



# Economic Letter

## Falling Off the Fiscal Cliff

by Jason Saving

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**R**arely has a Federal Reserve chairman spoken of an event in more ominous terms. Falling off the “fiscal cliff,” a phrase coined by Ben Bernanke to describe a massive and abrupt shift in federal taxes and spending, may accompany the last words of “Auld Lang Syne” to begin 2013.

Commentators spanning the ideological spectrum have pronounced an economic apocalypse of varying proportions. Some have forecast that the country will slide into recession for at least two quarters and possibly all of 2013, that consumers will become even more reluctant to spend and that the international economy will suffer. The Group of 20—a collection of industrialized nations whose members (including Japan and much of Europe) face their own economic challenges—pegged the cliff as the single most significant threat to global economic growth in 2013.

These are serious claims, with wide-ranging implications not only on Capitol Hill but also for monetary policymakers. As such, it’s important to better understand the fiscal cliff and its overall economic implications, examining key components, their size and how they interact.

Assessments of the fiscal cliff are complicated by the nation’s high

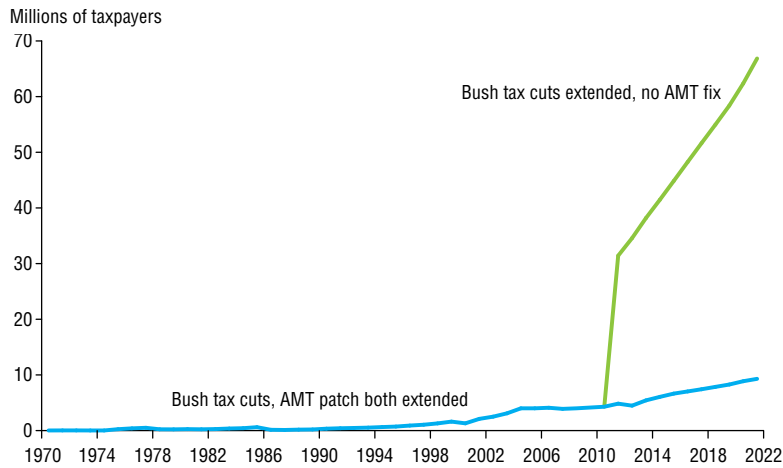
unemployment rate and slow growth in the three-and-a-half years following the end of the last recession. Most macroeconomic analyses of a fall from the cliff indicate a large hit to gross domestic product (GDP), at least in the short run. Some suggest the best alternative strategy may be to combine short-term spending with longer-term fiscal consolidation—though such a strategy may be easier said than done.

### Fiscal Cliff Components

While many people view the fiscal cliff as a monolithic entity, it’s actually a collection of six major provisions that happen to occur at about the same time, involving: income taxes, the alternative minimum tax, labor-market support, health care taxes, Medicare reimbursement reductions and across-the-board spending cuts.

The first and among the largest of these are income tax provisions contained in the Economic Growth and Tax Relief Reconciliation Act of 2001 and companion legislation passed in 2003. Better known as the “Bush tax cuts,” the legislation included lower marginal rates on income, capital gains and dividends; a smaller “marriage penalty”; larger child tax credits; and gradual elimination of the estate tax. Extending these tax provisions would

### Chart 1 Alternative Minimum Tax Households Would Soar if Bush Tax Cuts Were Extended Without AMT Fix



SOURCE: Tax Policy Center.

cost the government \$110 billion in fiscal year 2013.

The second category concerns a design flaw in the alternative minimum tax (AMT)—a tax intended to ensure payments by high-income earners—that has increasingly ensnared middle-income earners. The AMT’s brackets are not indexed to inflation, causing an ever-deeper dip into the ranks of the middle class. For budgetary reasons, lawmakers adopted a series of patches rather than a permanent fix for this glitch. Another patch would cost \$90 billion in fiscal 2013.

