February 02, 2012

Economics Group

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The Fragile Fiscal Policy Outlook: I

The Congressional Budget Office's release this week of the Budget and Economic Outlook reiterated the unsustainable nature of current fiscal policy and reflected a more pessimistic outlook for economic growth.

Comparing the Economic Outlooks

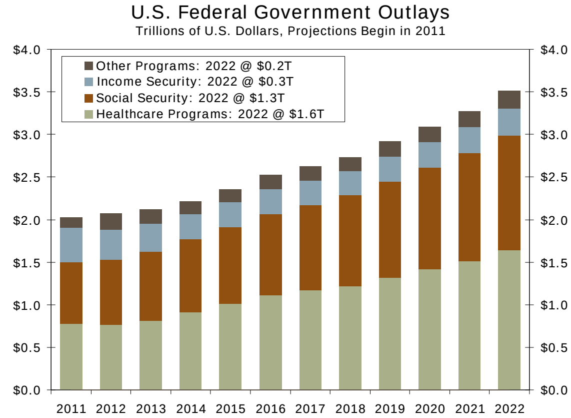
The release this week of the Congressional Budget Office's Budget and Economic Outlook painted a picture of unsustainable fiscal policy and a much slower economic growth environment over the next decade. The path of economic growth according to the CBO is that the economy will grow by 2.0 percent in 2012 and then slow in 2013 to 1.1 percent. The CBO expects that long-run growth will average around 4.1 percent from 2014-2017 and slow to 2.5 percent from 2018-2022. The primary reason for the slower pace of growth in 2013 will be the result of fiscal policy changes under existing law. In contrast to the CBO forecast, our view is that the economy will grow around 1.9 percent in 2012, slowing slightly to 1.8 percent in 2013. Both the CBO and our group forecast low rates and low inflation over the next two years. In addition, both our forecast and the CBO expect the unemployment rate to remain above 8 percent this year and in 2013.

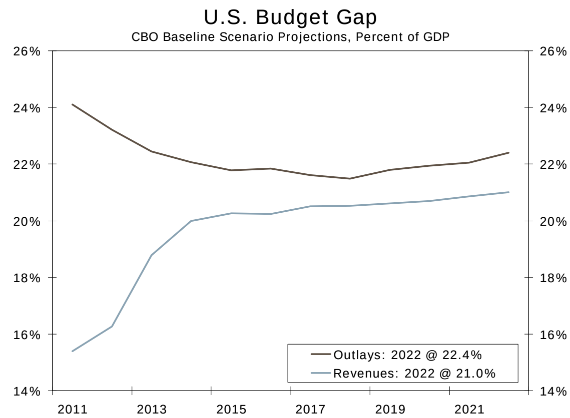
Outlook for Revenues and Outlays

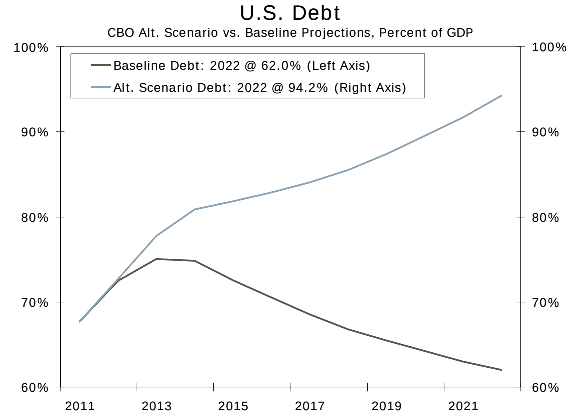
The CBO projects that revenue growth will continue over the next two years, with the bulk of the revenue growth occurring in 2013 due to significant increases in taxes. Among the tax increases that will affect revenues the most are: an increase in income tax rates for the highest tax brackets, the phasing out of itemized deductions and exemptions for high income earners, expiration of the higher education tax credit, increased capital gains taxes on long-term investments to 20 percent from 15 percent, dividend taxes increase to 39.6 percent, expiration of the alternative minimum tax "patch" will raise the limit for applying the AMT, expiration of accelerated deprecation on business investments, corporate income tax payments become accelerated and fee increases begin related to the implementation of healthcare reform. Under existing law, outlays, including entitlement spending (top graph), continue to grow at an unsustainable rate. Even after accounting for the reductions in spending due to the Budget Control Act, there still exists a budget gap (middle graph), highlighting the persistent future challenges that remain.

Fiscal Policy Risks to Growth in 2013

We recognize the potential effect on GDP growth in 2013 of the tax policy changes under existing law and expect that some tax increases will occur, but not all of them. Thus, the trajectory of the U.S. debt will likely be somewhere between the CBO's baseline and alternate scenarios (bottom graph). Should all of these policies under existing law go into effect in January 2013, we agree with the CBO that the significant tax policy changes, in combination with sizable reductions in government spending, would reduce GDP growth in 2013. Thus, the policy changes and uncertainty around future tax liabilities represent a substantial downside risk to our forecast beyond this year.







Source: Congressional Budget Office and Wells Fargo Securities, LLC

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