

MACROECONOMIC ADVISERS'  
**MACRO FOCUS**



### FIVE MONTHS UNTIL SUNSET

**The European sovereign debt crisis has led to serious consideration of allowing the Bush and Obama tax cuts to sunset in their entirety. Our analysis suggests that doing so would come at a cost in terms of near-term economic growth.**

- Full sunset of the Bush and Obama tax cuts, as called for under current law, would result in a sharp rise in personal taxes on January 1.
- We considered the macroeconomic effects of this and two alternative policies: (i) extend the tax breaks indefinitely and (ii) allow only tax cuts on high-income individuals to sunset.
- Relative to the indefinite-extension case, full sunsets would shave 0.9 and 0.3 percentage points off real GDP growth in 2011 and 2012, respectively.
- The unemployment rate would be 0.6 percentage point higher and core inflation 0.1 percentage point lower at the end of 2012.
- This happens despite an assumed delay in Fed rate hikes and additional unconventional easing, which is assumed to reduce long-term yields about 100 basis points.
- Allowing only tax cuts on high-income individuals to sunset would trim only 0.2 percentage point from growth over both 2011 and 2012. This is essentially what is assumed in the Macroeconomic Advisers' forecast.

Under current law personal taxes will rise sharply on January 1. According to CBO estimates, failure to extend tax law provisions scheduled to expire at year's end will boost receipts by \$235 billion in fiscal year (FY) 2011 (or \$313 billion at an annualized rate) and \$377 billion in FY 2012, or roughly 2.4% of GDP. Given the anemic economic recovery, not long ago it seemed unthinkable to allow taxes to rise so dramatically in 2011. Now, however, given the specter of the European sovereign debt crisis, some observers, including Alan Greenspan, are openly discussing the immediate need for these tax increases.<sup>1</sup>

In this Macro Focus we assess the impact on the near-term economic outlook of the expiration of previous tax cuts. First we review the provisions slated to lapse at year's end. Then we present macroeconomic projections with and without these tax "sunsets."

Our analysis suggests that, relative to the case in which all expiring provisions are extended, allowing them to expire instead would reduce GDP growth the next two years an average of 0.6 percentage point. In addition, the yield on 10-year Treasury notes would fall by about 100 basis points as investors come to expect the Federal Open Market Committee (FOMC) to

<sup>1</sup>For example, On July 16 Judy Woodruff interviewed Alan Greenspan for Bloomberg TV:  
 WOODRUFF: On those tax cuts, they are due to expire at the end of this year. Should they be extended? What should Congress do? GREENSPAN: I should say they should follow the law and let them lapse.  
 WOODRUFF: Meaning what happens?  
 GREENSPAN: Taxes go up.

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delay the first tightening from early 2011 until late 2012, to tighten more gradually thereafter, and to make additional asset purchases.

### EXPIRING TAX PROVISIONS

The list of tax cuts that may lapse at the end of the year is both long and consequential. The major provisions slated to expire were enacted as part of either the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), or the American Recovery and Reinvestment Act of 2009 (ARRA).

*Individual Income Tax Rates:* The 10% individual income tax bracket will be eliminated, with the rate returning to 15% for single filers earning below \$8375 and joint filers earning below \$16,750. The remaining structure of individual income tax rates will shift up: from 25% to 28%, from 28% to 31%, from 33% to 36%, and from 35% to 39.6%.

*Personal Exemption Phase-Outs (PEP):* The PEP will be reinstated for high-income taxpayers (at \$170,000 for single filers and \$256,700 for married joint filers).

*Marriage Penalty:* The size of the 15% bracket for married joint filers, which currently is double that of single filers, will shrink to less than double that of single filers. The standard deduction for married joint filers, which currently is double that of single filers, will shrink to less than double that of single filers.

*Capital Gains:* The capital gains tax rate will rise from 0% to 10% for those subject to a top marginal rate of 15%, and from 15% to 20% for all others.

*Dividends:* Personal dividend income, which currently is taxed as capital gains, will be taxed as ordinary income.

*Alternative Minimum Tax (AMT):* There would be no “patch” or indexation against inflation, without which the number of taxpayers paying taxes under the AMT is projected to rise from 16 million in 2011 to 35 million by 2020.