Just how many Americans are shielded by these patches? Roughly 4 million taxpayers were subject to the AMT in tax year 2011 (*Chart 1*). Without a new patch, that number would immediately rise to 30 million and would escalate, possibly reaching 66 million over the next decade.

Not included in the AMT figure is an interactive effect with the 2001/03 Bush tax cuts. Because the AMT acts as a floor on how much income tax households pay, reductions in ordinary income tax rates increase AMT coverage, inadvertently broadening the AMT’s reach. This effect makes patching the AMT a more expensive proposition when accompanied by extension of the Bush tax cuts. The cost—\$35 billion in fiscal 2013—also increases over time.

The third category, labor-market

support, encompasses unemployment insurance extensions and a payroll tax cut of 2 percentage points that were enacted as part of the Job Creation Act of 2010. Studies suggest these measures have significant stimulative macroeconomic effects over the short term. However, some analysts believe further unemployment extensions may discourage job-seeking, while the payroll tax cut may have troubling implications for the solvency of entitlement programs such as Social Security over the longer term. Extending the labor-market support package would cost \$115 billion in fiscal 2013.

The fourth category includes tax increases adopted under the Affordable Care Act of 2010. Principal among them is a 0.9 percent Medicare payroll-tax increase for upper-income workers and an accompanying 3.8 percent “payroll tax” applied to the investment income of high-income households. Also included are new taxes on specific manufacturers, such as medical device makers. Postponing these taxes would cost \$25 billion in fiscal 2013.

The fifth category includes currently scheduled reductions in Medicare payments to doctors, hospitals and other health care providers. In the late 1990s, Congress examined Medicare reimbursements and concluded that a slower, sustainable growth rate in payouts to doctors and hospitals was

needed to help safeguard Medicare’s long-run solvency. As soon as those limits began to bite, providers persuaded policymakers in 1997 to temporarily waive them, a reprieve that has continued through this year even as the gap between sustainable spending and actual reimbursements swelled to almost 30 percent. Continuing those waivers—the so-called “docfix”—would cost an estimated \$10 billion in fiscal 2013.

The last component, across-the-board spending cuts, became a factor only last year. As part of the debt-limit agreement that narrowly averted a U.S. debt default in August 2011, lawmakers vowed to reach consensus on a \$1.2 trillion “down payment” on deficit reduction over the next 10 years or submit to a “sequester,” automatic spending cuts that would fall equally on defense and nondefense portions of the budget beginning in 2013. Canceling the sequester would raise the deficit by \$65 billion in fiscal 2013.

With these components and an “other” category that encompasses smaller provisions and feedback effects, fiscal cliff consolidation amounts to \$560 billion in fiscal 2013 alone (*Chart 2*).

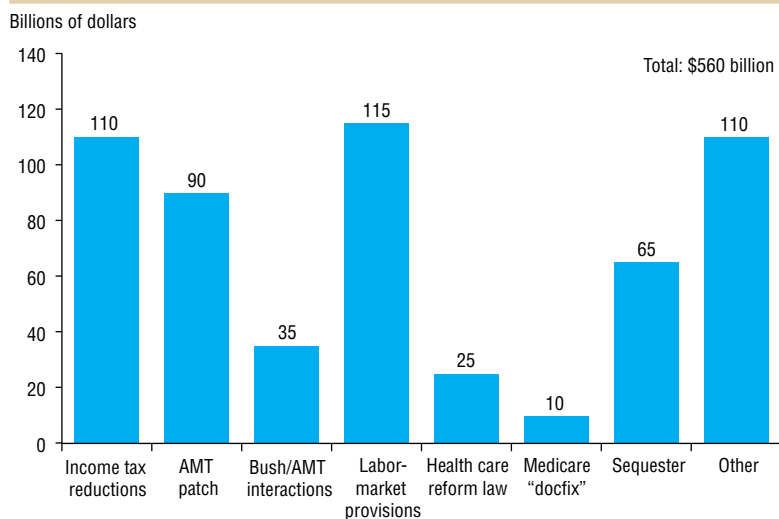
### Short-Term Economic Impact

To understand the economic impact of the fiscal cliff, it’s important to understand the logic underlying the models agencies use to assess the macroeconomic impact of government policy.

