ibid.

beneficial programs. It should also require UI recipients to improve their skills (for example, through online education). As the labor market continues to improve, Congress should further reduce UI benefits, fully phasing them out when unemployment returns to normal levels.

Avoiding the Cliff

Congress and the President should show principled leadership by avoiding tax hikes on all Americans and by offsetting defense sequestration with cuts in spending elsewhere.[9] Rather than try for some "grand bargain," lawmakers should simply steer clear of the fiscal cliff by neatly paving the way for entitlement reform and pro-growth tax reform.

*—**Romina Boccia** is Research Coordinator in the Thomas A. Roe Institute for Economic Policy Studies, **James Sherk** is Senior Policy Analyst in Labor Economics in the Center for Data Analysis, and **Katie Tubb** is a Research Assistant in the Roe Institute at The Heritage Foundation.*

9. See Knudsen, "$150 Billion in Spending Cuts."