Table 1. Effects of Extending Tax Provisions (Billions of Dollars, Fiscal Years)

Tax Provision	Expiration	2010	2011	2012	2013	2014	2015
Increased AMT Exemption Amount	12/31/2009	-6.6	-68.9	-31.1	-34.4	-38.1	-42.6
Alcohol Fuel Tax Credit	12/31/2010	n.a.	-3.8	-5.2	-5.5	-5.9	-6.1
American Opportunity Tax Credit	12/31/2010	n.a.	-1.1	-5.7	-5.7	-5.7	-5.5
Child Credit Refundable Threshold to \$3000	12/31/2010	n.a.	n.a.	-9.0	-9.1	-9.2	-9.2
Defer Income Arising from Debt Reacquisition	12/31/2010	n.a.	-6.3	-7.2	-5.5	-5.7	-4.7
Estate and Gift Tax Changes	12/31/2010	-0.5	-16.4	-43.6	-48.6	-53.9	-59.2
Income Tax Provisions of EGTRRA	12/31/2010	n.a.	-79.0	-149.5	-156.4	-163.5	-168.5
Increase Earned Income Tax Credit	12/31/2010	n.a.	*	-3.0	-3.0	-3.0	-2.9
Making Work Pay Credit	12/31/2010	n.a.	-30.1	-58.7	-59.5	-60.0	-60.3
Reduced Tax Rates on Capital Gains and Dividends	12/31/2010	-1.8	-14.7	-16.5	-32.3	-34.3	-37.3
Combined Interaction from Extending EGTRRA and AMT Provisions		0.0	-12.4	-42.2	-45.7	-50.1	-54.1
All Others Expiring on December 31, 2010		n.a.	-2.3	-5.0	-6.8	-8.4	-10.6
<b>Total</b>		<b>-8.9</b>	<b>-235.0</b>	<b>-376.7</b>	<b>-412.5</b>	<b>-437.8</b>	<b>-461.0</b>

Source: Congressional Budget Office, The Budget and Economic Outlook: Fiscal Years 2010 to 2020 (January 2010)

*Making Work Pay (MWP) Tax Credit:* Currently the credit is 6.2% of income up to \$800 for married joint filers and \$400 for single filers with phase-outs at higher levels of income.

*Child Care Credit:* The credit will fall from \$1,000 to \$500 and families with less than 3 children will no longer qualify for the refundable portion.

*Earned Income Tax Credit:* Both the threshold and the limit for the phase-outs are reduced for married couples.

*Estates, Generation Skipping Trusts (GSTs), and Gift Taxes:* The maximum tax rate on estates and GSTs will rise from 0% to 55%. The maximum tax rate on gifts will rise from 35% to 55%. Lifetime exemptions for these taxes revert to previous, lower levels.

CBO's estimates of the static revenue impacts of the expiring provisions, prepared in January, are summarized in Table 1. Easily the single most important line item is the income tax provisions of EGGTRA, but others — including the AMT and its interaction with EGGTRA, the MWP credit, and the estate tax — are important, too.

## **SIMULATION DESIGN**

We began by constructing a simulation that assumes the current tax code is extended indefinitely. To do this, we removed from the MA forecast the assumed high-end tax increase of about \$60 billion per year that is included in the Administration's proposed budget for FY 2011.<sup>2</sup> This simulation is referred to as "indefinite extension" in the nearby charts. Next we introduced all the tax sunsets by raising the average personal tax rate to generate the "static" revenue estimates shown in Table 1 and also restoring marginal tax rates on wages, dividends, interest income and capital gains to their 2000 levels. This simulation is labeled "full sunset" in the nearby charts. In our model, an increase in the average personal tax rate reduces disposable income, consumption and hence aggregate demand in the short-run, while higher marginal tax rates discourage saving and investment over the longer haul.

The near-term fiscal drag associated with the tax sunsets is substantial enough to warrant a monetary response. We assumed that the FOMC: (a) delays raising the federal funds rate from the second quarter of 2011 to the fourth quarter of 2012; (b) thereafter raises the funds rate more gradually than in the MA forecast; and (c) takes additional action, such as changing its MBS reinvestment policy, that lead market participants to, at least, price out any possibility of near-term asset sales and, perhaps, even start pricing in a greater likelihood of further purchases. The combined effect of these steps is to lower the ten-year Treasury yield by roughly 100 basis points over the next couple of years, which provides a partial offset to the fiscal drag.<sup>3,4</sup> Nevertheless, given the initial extraordinarily low level of interest rates, the FOMC's ability to offset the fiscal drag by facilitating further rate declines is limited.

