Don discount the Republicans yet

BR RESEARCH (January 04, 2013) : In the United States of America, following weeks of partisan-squabbling and turkey-cocking, the symbolic sacrificial lamb was presented to the gods to avert the imminent wrath of an overnight shrinking of the US GDP by five percent. Stock markets across the world rose with recent-record busting performances in Britain, Hong Kong and Australia. France, Germany, South Korea and the USA all saw upshots. The bipartisan deal to avoid the so-called "fiscal cliff" lifted the cloud that hung over the economy and investor confidence. The USA will not go over the fiscal cliff after all. If all goes as planned, the worst of the cliff, a withering combination of tax increases and spending cuts, will be avoided, while the ugly fiscal arithmetic and political dysfunction that produced the cliff in the first place will remain. The fiscal cliff primarily deals with a set of tax-cuts first instituted by President Bush in 2001 and 2003 which were due to expire on December 31, 2012. Further components of the fiscal cliff included expiring extended unemployment insurance benefits; an expiring payroll tax cut; automatic spending cuts worth $110 billion per year, spread equally across defence and domestic programmes (called a sequester); and the debt ceiling; the statutory limit on how much the Treasury must borrow. The deal leaves in place significant short-term austerity while doing nothing to change the long-term trajectory of debt. It doesn deal with several key components of the cliff. The "sequester" - which was due to take effect this week - will be delayed for a few months. Enhanced unemployment-insurance benefits will continue for one more year. A series of accounting shenanigans will allow the Treasury two more months before hitting the debt ceiling and being unable to meet obligations as they fall due, thus bringing on default. The payroll-tax cut will expire as scheduled, sapping workers purchasing power by roughly $1,000 each. As for the tax cuts, most of them have been made permanent, except for the wealthy. Individuals earning $400,000 and couples earning $450,000 and more will see a 4.6 percent hike in tax rates to 39.6 percent. Estate taxes will go up; taxes on capital gains and dividends will increase to 20 percent (an upshot of five percent), and in both cases, the revised amount is less than pre-2001 levels. President Obamas tax credits for families, workers and college students will be extended for five more years. In all, the deal has saved the USA from a retraction of $300billion this year of government participation in the economy - the prevention of a fiscal drag that could be devastating for a flailing economic recovery. However, intensive new negotiations are required to replace the "sequester" effectively and raise the debt ceiling. The insufficiency is illustrated by the fact that only $600 billion in additional revenues will be gained from the higher tax on the rich; and in the face of a $10 trillion deficit projected over the next 10 years, this inconsequential sum is almost a rounding error. The Democrats are celebrating two back-to-back victories, but this may be pre-mature. The Republicans have averted political disaster for themselves in the face of a deadline, and will now have an upper-hand in the new round of negotiations when their majority in the Congress will allow them to hold the debt-ceiling hostage against augmented spending cuts. In the long run, the lower taxes and spending cuts are the economic mandate of the Republicans, and structurally uprooting the deficit will inevitably progress their normative agenda.