



Major Fiscal Issues Before Congress in FY2013

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Summary

This report provides a brief overview of the major tax and spending policy changes set to take effect under current law at the end of 2012 or early in 2013. Collectively, these policies have been referred to by some as the “fiscal cliff.” Extending current revenue policies (e.g., extending the Bush tax cuts) and changing current spending policies (e.g., not allowing the BCA sequester to take effect) would increase the projected budget deficit relative to current law. The Congressional Budget Office (CBO) estimates that if current law remains in place, the budget deficit will fall by \$502 billion between FY2012 and FY2013.

Revenue provisions that are set to expire at the end of 2012 include the “Bush tax cuts,” as well as provisions related to the estate tax and the Alternative Minimum Tax (AMT). Collectively, the Bush tax cuts reduced income taxes by reducing tax rates, reduced the marriage penalty, repealed limitations on personal exemptions and itemized deductions (PEP and Pease, respectively), expanded refundable credits, and modified education tax incentives. The Bush tax cuts also reduced estate tax liabilities by increasing the amount of an estate exempt from taxation and by lowering the tax rate. The two-percentage-point reduction in the Social Security payroll tax is also set to expire at the end of 2012 and a number of temporary tax provisions (also known as “tax extenders”) expired at the end of 2011 with more scheduled to expire at the end of 2012. Under current law, these provisions are collectively estimated to reduce the budget deficit by nearly \$400 billion between FY2012 and FY2013.

There are a variety of spending policies set to change at the end of 2012 or early in 2013. These include the federal share of extended benefit payments for unemployment and the authorization for temporary emergency unemployment benefits. Payments to physicians under Medicare are scheduled to be reduced by 27% in 2013 under the Sustainable Growth Rate (SGR) system. Automatic spending cuts enacted as part of the Budget Control Act of 2011 (BCA; P.L. 112-55) are scheduled to reduce spending beginning in FY2013. Under current law, these policy changes are collectively estimated to reduce the budget deficit by over \$100 billion between FY2012 and FY2013.

In making fiscal policy choices, Congress will have to weigh the benefits of deficit reduction against the potential implications of fiscal policy choices for the ongoing economic recovery. Maintaining current revenue and spending policies will add to the deficit, while increasing revenues and reducing spending, as under current law, could slow economic growth. Thus, deficit reduction measures must be balanced against concerns that spending cuts or tax increases could dampen an already weak economic recovery. CBO has concluded that allowing current law fiscal policies to take effect will dampen short-term economic growth, but accelerate long-term economic growth. Conversely, CBO has concluded that postponing the fiscal restraint would accelerate short-term economic growth, but dampen long-term economic growth. In that context, several policy observers have recommended implementing a credible medium-term plan that balances economic considerations with deficit reduction.

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The federal budget deficit has exceeded \$1 trillion in each of the last three fiscal years and is expected to exceed that level in FY2012. Concern over these large deficits, as well as the long-term trajectory of the federal budget, has resulted in significant debate during the 112th Congress over how to achieve meaningful deficit reduction and how to implement a plan to stabilize the federal debt. At the same time, the economy is recovering from its largest downturn since the Great Depression, and concerns have been expressed that growth in the United States may falter to the point where the U.S. economy again experiences recession. This has resulted in some renewed debate over whether additional stimulus may be needed.

Over the next few months through the early part of calendar year 2013, Congress will be facing choices on how to deal with numerous expiring provisions, across-the-board spending cuts, and other short-term considerations that will have major effects on the federal budget. Some have referred to this as the “fiscal cliff.” Choosing how to address these issues will have a significant impact on the size of the budget deficit and the pace of economic recovery going forward. Further changes to other spending and revenue policies could also address some of the longer-term drivers of projected budgetary imbalance, while simultaneously impacting the economy.

This report provides a brief overview of the major tax and spending policy changes set to take effect under current law at the end of 2012 or early in 2013. Collectively, these policies have been referred to by some as the “fiscal cliff.” The report also includes links to other CRS reports which provide more information and analysis of the individual provisions discussed below.

Major Fiscal Policy Changes

A variety of revenue and spending provisions are set to expire around the end of calendar year 2012, including the Bush tax cuts and other related tax provisions,¹ extended emergency unemployment benefits, the Social Security payroll tax reduction, the “doc fix,” and other tax extenders.² If Congress and the President allow all of these measures to expire as scheduled under current law and let the spending cuts under the Budget Control Act (BCA) take effect (see discussion below), the budget deficits beginning in FY2013 will gradually fall as a percentage of gross domestic product (GDP) and are projected to remain at sustainable levels through FY2022.³ The decline in projected budget deficits is a result of declines in spending levels and increases in revenue levels as a percentage of GDP, relative to the levels seen over the past few fiscal years.⁴

Under current law, the budget deficit is estimated to fall \$502 billion between FY2012 and FY2013 (see **Table 1**) as a result of fiscal policy changes set to take place at the end of 2012 and

¹ Collectively, the Bush tax cuts reduced income taxes by reducing tax rates, reduced the marriage penalty, repealed limitations on personal exemptions and itemized deductions (PEP and Pease, respectively), expanded refundable credits, and modified education tax incentives. The Bush tax cuts also reduced estate tax liabilities by increasing the amount of an estate exempt from taxation and by lowering the tax rate.

² As discussed below, a number of temporary tax provisions, often referred to as “tax extenders,” expired at the end of 2011. Congress may choose to reinstate a number of these expired tax provisions, making them available to taxpayers in 2012.

³ Budget deficits are considered sustainable if the budget deficit as a percentage of GDP does not exceed the growth in the economy. Generally, this implies a budget deficit of less than 3% of GDP. The budget deficit for FY2012 is currently estimated at roughly 8% of GDP.

⁴ Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2012 to 2022*, January 2012, Table 1-3.

early in 2013.⁵ This estimated deficit reduction assumes that current law will be implemented as scheduled. If, however, Congress changes the trajectory of these policies by increasing spending (i.e., by eliminating the BCA automatic spending cuts) or decreasing revenue (i.e., by extending a portion of the Bush tax cuts), these policies would increase the deficit relative to the baseline. However, the amount by which the deficit would increase as the result of such policy changes could be different than the figures shown below. This is due to various factors that are taken into account when compiling a cost estimate. Because these factors could be different than the ones assumed in the figures below, the budgetary impact of reversing these policies may not be directly comparable to their impact on the deficit under current law.

