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There are Worse Fates than Walking off the Fiscal Cliff

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For years, market analysts, financial market participants, and commentators on Wall Street have lamented the federal government's inability to enact a credible deficit reduction package. Washington's failure to confront rising debt and deficits has been regarded by some as inviting a crisis of public finances similar to the one currently engulfing Greece. Yet, the suggestion that Congress has put no policies in place to curb excessive deficits is inaccurate. If Congress takes no action between now and January 1, an estimated $607 billion (nearly 4% of GDP) of annual deficit reduction will occur automatically. Colloquially referred to as the "fiscal cliff," this automatic deficit reduction package would reduce federal indebtedness by $7.8 trillion over ten years (relative to an extension of 2012 fiscal policy) and generate primary budget surpluses (outlays net of revenues and interest expense) starting in 2016.[1]

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While the longer-run U.S. budget situation would remain deeply imbalanced due to the rising costs of Medicare, Social Security, and Medicaid, this deficit reduction package would largely erase federal deficits for the next ten years. The U.S. debt-to-GDP ratio, for example, would fall from 73% of GDP in 2012 to just 61% in 2022. When measured relative to current policies, the deficit reduction is even greater, as public debt would reach 93% of GDP if Congress extends fiscal policies in place in 2012. One would have to go back to the military demobilization after World War II to see cumulative debt reduction of 32% of GDP over ten years.

Yet, somewhat ironically, many of the same voices previously clamoring for credible deficit reduction are now demanding that Congress take swift action to prevent currently scheduled deficit reduction from taking effect. The magnitude, timing, and composition of the fiscal tightening make the scheduled deficit reduction both economically and politically toxic, at least in the near-term. The Congressional Budget Office (CBO) believes an "austerity" package of nearly 4% of GDP would push the U.S. economy into recession, with output contracting by 1.3% (annualized) in the first two quarters of the year, with anemic growth of just 0.5% for all of 2013. The resulting recession would also reduce the size of the deficit reduction by about $50 billion, due to lower taxable incomes and more unemployment.

These projections are consistent with those of private forecasters and, implicitly, those of the Federal Reserve Board of Governors. On numerous occasions, Federal Reserve Chairman Bernanke has suggested

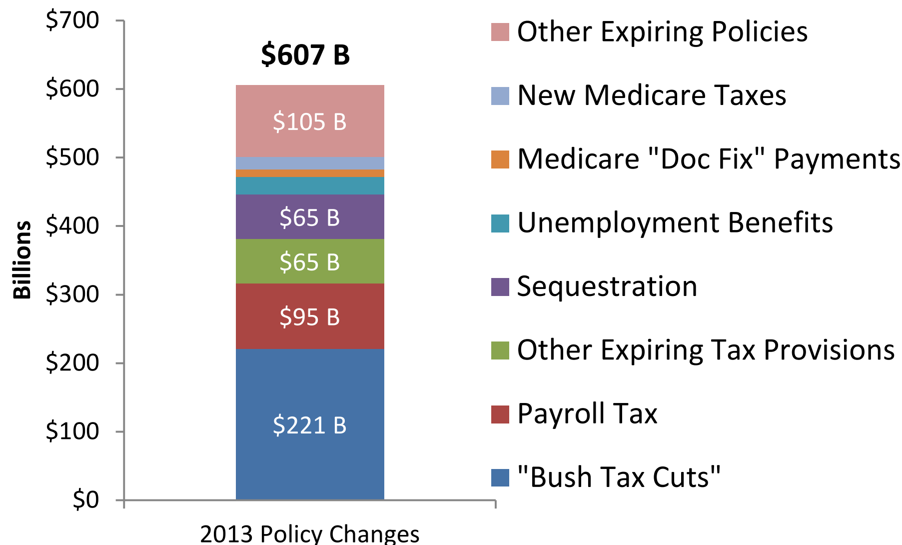
[1] All budget projections taken from the Congressional Budget Office (CBO), 2012. "Current policy" or "2012 fiscal policy" references the Alternative Fiscal Scenario.

that the “headwinds” generated by the fiscal cliff would be so great that additional monetary accommodation would not be sufficient to prevent a contraction or extreme slowdown in growth.[2] The median forecast suggests a recession is likely absent enactment of some legislative package to extend 2012 fiscal policy.

