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US Economy's Fall From Fiscal Cliff

The phrase "Fiscal Cliff" has attracted huge attention recently. Ben Bernanke in his recent testimony to Congress warned that US economy faces risks from fiscal cliff. This soon became a catchphrase for the media with discussions on what this phrase means and its implications on US economy.

This note discusses the term fiscal cliff and its impact for US economy.

I. Fiscal Cliff - Meaning

Fiscal Cliff basically refers to sudden decline in US fiscal/budget deficit expected to occur in 2013. This is on account of both expiry of tax cuts and automatic expenditure cuts which are to start from 2013 onwards. Both these will lead to lower fiscal deficit and the amount of fall is such that it is akin to the fiscal deficit falling from a cliff.

The expiry of tax cuts are going to come from two major sources.

- Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA): This is a sweeping piece of tax legislation in the United States signed by President George W. Bush. EGTRRA reduced both taxes across income categories and provided tax rebates.
- Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA): This act increased the tax benefits given in EGTRRA. Both these provisions are also called as Bush tax cuts.

Sunset clause was attached to both these measures implying they will remain only for ten years. The idea behind the clause was to escape Byrd rule. The Byrd Rule is named after West Virginia Senator Robert Byrd. It is a Senate rule that allows Senators to block a piece of legislation if it purports significantly to increase the federal deficit beyond a ten-year term.

However, these cuts were extended for two years under the 2010 Tax Act. In 2010, US economy was again weakening as policy stimulus was wearing off. There were heightened concerns over US economy slipping into deflation like Japanese economy. In such times if Bush tax cuts were allowed to expire, it would have worsened US economy prospects. Amidst stiff political discussions, the Bush era tax-cuts were extended for another two years and set to expire in 2012.

The same arguments made in 2010 have returned in 2012 as well. After showing signs of optimism in winter/spring, the US economy is again facing another round of harsh summer reality. Growth rates have again started to slip and unemployment rates remain sticky at elevated levels. In such times, once again there is clamor for extending Bush tax cuts (more on this later).

Apart from Bush tax cuts, Fiscal cliff also includes other components which will lead to higher tax revenues in 2013. These are:

- Higher tax rates in social security tax: Under Middle Class Tax Relief and Job Creation Act 2012, a cut in social security tax was extended till 2012. The rate on this tax would increase from 4.2% to 6.2% in 2013.
- Affordable Care Act: Some tax provisions of this act to apply from 2013 including increased tax on earnings and investment income for high-income taxpayers.
- There are some other provisions of the tax code which will apply from 2013 onwards. The most prominent item under this is expiry of partial expensing of investment property.

Fiscal Cliff includes both higher tax revenues and lower expenditure. The policies that will lead to lower expenditure are:

- Budget Control Act of 2011: This act brought conclusion to the US debt-ceiling crisis. This act was a compromise between the Republicans and Democrats. The Republicans agreed to increase the US debt ceiling only if Democrats agreed to cut expenditure levels. For cutting expenditure, it was decided to set up a super committee to advice on the spending cuts. If the super-committee failed to agree to a consensus, it would trigger across-the-board cuts of spending equally split between security and non-security programs. As the super-committee failed to bring a consensus amidst huge hype, these cuts are to trigger from 2013 onwards.
- Middle Class Tax Relief and Job Creation Act 2012 extended emergency unemplpyment benefits to Dec-12. These would expire as well.
- There are other scheduled reductions like medicare payments to physicians etc.

II. Impact of Fiscal Cliff

In May-12, CBO (Congressional Budget Office) released a report analyzing the impact of Fiscal Cliff (Economic Effects of Reducing the Fiscal Restraint That Is Scheduled to Occur in 2013). Table 1 looks at the impact of fiscal cliff on US fiscal position. Overall, this would lead to gross budget gains of $607 bn in 2013.