Table 1. Budget Deficit Effects of Major Fiscal Policies Under Current Law

Projected Decreases in the Deficit from FY2012 to FY2013

Fiscal Policy Provision	Billions of Dollars
Revenue Policies	
Expiration of Bush Tax Cuts, Estate and Gift Tax, and AMT Provisions	221
Expiration of Payroll Tax Rate Reduction	95
Other Expiring Tax Provisions	65
Affordable Care Act (ACA) Taxes on High Income Filers	18
Spending Policies	
Budget Control Act (BCA) Automatic Spending Cuts	65
Expiration of Unemployment Insurance Benefits	26
Sustainable Growth Rate (SGR) Provisions	11
Total (Excluding Economic Feedback Effects)	502

Source: Congressional Budget Office, *Economic Effects of Reducing the Fiscal Restraint That Is Scheduled to Occur in 2013*, Table 1.

Notes: Positive numbers above indicate a decrease in the deficit resulting from the scheduled expiration of provisions or the scheduled enactment of new policy. The CBO projects a budget deficit of \$1,171 billion in FY2012. Under current law, that deficit is projected to decrease to \$612 billion in FY2013. The figures in the table reflect the increase in the budget deficit that would result from extending current policy through FY2013. These figures do not take into account any economic feedback effects which may further alter the impact on the deficit. Totals may not sum due to rounding.

The full effects of the economic and budgetary impact of these policies may not be felt immediately. Immediate effects would be felt by individuals who have been receiving emergency unemployment compensation who would face the expiration of long-term benefits. The effects of tax changes, such as the expiration of the two-percentage-point payroll tax rate reduction, would be spread out over the course of the year.⁶ Likewise, for taxpayers experiencing an increase in tax liability as a result of the expiration of Bush tax cut provisions, these effects may be spread out

⁵ All deficit increase figures for FY2013 are taken from Congressional Budget Office, *Economic Effects of Reducing the Fiscal Restraint That is Scheduled to Occur in 2013*, Table 1. These figures do not take into account any economic feedback which may further alter the impact on the deficit.

⁶ The two-percentage-point payroll tax rate reduction was generally provided to taxpayers through reduced withholdings throughout the year. Just as the benefits of the reduced tax rate were provided over the course of the year, the higher payroll tax rate will also be collected over the course of the calendar year.

over the course of the tax year through adjusted tax withholdings, or may be realized when 2013 taxes are paid early in 2014.

The effects on the spending side may also be muted in the early part of 2013. The automatic cuts scheduled to be implemented as part of the Budget Control Act will result in agency budget authority being immediately reduced on January 2, 2013. The effects of these reductions will be seen throughout the remaining nine months of the fiscal year, and in future fiscal years, as outlays that would have otherwise occurred, do not.

Though these gradual effects may provide Congress with additional time to act to address these policies, delaying such action can increase uncertainty throughout the economy and will further delay the return of the federal budget to a sustainable path. Despite the fact that these spending reductions and revenue increases are spread over the entire year, CBO estimates that if all of these policies go into effect as scheduled under current law, the economy will contract during the first two quarters of calendar year 2013.⁷

Bush Tax Cuts and Other Related Tax Provisions

The Bush tax cuts included provisions to reduce tax rates initially enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA; P.L. 107-16) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (P.L. 108-27).⁸ Also included in the Bush tax cuts were provisions that reduced tax rates on long-term capital gains and dividends; reduced and ultimately repealed limitations for personal exemptions (PEP) and itemized deductions (Pease);⁹ and expanded certain tax credits, including the Earned Income Tax Credit (EITC),¹⁰ child tax credit,¹¹ adoption tax credit,¹² and dependent care tax credit.¹³ The Bush tax cuts also contained provisions to reduce the marriage tax penalty,¹⁴ as well as modified various education-related tax incentives.

The American Recovery and Reinvestment Act of 2009 (ARRA; P.L. 111-5) made modifications to two provisions of the Bush tax cuts and enacted two new tax provisions. Specifically, ARRA's modifications expanded the refundability of the child tax credit and further reduced the marriage

⁷ Congressional Budget Office, *Economic Effects of Reducing the Fiscal Restraint That is Scheduled to Occur in 2013*, pp. 1-2.

⁸ Under the Bush tax cuts, tax rates in the top four brackets were reduced to 35%, 33%, 28%, and 25%. Under current law, these rates are scheduled to increase to 39.6%, 36%, 31%, and 28% after 2012. The Bush tax cuts also introduced a 10% tax bracket at the low-end of the income distribution. After 2012, the 10% bracket is scheduled to expire, with the lowest tax bracket scheduled to be 15%.

⁹ See CRS Report R41796, *Deficit Reduction: The Economic and Tax Revenue Effects of Personal Exemption Phaseout (PEP) and Limitation on Itemized Deductions (Pease)*, by Thomas L. Hungerford.

¹⁰ See CRS Report RL31768, *The Earned Income Tax Credit (EITC): An Overview*, by Christine Scott and CRS Report RS21477, *The Earned Income Tax Credit (EITC): Legislative Issues*, by Christine Scott.

¹¹ See CRS Report R41935, *The Child Tax Credit: Economic Analysis and Policy Options*, by Margot L. Crandall-Hollick and CRS Report R41873, *The Child Tax Credit: Current Law and Legislative History*, by Margot L. Crandall-Hollick

¹² See CRS Report RL33633, *Tax Benefits for Families: Adoption*, by Christine Scott.

¹³ See CRS Report RS21466, *Dependent Care: Current Tax Benefits and Legislative Issues*, by Christine Scott and Janemarie Mulvey.