<sup>2</sup> This is our BASE006 Forecast published in MA's Outlook Commentary dated July 2, 2010. For upper-income taxpayers, the Administration's proposal includes: (a) expansion of the 28% bracket at and re-instatement of the 36% and 39.6% rates; (b) re-instatement of the personal exemption phase out and limitations on itemized deductions; (c) imposition of a 20% tax rate on capital gains and dividends. These provisions would raise about \$60 billion annually over 2011 and 2012.

<sup>3</sup> The difference between the MA baseline forecast and the "Indefinite Extension" simulation was modest enough that we did not include a monetary response in the latter.

<sup>4</sup> We assume that the changes in the expected funds rate path account for 70 to 85 basis points of the roughly 100 basis point lower path for the ten-year Treasury yield.

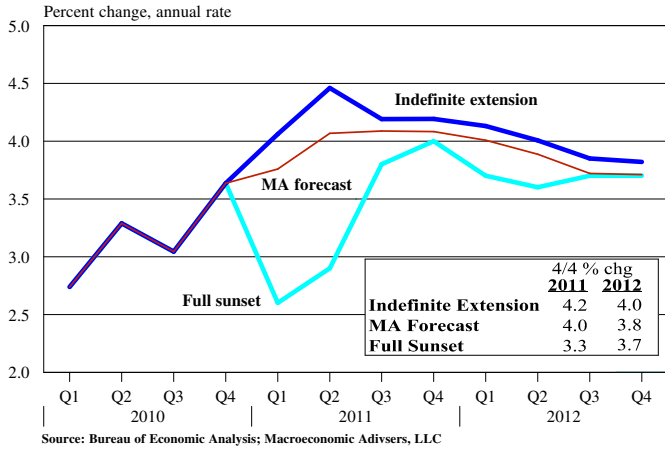
## SIMULATION RESULTS

Charts 1 through 4 show the results under the three simulations: indefinite extension of the current tax code, full sunset of the earlier tax cuts as envisioned under current law, and the intermediate case of the MA forecast where only high-income individuals and families are assumed to see their taxes rise.

The simulations suggest that if all the previous tax cuts sunset, the annualized growth of real GDP will be reduced by an average of 0.6 percentage point from the beginning of 2011 through the end of 2012 (Chart 1), leaving the unemployment rate at the end of 2012 0.6 percentage point higher (Chart 2). More slack means core inflation is lower by 0.1 percentage point by the end of 2012 (Chart 3). The monetary offset reduces the yield on the 10-year Treasury note by roughly 100 basis points in the first quarter of 2011 (Chart 4).<sup>5</sup> In contrast, allowing the expiration of only those provisions affecting high-income individuals (as in the MA forecast) trims a smaller 0.2 percentage point of growth from GDP over both 2011 and 2012.

