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Confronting the Fiscal Cliff

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After months of speculation about election scenarios, it's time for U.S. action on its fiscal problems. On December 31, an unprecedented change in U.S. policy is set to take effect. Without action, temporary spending and tax measures totaling $550 billion will expire. Given other spending and tax measures already set in train, this **"fiscal cliff"** threatens a contraction of almost 5 percent of GDP in 2013, reducing the deficit by nearly half but pushing the U.S. economy into a new recession.

Most analysts expect a "kick the can" deal, in which spending and tax measures are temporarily extended (or reinstated after a short expiration) and commitments are made to work toward a broader agreement or "grand bargain" in 2013. This consensus understates the risk that a deal will not be reached during the brief "lame duck" session following the election and that the country will go off the cliff. What happens next is unclear. Most likely, negotiations between the president and Congress would continue next year, and it's possible that a resolution is reached only when the debt limit needs to be raised, most likely in February or March.

Table 1 [bottom of page] shows the key elements of the fiscal cliff. There is broad support for extension of the temporary tax measures ("extenders"), the AMT patch, and the increase in reimbursements to health care providers (the "doc fix"), if a path forward for those measures can be found separate from the broader debate over taxes and spending. Conversely, there seems to be little support for an extension of the payroll tax reduction and further extension of unemployment benefits. This means that the focus of the debate will be on the tax cuts introduced by President George W. Bush and the sequester.

Fiscal Cliff or Slope?

While some of the tax measures would hit paychecks and corporate bottom lines on day one, other elements will take effect gradually, leading some to suggest the cliff will be more of a slope or glide. Notably, the sequester cuts would not be required until May 2013, and other measures could be delayed by the administration, while individuals may dig into savings if they expect the disruption to be temporary.

The Congressional Budget Office (CBO) estimates that going off the cliff would reduce growth by about 4 percentage points from what it would have been otherwise, which almost surely would lead to a recession in the first half of 2013. There is a lot of uncertainty around that number: If there is a broad deal after a few months, the effects will be less; conversely, if the shock is permanent, the estimate looks low. **Recent work from the IMF** and others suggests that fiscal multipliers – that is, the compounded effect of fiscal measures on the overall economy – could be substantially larger than the CBO assumes, given the weakness in the global environment and the limited ability of the Fed to ease policy to offset the fiscal tightening.

There are three key channels through which the cliff affects activity:

- **Direct fiscal drag.** The effect of reduced government spending on the economy will depend on how individuals respond. If consumers respond to lower take-home pay after the payroll tax expires by reducing saving, the multiplier will be low and the effects on the economy muted. Such would be the case, for example, if people believe the tax hike to be temporary and a deal extending the cuts to be likely. It is also presumed that higher income individuals are more likely to dissave.

- **Investment uncertainty.** Uncertainty about the tax rates firms will pay, as well as demand for their products, appears to already be having a significant impact on investment. Particularly when uncertainty is high but temporary, the incentive to delay investment can be especially strong. One estimate by analysts at Nomura, the global investment bank [issued in October 2012], says that higher uncertainty alone could reduce GDP by 0.5 percentage points over the course of a year. This, in turn, does suggest that a successful resolution could unleash a strong snapback.

- **Market effects**. During last year's showdown over the debt ceiling, market disruptions were muted, at least by comparison to the stock market decline following the first TARP vote. Indeed, U.S. government debt rallied as investors sought a safe haven, and throughout the episode, investors assumed a solution would be reached. Would it be different this time, putting pressure on the political players to reach a timely deal? Most analysts expect safe haven effects to continue to support U.S. government debt (though more risky credits could be hit hard), but in contrast with 2011, concern about failing growth and earnings would likely be felt on stock prices, and indeed may already be partly priced in. Overall, it is reasonable to expect a tightening of financial conditions to be felt in coming weeks if, absent progress on a deal, concerns about the cliff rise.

Getting to Yes

The fiscal cliff is the leading edge of a broader challenge, a critical one, to put the U.S. fiscal house in order for the longer term. The bigger question is whether Washington has the political will to deal with

the longer-term challenge facing the country. CBO estimates are that, on current policies, U.S. government debt would approach 200 percent of GDP by 2037, fueled by rising entitlement costs. Various plans have been put forward by both parties – centered on the **Simpson-Bowles deficit commission proposal** – to reduce the deficit by $3 trillion to $4 trillion over the next ten years through a combination of spending cuts, entitlement reforms, and revenue increases.

The components differ, of course, but what they share is a longer-term framework for fiscal viability that allow for a more gradual pace of fiscal consolidation than the cliff would deliver. This, in turn, allows the U.S. government to address other critical deficits, notably education and infrastructure.

It is easy to be pessimistic that such a deal can be done. Strong fundamental differences over fiscal policy, political gridlock, and the fact that this is but one step in a longer battle – a "repeat game," in the language of economists – underscore the challenge of reaching a comprehensive deal. However, kick-the-can solutions are at best a temporary palliative. Credit rating downgrades and lost confidence will follow. As this debate plays out, this scenario promises substantial market volatility and uncertainty that could cause damage to the U.S. economy if not handled well.

The economist Rudi Dornbusch once famously said of crises that they take longer to happen than economists expect, but that when they do occur, they happen faster than you would expect. Certainly, from this perspective, dealing with our fiscal challenge before that day comes would be far preferable than waiting. If the fiscal cliff provides the context for a comprehensive deal, it will have been worth it.

Table 1: Key elements of the fiscal cliff

Cliff item	**2013 impact (CY, $billion)**	**% of GDP**	**Prospects**
Total revenue increases	**530**	**3.3**	
Bush tax cuts (with AMT)	300	1.9	A deal on the tax cuts is central to a resolution; AMT will be difficult to change retroactively
Payroll tax cuts	120	0.8	Little support for renewing; the

			administration is reportedly considering alternatives
Short-term tax measures ("extenders")	110	0.7	Broad support for renewing, but these are tied up with broader tax reform
Total spending cuts	**175**	**1.1**	
Sequester	110	0.7	Broad support for replacing, but no agreements on specific cuts to replace it
Unemployment benefits	50	0.3	Little support for extending
Medicare cuts ("doc fix")	15	0.1	Strong support for extending
Fiscal cliff: total revenue increases and spending cuts	***705***	***4.4***	***Estimates range from 4 to 5 percent of GDP***
Total fiscal drag	**825**	**5.1**	**Includes other measures scheduled to take effect**