¹⁴ For background information on marriage tax penalties and bonuses, see CRS Report RL33755, *Federal Income Tax Treatment of the Family*, by Jane G. Gravelle.

penalty of the EITC. In addition, ARRA increased the EITC for families with three or more children and enacted a new higher education tax credit—the American Opportunity Tax Credit (AOTC).¹⁵

The original Bush tax cut provisions, as well as the modifications enacted by ARRA, were extended through 2012 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312). Under current law, beginning in January 2013, marginal tax rates and tax credits and deductions will return to the 2001 levels that existed prior to the enactment of EGTRRA.

For more information on how changing current law with regard to these tax provisions could change federal revenue levels, see CRS Report R42020, *The 2001 and 2003 Bush Tax Cuts and Deficit Reduction*, by Thomas L. Hungerford and CRS Report R42485, *An Overview of Tax Provisions Expiring in 2012*, by Margot L. Crandall-Hollick. For a comparison of recent legislative proposals to extend the Bush tax cuts, see CRS Report R42622, *An Overview and Comparison of Proposals to Extend the “Bush Tax Cuts”*: S. 3412, S. 3413, H.R. 8, by Margot L. Crandall-Hollick.

Estate Tax

EGTRRA enacted provisions to phase out the estate and generation-skipping taxes over a 10-year period. In 2010, there was no federal estate or generation-skipping tax. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 temporarily reinstated, through 2012, the estate and generation-skipping taxes. As reinstated, the top rate for the estate tax was lower than it had been in 2009 (35%, as opposed to 45%). The exemption amount, as reinstated, was also higher than it had been in 2009 (\$5.0 million,¹⁶ as opposed to \$3.5 million). Absent legislative action, after 2012 the estate tax will return to pre-EGGTRA rules, with a top rate of 55% and a \$1 million exemption. Extending current estate tax provisions would increase the budget deficit, relative to current law.

For additional information on the estate tax, see CRS Report R41203, *Estate Tax Options*, by Jane G. Gravelle; CRS Report 95-416, *Federal Estate, Gift, and Generation-Skipping Taxes: A Description of Current Law*, by John R. Luckey; and CRS Report 95-444, *A History of Federal Estate, Gift, and Generation-Skipping Taxes*, by John R. Luckey.

Alternative Minimum Tax Patch

When the alternative minimum tax (AMT) was enacted, the exemption amounts were not indexed for inflation. This means that absent legislative action, the cumulative effect of inflation will result in an estimated 27 million additional taxpayers to being subject to the AMT in 2012.¹⁷

¹⁵ See CRS Report R42561, *The American Opportunity Tax Credit: Overview, Analysis, and Policy Options*, by Margot L. Crandall-Hollick and CRS Report R41967, *Higher Education Tax Benefits: Brief Overview and Budgetary Effects*, by Margot L. Crandall-Hollick.

¹⁶ This figure is adjusted for inflation. Thus, the exclusion in 2012 is \$5.12 million.

¹⁷ Joint Committee on Taxation, *Overview of the Federal Tax System as in Effect for 2012*, JCX-18-12, Washington, DC, February 24, 2012, p. 30. The number of additional taxpayers that would be subject to the AMT in the years beyond 2013, absent legislative action, depends on whether the provisions of EGTRAA and JGTRRA are extended. For example, in 2013, if both EGTRRA and JGTRRA are extended and the AMT indexed for inflation, a projected 4 (continued...)

Congress has regularly increased the AMT exemption amount to adjust for inflation (this adjustment is also known as the AMT “patch”). The 2001 and 2003 Bush tax cuts temporarily increased the basic exemption for the AMT. This exemption amount has been extended and adjusted a number of times over the past decade. In 2005, the Tax Increase Prevention and Reconciliation Act of 2005 (P.L. 109-222) allowed nonrefundable personal tax credits to offset AMT liability in full. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 patched the AMT and extended provisions allowing nonrefundable personal tax credits to offset AMT liability through 2011. Patching the AMT for 2012 and beyond will increase the budget deficit relative to current law. Indexing the AMT for inflation permanently, as proposed in the President’s FY2013 budget, would cost an estimated \$1.9 trillion over the 2013 to 2022 budget window, as measured against current law.

For more information, see CRS Report RL30149, *The Alternative Minimum Tax for Individuals*, by Steven Maguire.

Payroll Tax Reduction

In an effort to stimulate the economy, Congress, in December 2010, temporarily reduced the employee and self-employed shares of the Social Security payroll tax by two percentage points (to 4.2% for employees and 10.4% for the self-employed). Social Security trust funds were “made whole” by a transfer of general revenue, so that Social Security did not lose revenues as a result of the payroll tax rate reduction. The temporary reduction was scheduled to expire at the end of 2011, but the reduction was extended for two months as part of the Temporary Payroll Tax Cut Continuation Act of 2011 (P.L. 112-78). Congress later extended the payroll tax rate reduction through the remainder of 2012 as part of the Middle Class Tax Relief and Job Creation Act of 2012 (P.L. 112-96).

CBO estimates that allowing the two-percentage-point payroll tax reduction to expire would reduce the budget deficit by \$95 billion between FY2012 and FY2013 (see **Table 1**).¹⁸ Further extensions of the payroll tax rate reduction would increase the budget deficit, unless the cost of the extension were offset.

For more information on the temporary payroll tax rate reduction, see CRS Report R42103, *Extending the Temporary Payroll Tax Reduction: A Brief Description and Economic Analysis*, by Donald J. Marples and Molly F. Sherlock and CRS Report R41648, *Social Security: Temporary Payroll Tax Reduction*, by Dawn Nuschler.

(...continued)

million taxpayers will be subject to the AMT. Under current law, a projected 19.2 million taxpayers would be subject to the AMT in 2013. If, however, the provisions of EGTRRA and JGTRRA were extended, and the AMT exemption amount is not indexed for inflation, an estimated 32.7 million taxpayers would be subject to the AMT in 2013.

¹⁸ Congressional Budget Office, *Economic Effects of Reducing the Fiscal Restraint That is Scheduled to Occur in 2013*, Table 1.

Tax Extenders

A number of temporary tax provisions expired at the end of 2011, and more are scheduled to expire at the end of 2012.¹⁹ A tax extender package was included as part of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312). This legislation extended a number of temporary provisions that had been allowed to expire at the end of 2009, as well as several temporary provisions that were set to expire at the end of 2010.