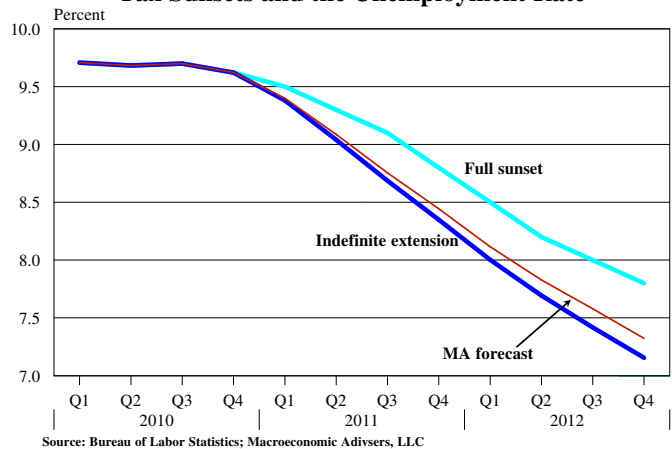
**Chart 1**

### Tax Sunsets and Real GDP Growth



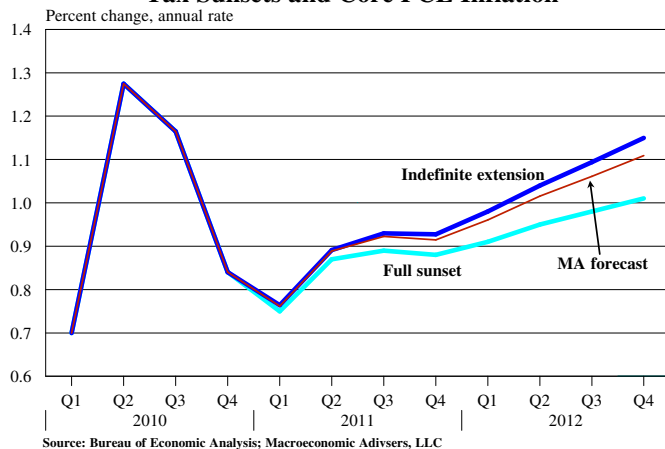
**Chart 2**

### Tax Sunsets and the Unemployment Rate



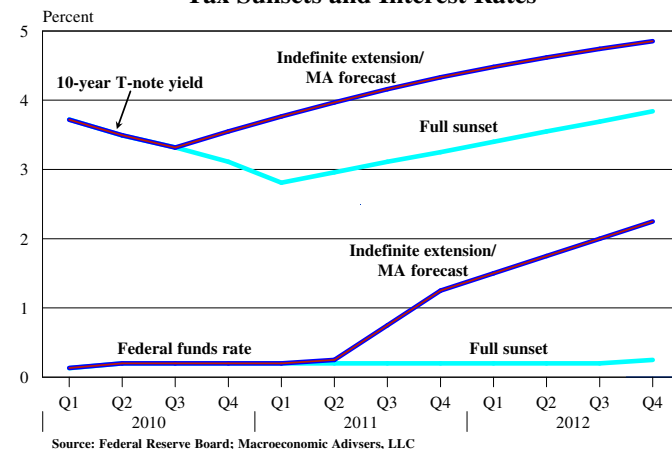
**Chart 3**

### Tax Sunsets and Core PCE Inflation



**Chart 4**

### Tax Sunsets and Interest Rates



<sup>5</sup> The simulation assumes that over the course of the fourth quarter of 2010 investors come to assume the full sunsets, so that long-term yields actually fall by about 45 basis points in the quarter before the sunsets. Given the lags in our model, this has no impact on real GDP in 2010.

## CONCLUDING OBSERVATIONS

Tax increases may be necessary to address the nation's long-term fiscal imbalance, and these results suggest that the fiscal drag from all the approaching tax sunsets could be absorbed by a robust economy in which the Fed has ample room to pursue an accommodative policy.<sup>6</sup> However, given the still tentative recovery, with growth risks skewed to the downside, and the FOMC's limited ability to maneuver now, we believe that the consideration of such large tax increases should be delayed until the economy is growing more strongly, with more certainty, closer to full employment, and with the federal funds rate well off the zero bound. An intermediate, and safer, near-term strategy is to let expire in 2011 just those provision affecting high-income individuals while extending the other provisions until they can be considered in the context of a healthier economy. This is what is assumed in the MA forecast.

Our focus here has been on the implications for near-term growth. To some extent this is the old story about short-term pain for long-term gain. While the process of reducing deficits can be expected to have a near-term cost in terms of slower growth, longer-term benefits of lower interest rates, more capital formation, and stronger growth of potential GDP can also be expected. Perhaps as important as reducing the deficit to sustainable levels (for example defined as levels consistent with a stable debt-to-GDP ratio) is the composition of revenue increases and spending reductions required to achieve meaningful deficit reduction. Thus, while we view the growth implications of allowing these prior tax cuts to expire as manageable (at least for a healthy growing economy when the Fed has ample room to support growth if needed), this does not imply that we endorse a full sunset. Rather, a comprehensive approach that simultaneously addresses both the spending and revenue sides of the budget is preferred.

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<sup>6</sup> Indeed, in our long-term forecast we do assume an eventual rise in personal taxes comparable in cumulative magnitude to those implied by current law.

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