Congressional Brief: Taxes, Spending and the Debt Limit

The main impact of the Fiscal Cliff was averted on January 1, 2013, by a last minute agreement by the Obama administration with the Senate and House of Representatives. Among other things, the American Taxpayer Relief Act of 2012 permanently extended most of the 2001 and 2003 Bush tax cuts for low- and middle-income taxpayers, which were set to expire.

The Act also temporarily extended the Obama tax cuts in the American Recovery and Reinvestment Act of 2009. It also delayed across-the-board spending cuts — or budget sequestration — required by the Budget Control Act of 2011. These changes in tax policy helped to avert a predicted recession — negative economic growth — however, the automatic cut in spending ("the sequester") was only postponed two months.

The postponement of the "fiscal cliff" reduced federal revenues and increased the budget deficit each year, compared to the higher revenues that would have resulted from the tax increases imposed by going over the cliff. The Congressional Budget Office says that there will be $4.6 trillion in additional deficits from 2013 to 2022 and additional interest on the federal debt will cost about $600 billion altogether.

Bush Tax Cuts. The Act, signed into law on January 2, 2013, permanently extended the 2001 and 2003 tax cuts for most Americans. Under the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, income taxes for all taxpayers would have reverted to the higher Clinton-era rates. The American Taxpayer Relief Act:

- Retained the 10, 25, 28 and 33 percent income tax brackets, and kept the 35 percent bracket for taxable income under $400,000 for individuals, $450,000 for joint filers.
- Kept the child tax credit at $1,000 (averting a 50 percent drop to $500).
- Extended the refundable Earned Income Tax Credit (EITC) for low-income workers (who can receive up to 15 percent of earned income in excess of $10,000 or the taxpayer's Social Security tax liability if it exceeds the credit).

Furthermore, the Act:

- Allowed taxpayers to apply the EITC credit against the Alternative Minimum Tax and repealed the AMT offset of refundable credits.
- Set the standard deduction and 15 percent bracket for married filing jointly at twice the amount for a single filer, and modified and simplified the EITC.

Obama Tax Cuts. The Act extended for five years the tax cuts in the American Recovery and Reinvestment Act of 2009, including:

- The American Opportunity Tax Credit for individuals with eligible college expenses, including some individuals with no income tax liability.
- The reduction to $3,000 of the earnings threshold or income floor for the refundable portion of the child tax credit.
- The EITC for families with three or more children.

Unemployment Benefits. The Act extended emergency unemployment compensation and extended benefits for another year for 2 million people at a cost of $30 billion.

Estate Tax. The Act raised the highest estate and gift tax rate from 35 percent to 40 percent, but exempted estates worth up to $5.25 million per person. This is still lower than the 55 percent tax on estates over $675,000 that was in effect in 2001.

Health Care. The Act extended a number of Medicare and health provisions.

- The law extended for one year the so-called "doc fix," avoiding a 27 percent cut to reimbursements for doctors seeing Medicare patients for 2013.
- It authorized a new commission on long-term care that would replace the Community Living Assistance Services and Supports Act (CLASS), a long-term care program in the 2010 Patient Protection and Affordable Care Act that proved to be unworkable.

Alternative Minimum Tax. The new law indexed for

inflation the amount of income tax exemptions individuals can take before they are subject to the parallel AMT system, protecting millions of Americans from potential tax increases.

State and Local Taxes. The new law extended the federal income tax deduction for state and local general sales taxes for one year.

Other Provisions. Additional business, education and energy tax relief was extended.

Renewable Fuels. The law extended tax credits for the development and use of more renewable fuels, such as biodiesel and solid waste, and alternative fuels, including algae-based fuels.

Educational Tax Relief. The law expanded education savings accounts and student loan and scholarship programs. For example, it increased the maximum contribution limit to $2,000 for tax-deferred Coverdell Education Savings Accounts.

Small Business. The law included a new markets tax credit ($3.5 billion allocation in 2012 and 2013) and 15 year straight-line cost recovery for qualified leasehold, restaurant and retail improvements.

General Business. The law made some short-line railroad maintenance expenses eligible for a 50 percent business tax credit. It also extended and modified the general tax credit for business research and development.

Military. The legislation created an employer wage credit for activated reservists and work opportunity tax credit for qualified veterans.

Tax Hikes. As of January 1, 2013, a number of taxes took effect.

- New taxes in the Affordable Care Act included an increase in the tax rates on salaries and investment income for high-income taxpayers, raising an estimated $18 billion in additional revenue in 2013. The 3.8 percent health care tax was imposed on the investment income of income tax filers with adjusted gross incomes of more than $200,000 for a single filer and $250,000 for joint filers.
- Because the Bush tax cuts were not extended for high income taxpayers, tax rates on incomes over $400,000 for single filers and $450,000 for joint filers increased from 35 percent to 39.6 percent.

The 2 percentage-point Social Security payroll tax holiday expired and employers are deducting greater Federal Insurance Contributions Act withholding from employees' paychecks.

Debt Limit/Ceiling. The federal government reached the $16.4 trillion debt ceiling at the end of 2012 and the U.S. Treasury had to use emergency procedures to provide continued funding to pay for current spending. On February 4, 2013, President Obama signed legislation that temporarily suspended the limitation on borrowing and allowed the U.S. Treasury to borrow additional funds through May 18, 2013. If the debt ceiling is not raised, the United States will not be able to borrow money to pay for all of the scheduled spending, since 36 percent of annual federal spending is now financed by increased borrowing.

Because Congress and the administration could not reach an agreement to raise the debt ceiling in 2011, the bond rating firm Standard and Poor's downgraded the United States' long-term rating from AAA (the highest rating) to AA+. There is a potential for another credit downgrade of if the debt ceiling is not raised in a timely manner.

The Sequester/Spending Cuts. The cuts are part of the Budget Control Act of 2011 and were to take effect automatically on January 2, 2013. The law postponed the sequester until March 27, 2013. If the sequester takes effect:

- Planned defense spending will be cut by $55 billion across-the-board in 2013 and $55 billion per year to 2021 for a total of $440 billion over the entire period.
- Nondefense spending will be cut by $55 billion across-the-board in 2013 and $55 billion per year to 2021 for a total of $440 billion over the entire period.
- The nondefense spending cuts include a 2 percent annual cap on increases in Medicare spending, which would reduce projected spending from 2013 to 2021 by $123 billion.

Other Issues. There are other issues the federal government must address in the next few weeks.

Continuing Resolution. Instead of the normal appropriations process, Congress has been authorizing government spending through a series of temporary continuing resolutions. Absent regular appropriations or short-term continuing resolutions, the federal government would shut down. A partial shutdown would require furloughing nonessential federal employees and closing nonessential agencies. A similar shutdown happened in 1995 and 1996 after President Clinton and the Republican controlled Congress failed to agree on legislation to cut spending.

Entitlement Reform. Unless entitlements are reformed in ways that reduce projected spending increases, Social Security, Medicare and Medicaid spending is expected to increase from $1.6 trillion this fiscal year to more than double that amount in a decade.

Prepared by NCPA Research Fellow Lloyd Bentsen IV.