In August 2012, the Senate Finance Committee voted to approve a package that would extend more than 50 expired and expiring tax provisions through 2013.²⁰ Amongst provisions that would be extended under the Family and Business Tax Cut Certainty Act of 2012 are those that benefit research and development (R&D),²¹ increased expensing allowances designed to encourage investment,²² provisions related to the tax treatment of foreign-source income such as the active financing exception under subpart F,²³ and a number of energy-related tax incentives,²⁴ among others. Extending temporary tax provisions that have expired or are scheduled to expire will increase the budget deficit, relative to current law.²⁵ CBO estimates that allowing other expiring tax provisions to expire as scheduled would reduce the budget deficit by \$65 billion between FY2012 and FY2013 (see **Table 1**).

For additional background on expired or expiring provisions, see CRS Report R42105, *Tax Provisions Expiring in 2011 and “Tax Extenders”*, by Molly F. Sherlock and CRS Report R42485, *An Overview of Tax Provisions Expiring in 2012*, by Margot L. Crandall-Hollick.

ACA Taxes on Higher-Income Tax Filers

The Patient Protection and Affordable Care Act (ACA; P.L. 111-148 as amended) will, among other things, increase access to health insurance coverage (with most coverage provisions effective in 2014).²⁶ In addition to financial penalties imposed on most individuals who do not

¹⁹ For a complete list of expiring tax provisions, see U.S. Congress, Joint Committee on Taxation, *List of Expiring Federal Tax Provisions 2011–2022*, committee print, 112th Cong., January 6, 2012, JCX-2-12, <https://www.jct.gov/publications.html?func=startdown&id=4383>.

²⁰ See the Chairman’s Mark of the Family and Business and Tax Cut Certainty Act of 2012. Provisions were also included to increase the AMT exemption amount and allow personal tax credits against the AMT (see the section “Alternative Minimum Tax Patch” above). For more information on tax extender legislation as considered in the Senate Finance Committee, see <http://www.finance.senate.gov/hearings/hearing/?id=c36e29ca-5056-a032-5260-7997a539f948>.

²¹ See CRS Report RL31181, *Research Tax Credit: Current Law, Legislation in the 112th Congress, and Policy Issues*, by Gary Guenther.

²² See CRS Report RL31852, *Section 179 and Bonus Depreciation Expensing Allowances: Current Law, Legislative Proposals in the 112th Congress, and Economic Effects*, by Gary Guenther.

²³ See CRS Report R41852, *U.S. International Corporate Taxation: Basic Concepts and Policy Issues*, by Mark P. Keightley.

²⁴ See CRS Report R41769, *Energy Tax Policy: Issues in the 112th Congress*, by Molly F. Sherlock and Margot L. Crandall-Hollick.

²⁵ Extending provisions included in the Chairman’s Mark of the Business and Tax Cut Certainty Act of 2012 through the end of 2013 would cost an estimated \$205.1 billion over the 10-year budget window. Of this, \$132.2 billion is attributable to the AMT patch.

²⁶ For more information on other ACA provisions, see CRS Report R41664, *ACA: A Brief Overview of the Law, Implementation, and Legal Challenges*, coordinated by C. Stephen Redhead.

purchase health insurance coverage and certain employers who do not provide affordable and/or adequate coverage, the law includes a number of explicit revenue provisions to pay for expanded coverage. One-third of those revenues will be derived from taxes and fees on health insurers, plan administrators, and employers, with initial effective dates varying from 2011 up to 2018. However, nearly half of those revenues are to be derived from taxes on high-income taxpayers that will be effective in 2013, the same year in which the Bush Tax cuts expire. These include a Medicare payroll tax and a tax on unearned income.²⁷ According to CBO, these two taxes are projected to raise \$18 billion in revenue in 2013.²⁸

Under current law, employers and employees each pay a payroll tax of 1.45% to finance Medicare Hospital Insurance (Part A). ACA includes additional hospital insurance taxes on high-income taxpayers. Specifically, ACA imposes an additional payroll tax of 0.9% on high-income workers with wages over \$200,000 for single filers and \$250,000 for joint filers effective for taxable years after December 31, 2012. The additional payroll tax only applies to wages above these thresholds. Thus, the hospital insurance portion of the payroll tax will increase from 1.45% to 2.35% for wage income over the threshold amounts. These revenues will be credited to the Medicare Hospital Insurance Trust Fund (Part A).

ACA as amended also imposes an additional tax on net investment income. Households with modified adjusted gross income (MAGI) under specified thresholds will not be subject to the investment income tax. Specifically, effective for taxable years after December 31, 2012, the law will impose a tax equal to 3.8% of the *lesser* of

- (1) net investment income for such taxable year, or
- (2) the excess of MAGI²⁹ over \$250,000 for joint filers and \$200,000 for single filers.

For more information about these taxes, see Archived CRS Report R41128, *Health-Related Revenue Provisions in the Patient Protection and Affordable Care Act (ACA)*, by Janemarie Mulvey and CRS Report R41413, *The 3.8% Medicare Contribution Tax on Unearned Income, Including Real Estate Transactions*, by Mark P. Keightley.

Budget Control Act of 2011

In addition to the expiring provisions discussed above, additional spending cuts are scheduled to take effect beginning on January 2, 2013. On August 2, 2011, President Obama signed into law the Budget Control Act of 2011 (BCA; P.L. 112-25).³⁰ The BCA contained a variety of measures intended to reduce the deficit by at least \$2.1 trillion over the FY2012-FY2021 period, along with a mechanism to increase the debt limit. The deficit reduction provisions included \$917 billion in savings from statutory caps on discretionary spending and the establishment of a Joint Select Committee on Deficit Reduction (Joint Committee) to identify further budgetary savings of at

²⁷ Also effective in 2013, ACA imposes an excise tax on certain medical devices.

²⁸ Congressional Budget Office, *Economic Effects of Reducing the Fiscal Restraint That is Scheduled to Occur in 2013*, Table 1.

