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Would Obama-GOP tax plan be a game-changer for economy?

By John Waggoner and Paul Davidson, USA TODAY

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



Kim Edgerton works at a Ford transmission plant in Michigan. By Paul Sancya, AP

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.

WHO BENEFITS: [What's in it for you?](#)

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CHART: [Deal's cost could approach \\$1 trillion](#)

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% from 2.7%. 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% by the end of 2011, vs. his earlier 9.6% estimate.

"I think it's a game-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% next year. Consumers are still worried about jobs, and that means they may not open their wallets very far.

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. If the Bush tax cuts lapse, GDP growth would be a full percentage point lower, says Brian Bethune, director of financial economics for IHS Global Insight.

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.

"Add it all up, and you're talking a real hammer on growth," Bethune says. "You're talking about flirting with recession again."

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% 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.

Good for small business

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% 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."

Jim Murphy, president of ET Analytical, which makes environmental testing equipment, was previously uncertain about his hiring plans. "I was feeling like between health care costs rising and our tax burden rising to 39.6%, it was pretty dicey, especially when you have so much uncertainty remaining in the economy," he says.

Now, he says, "I know the government is not going to take anymore of our money out, so I'm fairly optimistic going into next year." Murphy says that if his tax rate had gone up, he would have hired one salesperson and an engineer, but now he'll hire an additional salesperson.

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% 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% of their capital investments for plants and equipment. [Drew Greenblatt, CEO of Marlin Steel Wire Products](#), which makes [metal brackets](#), [baskets](#) and other parts, says he's [considering buying a \\$1 million laser to cut metal](#). The new tax breaks would allow him to deduct \$400,000 of the cost in the first year, rather than \$57,000.

"This makes it easier," Greenblatt says. "My inclination is to go for it. In the past, I would have hesitated." He says he will hire another three people to operate the lasers.

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% from 4.3%. 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.

The stock market was flat Tuesday. The Standard & Poor's 500-stock index rose 0.63 points.

But the bond market rebelled, pushing up interest rates. Bond traders worried that the Treasury would have to increase its borrowing to finance the government's operations — and that the extra borrowing could lead to added inflation in the future. The yield on the benchmark 10-year Treasury note, for example, soared to 3.13% Tuesday — from 2.93% Monday— its highest level since June.

Those jitters didn't prevent the Treasury from auctioning \$32 billion in three-year T-notes, however. The notes sold for a median yield of 0.82%, well below the inflation rate, which was 1.2% the 12 months ended in October. Treasury received \$2.91 in bids for every \$1 in T-notes available.

If the inflation rate moves beyond the Federal Reserve's target of about 2%, the Fed could be prompted to raise interest rates sooner rather than later to keep inflation in check, says Anthony Valeri, fixed-income investment strategist for LPL Financial. "Short-term futures are showing a slight possibility of a rate hike in November of next year," Valeri says. He thinks that's unlikely, however, given the economy's weakness.

rCold comfort for some

If the tax deal does reignite the economy, the Fed may be able to cut short its second round of quantitative easing — buying government bonds on the open market to keep interest rates low. The Fed already has come under fire for its plan to buy \$600 billion in Treasuries by June to lower interest rates and stimulate growth. Critics say it will spark inflation down the road.

Valeri is skeptical that will happen. "The Fed is going to want to see evidence that tax cuts are translating into business hiring," he says. That evidence would include higher consumer spending and lower unemployment.

But for people concerned about the federal debt and its long-term effects on the economy, the tax deal was cold comfort. "At some point we have to get spending under control and raise taxes," says S&P's Wyss. But most people want — and vote for — representatives who cut taxes and increase spending. "People blame Congress, but the real problem is the voter," Wyss says.

DEAL'S COST COULD APPROACH \$1 TRILLION | [Story](#)

The potential cost of the Obama-GOP tax plan on the federal budget compared with current tax law, as estimated by Moody's Analytics, an economic research firm. The plan's elements in billions:

	Calendar year		
	2011	2012	2010-2012
Republican proposals			
High-income tax cuts	\$42	\$38	\$79
Estate tax	\$12	\$12	\$24
Total	\$54	\$50	\$103
Democratic proposals			
1-yr of unemployment benefits	\$46	\$0	\$50{+2}
1-yr of refundable credits ¹	\$1	\$19	\$20
Payroll tax reduction	\$120	\$0	\$120
Accelerated depreciation	\$99	\$47	\$146
Total	\$266	\$66	\$336²
Bipartisan proposals			
Middle-income tax cuts	\$140	\$140	\$280
Alternative minimum tax	\$70	\$70	\$140
Estate tax	\$22	\$22	\$44
Business tax extenders	\$40	\$40	\$80
Total	\$272	\$272	\$544
Combined totals	\$592	\$388	\$984

1 = Includes two-year extension of the American Opportunity Tax Credit for college education, a two-year extension of the Child Tax Credit and expansion of the Earned Income Tax Credit; 2 = Includes \$4 billion in 2010 unemployment benefits. Sources: CBO, Tax Policy Center, Treasury Department, Moody's Analytics

http://www.usatoday.com/money/economy/2010-12-08-taxecon08_CV_N.htm

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