It’s assumed that as higher income tax rates and smaller government “transfer” payments for social programs take effect, individuals find themselves with less disposable income and respond by purchasing fewer goods and services. As businesses feel the effects of this adverse shift in aggregate demand, they scale back output—and employment. In this way, contractionary fiscal policy has a negative impact on the economy in the short run (though not necessarily over the long run).

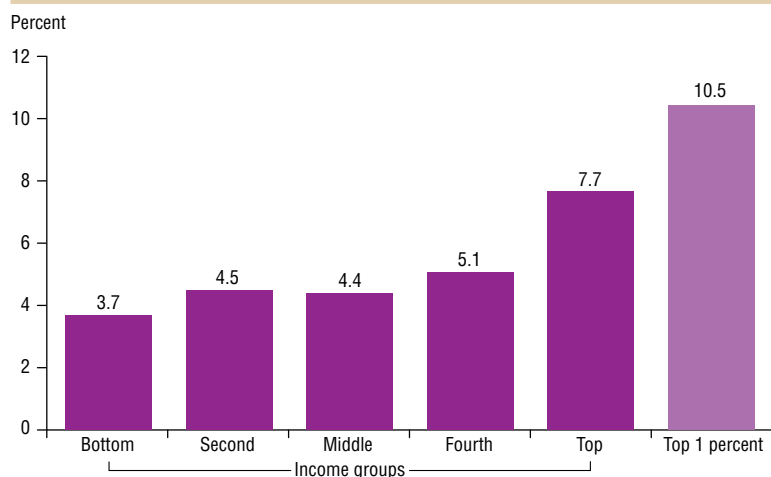
The Congressional Budget Office (CBO) found that the negative economic impact of going over the fiscal cliff would be heavily concentrated in the first half of the year, with a

**Chart 2** Fiscal Cliff Elements Total \$560 Billion in Fiscal 2013



SOURCE: Congressional Budget Office.

**Chart 3** Under Full Impact, All Earning Levels Would See Disposable Income Fall



SOURCE: Tax Policy Center.

reduction in growth of 3 percentage points.<sup>1</sup> Importantly, this implies the fiscal cliff would be stout enough to briefly take the country into recession, though it would likely emerge in the second half—unless the economy were hit by further headwinds. Employment over the year would be about 2 million behind where it would have been if the cliff had been addressed.

The Tax Policy Center (a joint venture of the Urban Institute and the Brookings Institution) found that disposable income would fall 4.4 percent

for the middle 20 percent of households if the fiscal cliff occurred in its entirety (*Chart 3*). Higher-income households would be hit harder by the cliff, suffering a 7.7 percent decline, primarily because the 2001/03 tax cuts disproportionately—though not exclusively—benefit high earners. The bottom 20 percent of households would suffer the smallest decline, 3.7 percent, because several significant chunks of the cliff bypass them.<sup>2</sup>

Interestingly, the various components of the fiscal cliff don't contribute

equally to these negative economic impacts. For example, it might appear that letting the 2001/03 tax cuts expire would have a large impact because this component is among the biggest fiscal cliff budget items, as detailed in *Chart 2*. However, the cuts are estimated to have the fourth-largest impact, behind the sequester, labor-market provisions and AMT patch.

The reason is that, in the short run, different fiscal policies can have a very different “bang for the buck” (often referred to in economic shorthand as a fiscal “multiplier”). When the government reduces its purchases and lays off workers, as would occur under the sequester, there is an immediate and sizable reduction in demand that feeds back into the overall economy—that's why the impact of the sequester on GDP is so large. Marginal rate cuts have the smallest multiplier because they flow disproportionately to higher-income individuals, who make the “wrong” choice from a short-run point of view and save those funds instead of spending and pumping them back into the broader economy.<sup>3</sup>

### Longer-Run Factors

If averting the fiscal cliff has such large positive effects on GDP growth in the short run, why not avert it permanently and enjoy those effects not only in 2013 but every year thereafter? The answer boils down to one word: debt.