²⁹ Modified adjusted gross income is defined as adjusted gross income increased by the excess of foreign earned income (defined in IRC Sec. 911(a)(1)) over the amount of any deductions or exclusions disallowed under IRC Sec. 911(d)(6) when determining foreign earned income.

³⁰ See CRS Report R41965, *The Budget Control Act of 2011*, by Bill Heniff Jr., Elizabeth Rybicki, and Shannon M. Mahan.

least \$1.2 trillion over 10 years. On November 21, 2011, the co-chairs of the Joint Committee announced that they were unable to reach an agreement before the committee's deadline. As a result, a \$1.2 trillion automatic spending reduction process has been triggered to begin in January 2, 2013, unless Congress and the President act to eliminate or change the process.

In FY2013, across-the-board spending reductions amounting to \$109 billion are scheduled to take effect, with \$54.7 billion being cut from defense spending and \$54.7 billion cut from non-defense spending through a sequester. Spending reductions of a similar amount are also scheduled to occur in each year between FY2014 and FY2021. There have been several measures proposed to cancel or modify this process including the Sequester Replacement Reconciliation Act, H.R. 5652, which was passed by the House on May 10, 2012.³¹ If the 2013 sequester is fully canceled, in other words, the reductions in spending no longer occur, the deficit would increase as a result by roughly \$65 billion in FY2013.³² Eliminating the entire automatic reduction process from FY2014 to FY2021 would cost an additional \$1.105 trillion through FY2022.³³

For more information on how the Budget Control Act's automatic spending reductions effect the budget deficit, see CRS Report R42506, *The Budget Control Act of 2011: The Effects on Spending and the Budget Deficit When the Automatic Spending Cuts Are Implemented*, by Mindy R. Levit and Marc Labonte.³⁴

Unemployment Compensation

The Unemployment Compensation (UC) program is a joint federal-state effort with basic income support for unemployed workers provided through the state-funded UC benefit. Once UC benefits are exhausted, the temporarily authorized Emergency Unemployment Compensation (EUC08) and the permanently authorized Extended Benefit (EB) programs may provide additional unemployment benefits, depending on worker eligibility, state law, and state economic conditions.

States provide funds for the regular UC benefit (approximately the first 26 weeks of benefits) and the state share of the EB payments. The federal government provides funds for UC program administration, the federal share of EB payments, and the EUC08 program. Under permanent law (P.L. 91-373), the EB program is funded 50% by the federal government and 50% by the states. P.L. 111-5, as amended most recently by P.L. 112-96, temporarily provides for 100% federal funding of the EB program until the end of 2012 when the federal share reverts back to 50%.

³¹ Other measures include Down Payment to Protect National Security Act of 2011 (H.R. 3662) and a similar measure in the Senate, titled Down Payment to Protect National Security Act of 2012 (S. 2065). President Obama has also offered his own proposal as part of his FY2013 budget.

³² The dollar amount of the spending reductions exceeds the dollar amount of deficit reduction because the spending reductions are made to budget authority, while the deficit is measured in terms of the amount that revenues exceed outlays. Generally speaking, there can be a lag between the time budget authority is provided in the appropriations process and the time it is actually spent or becomes an outlay.

³³ Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2012 to 2022*, January 2012, Table 1-6.

³⁴ For more information on the Budget Control Act, see CRS Report R41965, *The Budget Control Act of 2011*, by Bill Heniff Jr., Elizabeth Rybicki, and Shannon M. Mahan and CRS Report R42050, *Budget "Sequestration" and Selected Program Exemptions and Special Rules*, coordinated by Karen Spar.

The 100% federally funded EUC08 program was first authorized by P.L. 110-252. The EUC08 program's structure and authorization have been amended numerous times, most recently by P.L. 112-96. Currently, the entire EUC08 benefit structure is scheduled to expire at the end of 2012. The EUC08 program provides up to four tiers of additional weeks of unemployment benefits to certain workers who have exhausted their rights to UC benefits in states with high unemployment.³⁵

While the authorization for the temporary provisions ends on December 31, 2012, CBO has projected that federal spending would be lowered by \$26 billion in FY2013 if those provisions were not extended through FY2013.³⁶

For more information on unemployment insurance benefits, including benefits from the EUC08 and EB programs, see CRS Report RL33362, *Unemployment Insurance: Programs and Benefits*, by Julie M. Whittaker and Katelin P. Isaacs.

Sustainable Growth Rate System ("Doc Fix")

Reductions in payment rates to physicians under the Medicare program, as required under the Sustainable Growth Rate (SGR) system, were averted through December 31, 2012 as part of the Middle Class Tax Relief and Job Creation Act of 2012 (P.L. 112-96). The SGR system, the statutory method for determining the annual updates to the Medicare physician fee schedule, was established as part of the Balanced Budget Act of 1997 (P.L. 105-33) in an attempt to maintain Medicare physician spending levels close to a "sustainable" target level that reflected growth in GDP per capita, efficiency in delivering health care, and other measures. In the first few years of the SGR system, the actual expenditures did not exceed the targets and the updates to the physician fee schedule were close to the Medicare economic index (MEI, a price index of inputs required to produce physician services). For the next two years, in 2000 and 2001, the actual physician fee schedule update was more than twice the MEI for those years. Beginning in 2002, the actual expenditure exceeded allowed targets, and the discrepancy has grown with each year. With the exception of 2002, when a 4.8% decrease was applied, Congress has enacted a series of laws to override the reductions. However, legislative overrides since 2002 have only provided temporary reprieve from projected reductions in payments under the SGR calculation, requiring even steeper reductions in payment rates in the future. Unless Congress enacts legislation to override projected SGR changes, physician fees would be reduced by 27% in calendar year 2013. Allowing for a reduction in Medicare payment rates for physicians would reduce the budget deficit by \$11 billion between FY2012 and FY2013.³⁷

³⁵ For the more details on the level of EUC08 benefits and state unemployment requirements for each tier please see CRS Report R42444, *Emergency Unemployment Compensation (EUC08): Current Status of Benefits*, by Julie M. Whittaker and Katelin P. Isaacs.