The Dimensions of the Fiscal Cliff

About two-thirds ($399 billion) of the fiscal cliff comes from looming tax increases scheduled to take place under current law. These include the expiration of the “Bush tax cuts” and tax policies enacted as part of the 2009 “stimulus,” which total $221 billion. In addition, the 2 percentage point reduction in the payroll tax rate will expire at the end of the year, resulting in a $95 billion tax increase relative to 2012. The Affordable Care Act (ACA) created a new 3.8% payroll tax on income above $200,000 and expanded the tax to cover investment income like capital gains, interest payments, and dividends. This new tax would raise $18 billion in 2013. Finally, there are a variety of provisions in the corporate and personal income tax code that are scheduled to expire such as bonus depreciation, the R&D tax credit, Subpart F for active financing income, and the alcohol fuel tax credit. These “tax extenders,” as they are commonly known because of their recurring scheduled expiration, would reduce tax receipts by $65 billion if extended.

Figure 1: Fiscal Cliff Policy Breakdown



The spending cuts scheduled to take place in 2013 would total $103 billion. The sequestration agreed to as part of the Budget Control Act is the largest contributor to the spending reductions with $65 billion in cuts split between defense and domestic discretionary spending. The expiration of emergency unemployment insurance benefits would reduce spending by $26 billion and the change in Medicare payment rates for physicians would reduce spending by $11 billion. CBO also estimates that the interaction of effects from the spending cuts and tax policies would generate an additional $100 billion in deficit reduction, stemming largely from additional revenues.[3]

[2] For example, Bernanke (2012), “The Economic Outlook and the Federal Budget Situation,” Testimony Before the House Budget Committee, February 12, 2012.

[3] Congressional Budget Office, “Economic Effects of Reducing the Fiscal Restraint That Is Scheduled to Occur in 2013,” May 2012.

Likely Outcomes

Few observers believe there is any real chance that Congress will act to extend current policy before the election. Both Democrats and Republicans in Congress believe they will have increased leverage after the election and are unwilling to reach a compromise on less advantageous terms. The key questions are, therefore: (1) whether some accommodation can be reached during the "lame duck" session that occurs between the election and January 1; and (2) failing that, what is the best approach to create a path to force a negotiated agreement?

A compromise depends on three factors: (1) which party wins the Presidential and Congressional elections; (2) the state of the economy at the end of 2012; and (3) whether the debt limit needs to be raised before the end of the year. While it is difficult to assess how the myriad policies comprising the fiscal cliff would be impacted individually by these factors, it seems reasonable to believe that Bush tax cuts will be allowed to expire if President Obama is reelected, the economy is growing steadily, and the debt limit is not reached until 2013. In this scenario, an extension of the current tax rates for personal income below $200,000 would likely be considered in early 2013, either in isolation or as part of a broader fiscal framework.

Virtually every macroeconomic analyst's preferred outcome would be a "Grand Bargain" that replaces the fiscal cliff with a credible alternative that phases-in the deficit reduction over a period of years. As Chairman Bernanke has explained, such an outcome would boost growth in the near-term and reduce the risk of a fiscal crisis or unexpected spike in borrowing rates. Interestingly, CBO estimates that if Congress passed a law to extend all policies set to expire at the end of 2012 and delay all scheduled spending reductions and tax increases, growth in 2013 would average 4.4%. This would be the fastest annual growth rate recorded since 1999. The increase in output would boost employment by 2.2 million full-time workers by the end of 2013 and reduce expected deficits and debt by boosting taxable income and reducing social assistance programs.

Could Congress agree to such a package after the election? In a recent *Wall Street Journal* op-ed, former Treasury Secretary Robert Rubin expressed hope that the fiscal cliff would provide the impetus for Congress to act.[4] Rubin notes that the *status quo* could only be maintained through legislation that passes both Houses and is signed into law by the President. The choice, then, is between falling off of the fiscal cliff or some degree of accommodation between both parties. Should a negotiated settlement on long-run deficit reduction fail to materialize during the lame duck session, the most likely alternative might be a simple extension of current fiscal policy. While such an outcome would improve the near-term economic growth prospects, it would also relieve the pressure to agree to credible deficit reduction and substantially worsen the longer-run outlook. The best outcome, therefore, might be the expiration of current fiscal policies to create real pressure for both parties to work together and *quickly* reach a "Grand Bargain."

Is Everyone's Preferred Solution Tenable?