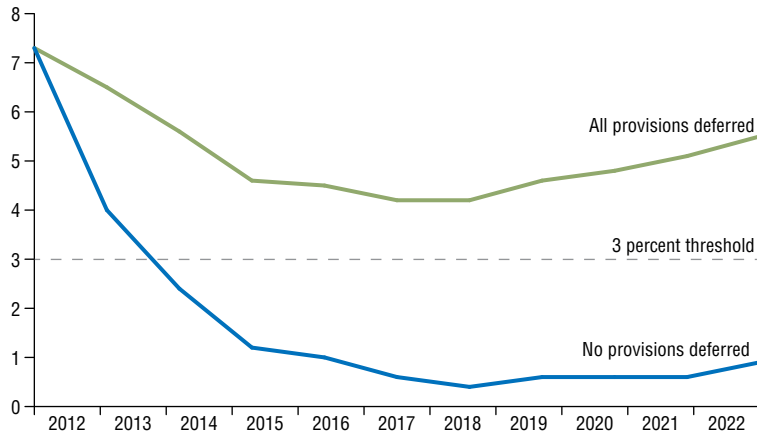
In the short run, most economists agree that spending borrowed funds can stimulate the economy. But over the longer term, debt incurred from these programs reduces future generations' standard of living several ways:

- Government spending crowds out private sector investment, reducing the size of the nation's capital stock.
- An increasingly large share of the government's budget is devoted to interest payments, eventually requiring spending cuts or tax increases.
- The ability to adopt countercyclical fiscal policy to ease the impact of future recessions is hampered.
- Given enough time and sufficiently large debt, even a Greek-style meltdown becomes more likely than

## Chart 4

### Going Over the Cliff Would Improve Deficit Outlook

Federal deficit as a percent of gross domestic product



SOURCE: Congressional Budget Office.

it otherwise would be (though there's little reason to believe the U.S. is on the cusp of such a calamity).

No matter how things shake out, deficits will remain—but they'll be a lot larger under some circumstances than others. If none of the expiring fiscal cliff provisions were extended past 2012, the CBO estimates that deficits would gradually fall to 1.2 percent of GDP and remain there for the next decade (*Chart 4*). If the fiscal cliff and smaller "fiscal clifflets" later in the decade were deferred in perpetuity, however, annual deficits would never fall below 4 percent of GDP and would reach 5.5 percent by 2022—leaving the U.S. poorly positioned to cope with the fiscal challenges of expected Social Security and Medicare shortfalls.

In fiscal policy as in monetary policy, it's necessary to carefully weigh short-term gain against long-term pain, often when no unambiguously optimal options are available. Many have suggested that the best strategy may be visible, loose fiscal policy today, coupled with strongly worded promises to embark upon fiscal consolidation as soon as it becomes reasonable to do so. But what's reasonable is not always apparent, making such proposals easier said than done.

Perhaps the real question today is whether we have entered an era of permanently greater polarization in Congress and permanently higher fiscal policy uncertainty. If that's the case, today's fiscal cliff may be a harbinger of what's to come.

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#### Notes

<sup>1</sup> See "Economic Effects of Reducing the Fiscal Restraint That Is Scheduled to Occur in 2013," Congressional Budget Office, May 2012. Subsequent economic developments have been less favorable than forecast, so it is possible the actual impact of the fiscal cliff would be at least slightly greater.

<sup>2</sup> These estimates do not consider feedback effects caused by a fiscal-cliff-induced weakening of the economy; thus, the true numbers may be somewhat greater.

<sup>3</sup> This choice is "wrong" only in the sense that it doesn't provide an immediate boost to growth—no judgment is being made here about whether it is a sound choice in any other context.

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