³⁶ See the statement on page 3 of Congressional Budget Office, *Economic Effects of Reducing the Fiscal Restraint That Is Scheduled to Occur in 2013*, May 2012. "The Middle Class Tax Relief and Job Creation Act of 2012 extended emergency unemployment benefits through December 2012. The expiration of those benefits will lower spending by \$26 billion in fiscal year 2013." http://www.cbo.gov/sites/default/files/cbofiles/attachments/FiscalRestraint_0.pdf.

³⁷ Congressional Budget Office, *Economic Effects of Reducing the Fiscal Restraint That is Scheduled to Occur in 2013*, Table 1.

For additional background information and history on the SGR system, see CRS Report R40907, *Medicare Physician Payment Updates and the Sustainable Growth Rate (SGR) System*, by Jim Hahn and Janemarie Mulvey.

Other Short-Term Considerations

In addition to the policies discussed above, there are several other policy items that Congress may consider late in 2012 or early in 2013.

FY2013 Appropriations Bills

By the start of FY2013, October 1, 2012, Congress must agree to and the President must sign a set of 13 appropriations bills or a continuing resolution, which will provide discretionary funding to departments and agencies for the fiscal year. If there is a funding gap due to the absence of an agreement to provide appropriations or as a result of the expiration of a continuing resolution at a later date, government activities will cease, except for emergency operations. In the past, government shutdowns have necessitated furloughs of several hundred thousand federal employees, required cessation or reduction of many government activities, and affected numerous sectors of the economy.³⁸ Dealing with issues related to a potential shutdown may divert legislative attention from other activities awaiting consideration.³⁹

Debt Limit

In addition to the specific fiscal policies discussed above, Congress will likely have to consider an increase to the debt limit sometime in late 2012 or early 2013. Negotiations on this issue in 2011 led to the passage of the BCA, which included a debt limit increase and deficit reduction provisions shortly before the limit was reached. Some in Congress have expressed a desire to see a similar agreement accompanying the next debt limit increase. The debt subject to limit will generally continue to rise as long as the budget remains in deficit or trust funds remain in surplus. Further, seasonal fluctuations could still require Treasury to sell debt even if the annual level of federal debt subject to limit does not increase.

The current debt limit stands at \$16.394 trillion. CBO estimates that the debt subject to limit at the end of FY2013 could reach \$16.796 trillion, or \$402 billion above the current limit. However, this estimate is based on maintaining current law. Changes in fiscal policy, as discussed throughout this paper, would impact the budget deficit and resulting levels of federal debt.

³⁸ For more information, see CRS Report RL34680, *Shutdown of the Federal Government: Causes, Processes, and Effects*, by Clinton T. Brass and CRS Report RS20348, *Federal Funding Gaps: A Brief Overview*, by Jessica Tollestrup.

³⁹ As of July 30, 2012, the House had passed seven FY2013 appropriations bills. The Senate has not passed any FY2013 appropriations bills. Before leaving for August recess, Speaker Boehner and Leader Reid announced an agreement on a 6-month continuing resolution (CR) to provide funding through March 2013, which will likely be considered in September 2012. For the most up-to-date status of FY2013 appropriations bills, see CRS Report AppropriationsStatusTable, *FY2013 Status Table of Appropriations*, by Justin Murray, Merete F. Gerli, and Jared Conrad Nagel.

For more information on the debt limit and potential consequences of not increasing it, see CRS Report R41633, *Reaching the Debt Limit: Background and Potential Effects on Government Operations*, coordinated by Mindy R. Levit and CRS Report RL31967, *The Debt Limit: History and Recent Increases*, by D. Andrew Austin and Mindy R. Levit.

Economic Considerations

Many budget analysts are concerned about future levels of federal debt and acknowledge that the current spending and revenue collection cannot continue at current or projected future levels. However, making significant changes to spending or revenue policies at this time may be harmful to the ongoing economic recovery.⁴⁰ The effects on the economy of certain policies enacted to combat the economic downturn, such as extended emergency unemployment benefits and the spending and revenue provisions of the American Recovery and Reinvestment Act of 2009 (P.L. 111-5), are waning under current law. CBO recently projected that economic output (as measured by GDP) will not return to its potential until FY2018.⁴¹ Further, they estimate that allowing the policies included in **Table 1** to take effect as scheduled under current law, would result in real GDP growth of 0.5% in calendar year 2013. In contrast, CBO estimates that reversing these policy changes as scheduled under current law would lead to real GDP growth of 4.4% in calendar year 2013.⁴²

There are also timing issues associated with various tax and spending policies scheduled to take effect under current law that have potential implications on the economy. Policies that are felt immediately, such as those that would reduce unemployment benefits, are more likely to have an immediate adverse effect on the economy than those policies that are spread out over the course of the year or beyond, such as the BCA's automatic spending cuts and income and payroll tax increases. Thus, the timing associated with various tax and spending policies scheduled to change under current law at the end of 2012 or early in 2013 has important consequences for the expected economic effects of individual policy choices.

The contraction economists expect will occur should current law fiscal policies take effect can likely be dampened with action taken to prevent spending cuts or tax increases. There are differences, however, in the level of expected growth and employment given different policy choices. A 2010 CBO report concluded that policies designed to increase aid to the unemployed are more effective at boosting unemployment than across-the-board income tax reductions.⁴³ Similar results were presented by Mark Zandi of Moody's Analytics in 2010 testimony before the Senate Finance Committee.⁴⁴ This result reflects the general tendency for policies that increase

⁴⁰ For discussion, see CRS Report R41849, *Can Contractionary Fiscal Policy Be Expansionary?*, by Jane G. Gravelle and Thomas L. Hungerford.

⁴¹ Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2012 to 2022*, January 2012, p. 113.

⁴² Congressional Budget Office, *Economic Effects of Reducing the Fiscal Restraint That is Scheduled to Occur in 2013*, pp. 1-2.

⁴³ Congressional Budget Office, *Policies for Increasing Economic Growth and Employment in 2010 and 2011*, Washington, DC, January 2010, <http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/108xx/doc10803/01-14-employment.pdf>.

