The Next Steps

What to Expect from the Continued Deficit Plan

By Michael Ratliff

The extreme brinksmanship brought out by the debt ceiling debacle may be destined to carry through the entire process of deficit reduction. And if it does, a polarized Washington will likely have an even bigger impact on the economy—and commercial real estate as a sector—than the tailspin brought on by the slight credit downgrades issued by Standard & Poor's Corp.

"I think the biggest damage that has been done so far is the fact that this generation of stewards in our political system have really fallen down and created an excuse for uncertainty, which then of course has massive reverberations through the system," said Lewis Feldman, chair of Goodwin Procter's Los Angeles office and a preeminent real estate attorney.

Feldman believes that skepticism over the government's ability to do its job will result in higher real estate risk premiums. Such premiums can either trigger a lack of investment or make those willing to invest require higher returns. Feldman maintains that a combination of political uncertainty and austerity drove the recovery to a screeching halt. "It was an interesting political standoff, and you can see exactly what the market did, which was crash," he added.

This short-term pain was to be expected, and is ultimately worth it, according to Kevin Thorpe, chief economist at Cassidy Turley.

"During the last four months' debate, we saw major projects getting canceled and business expansion plans being put on the shelf. So I think (the fact) that they did come together on a compromise and put together at least a plan that moves us toward long-term fiscal stability is extremely encouraging," Thorpe said.

On the downside, the $917 billion in immediate cuts was a bit higher than Thorpe and his colleagues at Cassidy Turley predicted. Considering both that and the fact that the stimulus years are now over, Thorpe sees a 2012 fiscal drag that is 1.5 to 2 percentage points off of GDP. He does, however, believe that commercial real estate will continue to recover, albeit on a lower trajectory than before.

"Even after the debt ceiling deal was signed, there is still uncertainty in the details," Thorpe added. "Can the government come together and create a plan that is transparent so that businesses can make informed decisions?"

The new 12-member super-committee tasked with taming $1.2 trillion more of our deficit by Thanksgiving certainly has its hands full. Even greater will be the challenges faced by Congress and the president while trying to pair up the seemingly contradictory goals of economic growth and job creation with deficit reduction.

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"How those two competing goals are dealt with presents a lot of risk, and potentially a lot of opportunity, for the economy and for real estate," said Jeff DeBoer, CEO & president of The Real Estate Roundtable.

DeBoer will be keeping a close eye on Washington over the coming months, and expects the continuing resolution to lead to a tax reform debate likely to include the dreaded carried-interest tax increase.

The super-committee will likely come up with some clever ideas to cut spending that will not end up amounting to much, added Feldman. Raising taxes will be the next thing considered. Many in the industry are worried there might not be a vote on the carried-interest tax. But Jeff Bilsky, tax senior director at BDO USA L.L.P., who specializes in both real estate and hedge fund clients, does not believe partnerships have reason for concern just yet.

"I can't imagine the group we just saw in action being able to get through the cuts that they need to do and increase the taxes that need to be incorporated while trying to figure out how to make something like carried interest work," Bilsky said.

While a carried-interest tax increase seems simple enough in theory, definitional issues complicate the concept when it is laid out on paper. Furthermore, Congress would not waste time and energy sorting out a carried-interest hike when there is a low-hanging, revenue-generating fruit ripe for the picking: the Bush-era tax extenders bill. Although it is clear by now that the Tea Party Republicans will not support any kind of tax increase, Bilsky said, he speculated that they might let the extenders bill go because it is technically an expiration of a law, not a vote to raise taxes.

"So they can probably get a fairly easy compromise on increasing tax revenues just by letting at least a portion of those expiring cuts continue to expire," Bilsky added. "I would expect that this is where the Democrats will win as well, because they would be giving in on extending the tax cuts for the middle class."

Letting the tax extenders bill expire would "raise" an estimated $2.5 trillion over the next 10 years, according to Bilsky. In addition, noted David Beers, managing director at Standard & Poor's, the U.S. outlook could be raised to "stable" if the Obama administration ended the Bush tax cuts.

And it could all be done through inaction—one thing that Washington knows how to do very well. CPE