While nearly every observer agrees that the preferred outcome is a "Grand Bargain" that replaces the fiscal cliff with a credible long-run deficit reduction package, the success of such a program depends critically on what is meant by "credible." Congress would have to convince market participants that a new law to postpone the deficit reduction enacted by previous Congresses would be left untouched by future Congresses. Market participants might not be willing to believe this given Congress' demonstrated track record of preferring extensions of current policy to deficit reduction at all turns. The practice of choosing to extend business tax cuts scheduled to expire is so entrenched that even the Congressional Research Service (CRS) refers to the $839 billion package as "tax extenders."[5]

[4] "A Budget Grand Bargain Will Follow the Election," May 28, 2012.
[5] Crandall-Hollick, Margot L. "An Overview of Tax Provisions Expiring in 2012," April 17, 2012

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The problem, as explained by former International Monetary Fund (IMF) chief economist Raghuram Rajan, is that "austerity is painful, which is why austerity tomorrow is not credible."[6] The lack of credibility stems from a phenomenon known as "dynamic inconsistency," where an otherwise rational agent assigns much greater value to the present than any future time.[7] Anyone who has ever decided to "postpone" a new diet until next week understands the dilemma. The same dynamic inconsistency may be at work with those who would "postpone" deficit reduction.

Debt Overhang and Economic Growth

Some advocate extending current policy and delaying deficit reduction until interest rates rise. Traditionally, high debt levels – or, to be precise, high debt-to-income ratios – are only thought to impair economic performance by raising borrowing costs. Higher real interest rates crowd out both public and private consumption and investment, as a larger share of national income is devoted to debt service payments and the marginal investment becomes uneconomic at the higher cost of capital. Higher real interest rates also reduce consumption expenditures on durable goods like cars, washing machines, and new homes.[8]

However, recent historical work by Reinhart, Reinhart and Rogoff (2012) demonstrate that elevated debt levels tend to slow growth even in cases where "debtor countries were able to secure continual access to capital markets at relatively low real interest rates."[9] In addition to the interest rate channel, large debt levels can reduce private sector investment, labor supply, and consumption by reducing national savings, increasing distortionary taxes, or by creating expectations of future tax increases. And, as Reinhart, Reinhart and Rogoff note, interest rates are unlikely to be particularly reliable indicators of over-indebtedness in cases where the government or central bank has the power to suppress market signals. If the central bank can print money to hit specific interest rate targets, then these rates will have very little informational value because they do not incorporate the views of market participants.

The suggestion that higher debt will slow long-run growth rates is entirely consistent with the CBO forecast. Although CBO assumes full extension of 2012 fiscal policy would boost real growth by 3.9% in 2012 (4.4% relative to 0.5%), this would come at the expense of slower growth in future years. Figures 2 and 3 provide graphics to explain this result. As shown in Figure 2, CBO assumes that nominal GDP converges with potential GDP over the course of the next six years so that by 2019 the economy is operating at its potential (full employment). Figure 3 shows how CBO reaches this result: nominal GDP is assumed to grow faster than potential for every year between 2012 and 2018 except for 2013, when the fiscal cliff temporarily depresses expected growth rates. Postponing the fiscal cliff would simply move economic activity from 2014-2016 into 2013. The result would be faster growth in 2013, slower growth between 2014 and 2016, and no change in cumulative growth rates over the next four years.

However, this isn't simply a question of moving a fixed amount of economic activity through time. In the long-run, indefinite continuation of current policy would result in a smaller economy. As CBO explains, "Although removing or reducing the fiscal restraint scheduled to occur next year would boost the economy in the short run, doing so would reduce output and income in the longer run relative to what would otherwise occur." The higher resulting debt levels would mean less investment, a smaller capital stock, expectations of

[6] Sensible Keynesians see no easy way out, *Financial Times*, May 22, 2012.

[7] See Thaler (1981), "Some Empirical Evidence on Dynamic Inconsistency," *Economic Letters*. For example, a person may prefer to buy a new sweater for $100 today rather than wait one week to buy it $90. At the same time, he may also prefer to wait 53 weeks and pay $90 for the sweater rather than buy it for $100 in 52 weeks. If the individual's discount rate were constant, both choices should be identical: a 10% discount in exchange for delaying the purchase by one week. The preferences imply the "future self" has a lower discount rate and is better able to defer gratification.

[8] Mankiw (1985), "Consumer Durables and the Real Interest Rate," *Review of Economics and Statistics*.