⁴⁴ Testimony of Mark Zandi before the Senate Finance Committee, "Using Unemployment Insurance to Help Americans Get Back to Work: Creating Opportunities and Overcoming Challenges," April 14, 2010, available at <http://www.finance.senate.gov/imo/media/doc/041410mztest.pdf>.

lower-income households income to have greater short-run economic impacts than policies that benefit higher-income households. Lower-income households are more likely than higher-income households to spend additional disposable income, thus providing a greater contribution to aggregate demand in the short-run. While spending cuts and tax increases are generally contractionary, there are differences in the potential magnitude of the growth and employment effects of allowing different fiscal policies to take effect as scheduled.⁴⁵

Federal Reserve Chairman Ben Bernanke, among others, has told Congress that they should take steps to “work to address the nation’s fiscal challenges in a way that takes into account both the need for long-run sustainability and the fragility of the recovery.” He stated that the spending and tax policies set to take effect in 2013 could endanger the recovery and recommended that Congress work to implement a credible medium-term plan for deficit reduction.⁴⁶

⁴⁵ For additional background, see CRS Report R41849, *Can Contractionary Fiscal Policy Be Expansionary?*, by Jane G. Gravelle and Thomas L. Hungerford.

⁴⁶ U.S. Congress, Senate Committee on the Banking, Housing, and Urban Affairs, *Semiannual Monetary Policy Report to the Congress*, Testimony of Ben S. Bernanke, July 17, 2012, available at <http://www.federalreserve.gov/newsevents/testimony/bernanke20120717a.htm>.

Appendix. Comparing Budget and Deficit Reduction Proposals

Table A-1 below provides a list of the major expiring provisions discussed above, the Budget Control Act's automatic spending reductions scheduled to begin in January 2013, and other short-term considerations, which will confront Congress around the end of the calendar year. It illustrates how specific deficit reduction plans or budget outlines propose to deal with these fiscal issues. The table examines the Debt Reduction Task Force (Dominici-Rivlin; November 2010), the National Commission on Fiscal Responsibility and Reform (Simpson-Bowles; December 2010), the President's FY2013 budget (February 2012), and the House FY2013 Budget Resolution (H.Con.Res. 112; March 2012).

Using any of the proposals or recommendations in the plans listed in **Table A-1** to sort out fiscal issues comes with certain constraints. First, outside of the President's Budget proposal and the House Budget resolutions, none of these plans were accompanied by legislative language.⁴⁷ Therefore, specific language would have to be written and agreed to. Second, budget resolutions do not become law. Therefore, separate legislation would have to be enacted in order to make the policy changes specified in the resolution, even if the House and Senate were to come to an agreement on the resolution itself. If an agreement were to be reached but certain provisions in the budget resolution did not become law, the spending, revenue, and deficit levels projected could change significantly. Finally, given the fairly lengthy time horizon over which these proposals were written and that fiscal conditions changed significantly, it is difficult to compare the amount of deficit reduction between plans.

Both the Dominici-Rivlin and Simpson-Bowles plans include comprehensive tax reform as part of broader debt or deficit reduction packages (see **Table A-1**), and thus do not present explicit recommendations regarding current fiscal policy choices. The substantial tax policy considerations being faced at the end of 2012 continue to stimulate interest in fundamental tax reform. Depending on its design, tax reform may or may not contribute to deficit reduction. Comprehensive tax reform that is revenue-neutral would not directly contribute to a longer-term deficit reduction strategy.

⁴⁷ The President's FY2013 budget, as scored by CBO, was offered as a substitute amendment during the consideration of the House Budget Resolution (H.Amdt. 999 to H.Con.Res. 112).

Table A-1. Addressing End-of-Year Fiscal Issues
Comparing Various Budget and Deficit/Debt Reduction Proposals

Issue	Debt Reduction Task Force (Dominici-Rivlin; November 2010)	National Commission on Fiscal Responsibility and Reform (Simpson-Bowles; December 2010)	President's FY2013 budget (February 2012)	House FY2013 Budget Resolution (H.Con.Res. 112; March 2012) ^a
Bush Tax Cuts	Individual income tax rates reduced to 15% and 27% as part of comprehensive tax reform. Capital gains and dividends would be taxed at ordinary rates (after \$1,000 exclusion for capital gains). Would provide child tax credit of \$1,600. The personal exemption and standard deduction would be eliminated. Most other tax expenditures also eliminated.	Individual income tax rates reduced to 12%, 22%, and 28% as part of comprehensive tax reform. Capital gains and dividends would be taxed at ordinary rates. Would maintain current law or equivalent for the child tax credit. The personal exemption phaseout would be eliminated, as would itemized deductions. Education tax incentives would also be eliminated.	Extend the tax cuts for married couples with income less than \$250,000 (\$200,000 for single filers). Sunset the tax cuts for higher-income taxpayers.	Generally, the budget resolution includes procedural provisions that would protect from a point of order, the following revenue measures: the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Jobs and Growth Tax Relief Reconciliation Act of 2003. ^b
Estate Tax	Permanently extend at 2009 levels (45% rate with \$3.5 million exemption).	Not explicitly discussed, although extension at 2009 levels (45% rate with \$3.5 million exemption) assumed in plan.	Make permanent the estate tax parameters that were in effect for 2009 (a top tax rate of 45%; exemption amount of \$3.5 million).	Generally, the budget resolution includes procedural provisions that would protect from a point of order, the following revenue measure: estate, gift, and generation-skipping transfer tax provisions of title III of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.
Alternative Minimum Tax (AMT)	Eliminate the AMT as part of comprehensive tax reform.	Eliminate the AMT as part of comprehensive tax reform.	Proposes to replace the AMT with the "Buffett Rule." If the "Buffett Rule" is not enacted, AMT exemption amounts would be adjusted for inflation.	Generally, the budget resolution includes procedural provisions that would protect the AMT patch from a point of order. ^b
Social Security Payroll Tax	One-year payroll tax holiday for employers and employees.	None included, but consideration of a temporary payroll tax holiday recommended.	Proposed extending the payroll tax cut through 2012 (as was enacted as part of the Middle Class Tax Relief and Job Creation Act of 2012 (P.L. 112-96)).	Not explicitly discussed.

