Tax deal called 'game changer' for next year

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USA TODAY

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The sweeping tax deal between the White House and Republicans would help prevent the economy from lapsing back into recession — and may give the recovery the jolt it needs to become self-sustaining, economists say.

The agreement, announced Monday, has all the hallmarks of a compromise: No one is entirely happy, but individuals, businesses and investors will all find something to please them. Individuals get lower payroll taxes for a year, businesses get tax breaks on new investments, and capital gains taxes will stay low. Most of all, the deal will avert several income-reducing policies due to start next year, such as higher income tax rates and a cutoff of jobless benefits.

Some say the tax cut package will provide an outsize lift to the economy. Mark Zandi, chief economist at Moody's Analytics, says the plan has led him to raise his forecast for economic growth next year to 4 percent from 2.7 percent. He says the economy will gain 2.8 million jobs in 2011 — up from 1.2 million under his previous estimate — and the jobless rate will fall to 8.5 percent by the end of 2011, vs. his earlier 9.6 percent estimate.

"I think it's a game-

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changer," he says. "It's going to make a big difference for 2011."

Others aren't as sure. Ken Goldstein, chief economist for the Conference Board, doesn't think GDP growth will get to 4 percent next year.

The biggest drawback: If you're worried about the nation's $9.3 trillion federal debt, the tax deal will do nothing to soothe your fears. "You can live with short-term damage if you fix stuff in the long run, but there's not much sign of fixing stuff in the long run," says David Wyss, chief economist for Standard & Poor's.

For many economists, the tax deal is far better than what will happen if Congress does nothing at all. The Bush tax cuts were set to expire Dec. 31 because Congress couldn't find any other way to get around rules requiring tax and spending changes to be revenue neutral.

But it's hard to argue for raising taxes in a sluggish economy. Toss in the other provisions that have lapsed, such as unemployment benefits and a stopgap measure to keep middle-class taxpayers from being bitten by the Alternative Minimum Tax, and gross domestic product would have fallen by about 1.5 percentage points.

Many of the rules in effect during the recession and anemic recovery would stay in place. Tax rates, for example, would be the same as they have been for the past decade. Those receiving unemployment benefits would continue to do so. And with unemployment at 9.8 percent in November and 15.1 million people out of work, many consumers aren't likely to start spending any time soon. "Consumers are already in an austerity program," says Goldstein.

Jim O'Sullivan, chief economist of MF Global, says, "Most of this is just averting a drag on growth."

Nevertheless, the tax deal does have a few measures that would put money immediately into consumers' pockets. Decreasing payroll taxes for Social Security, for example, would give consumers $120 billion via their paychecks. Individuals with incomes of $40,000 would save $800 next year, according to Bank of America Merrill Lynch. Those who earn more than the current cap on payroll taxes of $106,800 would save $2,136. "That's the path to increased spending," says Michael Englund, chief economist for Action Economics.

And the extension of unemployment benefits for a full year would help the recovery. Every $1 spent on jobless benefits provides up to $2 of benefit to the economy.

Small businesses, which typically account for two-thirds of jobs created in a recovery, could be big beneficiaries. So far, small firms have lagged in the upturn, mostly because, unlike large companies, they haven't benefited from surging exports and must borrow money from tight-fisted banks rather than thriving corporate bond markets.

Many small firms have held off investing and hiring because of fears that a boost in tax rates would affect the 75 percent of small firms that report their business profits as personal income.

"This is going to remove that cloud," says Chris Walters, manager for legislative affairs for the National Federation of Independent Business, a small-business trade group. Businesses "will know they have more money in their budgets."

Yet critics of extending the tax cuts for the affluent argue that many of those businesses are hedge funds or private-equity firms that don't do much hiring. And a report by the Joint Committee on Taxation notes that many of the affected businesses aren't small; in 2005, nearly 20,000 had receipts of more than $50 million. Only 10 percent of the income that exceeds the $250,000 threshold was reported by sole proprietorships, which tend to be smaller, according to the Tax Policy Center.

Small businesses also expect to benefit from the tax plan's proposal to allow businesses to write down 100 percent of their capital investments for plants and equipment. One drawback: The business investment incentive, says Zandi, would pull capital purchases forward into next year, reducing investment in 2012. As a result, he's lowered his forecast for growth in 2012 to 3.3 percent from 4.3 percent. Still, he adds, "It's a significant benefit, because you're employing people sooner and significantly raising the odds that this recovery is going to continue on." Plus, more robust growth next year could "lift the collective psyche and ignite a much stronger economic expansion."

Federal debt blowback

The biggest drawback to the tax bill is that it will add to the federal debt. Moody's Analytics estimates that the tax bill will cost $984 billion from 2011 through 2012.