[9] Reinhart, Reinhart, and Rogoff (2012), "Debt Overhangs Past and Present," NBER Working Paper 18015.

future tax increases, and a greater probability for a financial crisis. These long-run costs of avoiding the fiscal cliff are very rarely discussed, but actually raise the prospect that Congressional inaction might not be the worst of all possible outcomes.

Figure 2: Assumed Path for Nominal and Potential GDP

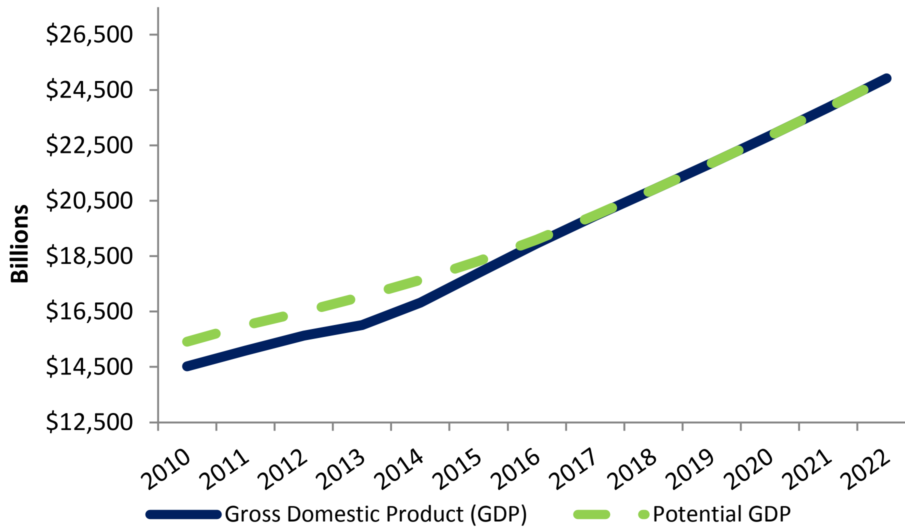
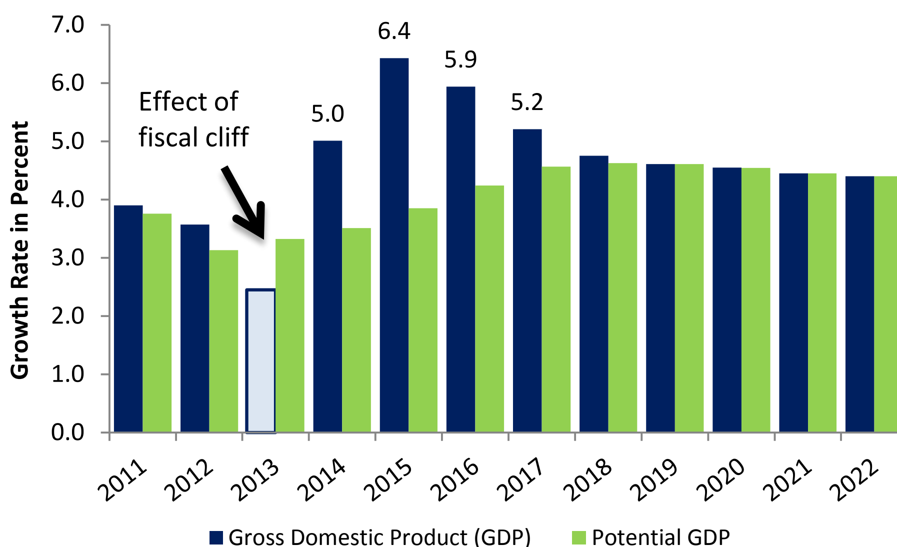


Figure 3: Assumed Growth Rates of Nominal and Potential GDP



Conclusion

If Congress takes no action between now and January 1, policies will automatically take effect that will reduce the 2013 deficit by $607 billion, or about 4% of GDP. In the short-run, this policy would reduce 2013 growth rates by as much as 4% and could trigger a recession in the first half of next year. At the same time, this automatic deficit reduction package would largely solve near-to-medium term fiscal problems and reduce 2022 public debt levels by $7.8 trillion, or 32% of GDP, relative to current fiscal policy. While the fiscal cliff would be a near-term disaster, an extension of 2012 fiscal policy that fails to address increasing indebtedness could actually represent the worst long-run outcome.

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