Issue	Debt Reduction Task Force (Dominici-Rivlin; November 2010)	National Commission on Fiscal Responsibility and Reform (Simpson-Bowles; December 2010)	President's FY2013 budget (February 2012)	House FY2013 Budget Resolution (H.Con.Res. 112; March 2012) ^a
Tax Extenders	Most tax expenditures eliminated as part of comprehensive tax reform.	Most tax expenditures eliminated as part of comprehensive tax reform.	Proposes to extend a number of temporary tax provisions that expired at the end of 2011 or are scheduled to expire at the end of 2012. Provisions selected for extension would be extended through 2013.	Not explicitly discussed. ^b
Unemployment Insurance ^d	Not explicitly discussed.	Recommends putting into place a more precise trigger mechanism for the permanent-law Extended Benefit (EB) program that would 1) make EB available in states more quickly when unemployment levels exceed a threshold and are increasing and 2) turn off the program when unemployment falls below the threshold level. Also recommends creating a second tier of EB benefits that could be turned on and off automatically "only in the hardest hit states" (p, 57; Recommendation 6.5).	No specific proposal to extend long-term unemployment benefits beyond the end of calendar year 2012. However, the budget does propose various reforms to the unemployment insurance system, including measures to alleviate state unemployment compensation financing stress, to improve the solvency of the unemployment insurance trust fund, and to provide funds for reemployment activities. Includes reauthorization of expired federal unemployment tax (FUTA) surtax and indexation of FUTA tax base.	This budget resolution assumes that the long-term unemployment benefit extension expires as scheduled under current law. It does not assume another extension of the authorization of the temporary Emergency Unemployment Compensation (EUC08) program or the 100% federal financing of the permanent-law EB program.
Sustainable Growth Rate (SGR) (known as the "Doc Fix") ^e	Baseline assumes a permanent fix to the SGR with a hold-harmless provision for Part B premiums. Physician payments would be updated using the Medical Economic Index (MEI).	Would replace scheduled reduction with a payment freeze through 2013 and a 1% cut in 2014. Directs the Centers for Medicare & Medicaid Services (CMS) to develop an improved physician payment formula that encourages care coordination and pays on the basis of quality rather than quantity. Reinstates the SGR in 2015 (using 2014 as a base year) until CMS develops a revised payment system. Requires cost of reforming the SGR to be fully offset with other specified health savings.	Includes an adjustment to the baseline that would not allow payments to physicians to be reduced because actual expenditures have exceeded targets. The adjustment to the baseline reflects the Administration's best estimate of continuing what Congress has done in recent years for physician payments (i.e., freezing payments at current levels).	Allows for budget neutral legislation to fix the physician payment formula.

Issue	Debt Reduction Task Force (Dominici-Rivlin; November 2010)	National Commission on Fiscal Responsibility and Reform (Simpson-Bowles; December 2010)	President's FY2013 budget (February 2012)	House FY2013 Budget Resolution (H.Con.Res. 112; March 2012) ^a
ACA Taxes on High Income Tax Filers	Not provided.	Not provided.	Not provided.	Not explicitly discussed.
Debt Limit ^f	Not provided.	Not provided.	If proposal was fully enacted, debt subject to limit would total \$25.936 trillion in FY2022.	If the proposals included in the budget resolution were fully enacted, debt subject to limit would total \$21.627 trillion in FY2022.
BCA Automatic Spending Reductions	N/A ^g	N/A ^g	Proposes replacing the BCA's FY2013 sequester and other automatic spending reductions through FY2021 with prescribed spending cuts and tax increases, including allowing the 2001/2003/2010 tax cuts for singles making over \$200,000 and households making over \$250,000 to expire, generating savings from changes to Medicare, Medicaid, agriculture, and other mandatory programs, and placing caps on spending on Overseas Contingency Operations (OCO).	Specifies replacing the BCA's FY2013 sequester only with targeted spending cuts by providing reconciliation instructions to six committees to find further deficit reduction of \$261 billion over 10 years. Policy options from the budget committee include changes to federal health programs, the Supplemental Nutrition Assistance Program, job training and education programs, and the federal workforce. However the committees receiving the reconciliation instructions have the authority to report whatever policy changes they want within their jurisdiction in response to the reconciliation directive.

Source: CRS analysis of the Office of Management and Budget, *The Budget of the U.S. Government, The Budget for Fiscal Year 2013*, February 2012; The National Commission on Fiscal Responsibility and Reform, *The Moment of Truth*, December 2010; Gang of Six, *A Bipartisan Plan to Reduce Our Nation's Deficits*, July 2011; *Make it in America, Preserve the Medicare Guarantee, and Provide Tax Relief for Working Families while Responsibly Reducing the Deficit*; Bipartisan Policy Center, *Restoring America's Future*, November 2010.

Notes:

- a. Because a budget resolution does not become law, separate legislation would have to be enacted in order to make the policy changes that are relied upon in the proposal. Therefore certain changes proposed by the budget resolution would not take effect even if both the House and Senate agreed to the budget resolution, but rather would take effect only when enacted into law in a separate legislative process.

- b. Budget Committee Chairman Paul Ryan released a deficit reduction plan titled “The Path to Prosperity” that provides additional details on various policy positions. The “Path to Prosperity” would reduce individual income tax rates to 10% and 25% (income levels are not specified). Unspecified tax expenditures would be eliminated through measures to broaden the tax base. The “Path to Prosperity” would also repeal the AMT as part of comprehensive tax reform.
- c. Documentation provides no further details; although this proposal likely refers to more effective triggers for the permanent-law EB program.
- d. For questions regarding Unemployment Insurance (UI), please contact Julie M. Whittaker, Specialist in Income Security (x7-2587) or Katelin P. Isaacs, Analyst in Income Security (x7-7355).
- e. For questions regarding the SGR, please contact Jim Hahn, Specialist in Health Care Financing (x7-4914) or Patricia Davis, Specialist in Health Care Financing (x7-7362).
- f. The current debt limit is \$16.394 trillion.
- g. Plan was released before the BCA became law.

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