Table 1: Impact of Fiscal Cliff (in USD bn)

A	**Changes in Specified Revenue Policies**	**399**
	Bush tax cuts and indexing the alternative minimum tax for inflation	221
	Expiration of the Social Security tax cut	95
	Other expiring provisions	65
	Taxes included in the Affordable Care Act	18
B	**Changes in Specified Spending Policies**	**103**
	Effects of the automatic enforcement procedures specified in the Budget Control Act	65
	Expiration of eligibility to start receiving emergency unemployment benefits	26
	Reduction in Medicare's payment rates for physicians	11
C	**Other Changes in Revenues and Spending**	**105**
D	**Total Change in Deficit Without Effects of Economic Feedback (A+B+C)**	**607**
E	Effects of Economic Feedback	-47
F	**Change in Deficit With Effects of Economic Feedback (D+E)**	**560**

Note: We have just changed the terms from the original table to connect the changes with the above terms.
Source: CBO

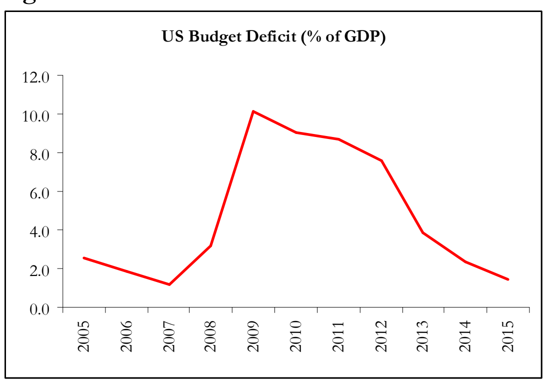
However, CBO also estimates decline in economic activity because of this sudden change in fiscal policy. The decline in economic activity will lead to lower tax revenues. The negative impact of this economic feedback is estimated at USD 47 bn. This implies the total net gains in US budget position in 2013 is expected at USD 560 bn.

Putting these numbers in overall perspective, it will reduce budget deficit by 4.7% of GDP in 2013. In 2012, budget deficit was $1171 bn and it could be around $611 bn in 2013 because of fiscal cliff.

Table 2: Impact on Fiscal Deficit (in $ bn)		
A	Budget Deficit in 2012	-1171
B	Improvement due to Fiscal Cliff	+560
C	Budget Deficit in 2013	611
Source: CBO		

This implies budget deficit in 2013 is expected around 3.8% of GDP, half of 7.6% of GDP expected in 2012. Figure 1 clearly resembles a cliff and hence the term fiscal cliff. As the various components of fiscal cliff are likely to remain permanent, CBO expects budget deficit to ease further to 1.5% of GDP by 2015. In a way, expected improvement due to fiscal cliff could alone push US budget deficit into a more acceptable trajectory of 1% from a high of 10% in 2009. The average budget deficit in 2009-12 is around 8.7% of GDP. CBO expects average fiscal deficit in next four years from 2013 onwards could be 2.2% of GDP, one fourth of the average of previous four years!

Figure 1

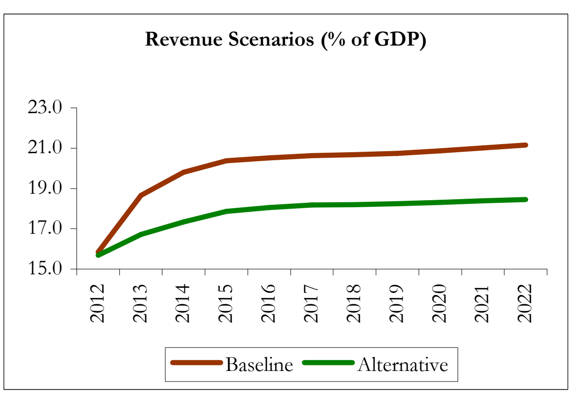


Source: CBO

In its Mar-12 update on US Budget Projections, CBO released the budget deficits under two scenarios Figure 2). The baseline scenario was based on allowing various components of fiscal cliff to expire. The alternative scenario is based on the assumption of again extending these benefits.

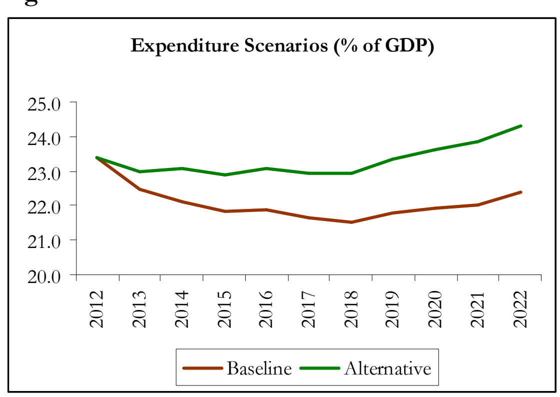
Under the baseline scenario, revenues improve from 15.8% of GDP ($2.5 tn) in 2012 to 18.7% of GDP ($2.9 tn) in 2013. Revenues continue to improve to touch 21.2% of GDP ($5.2 tn) by 2022. In the alternative scenario, revenues are lower at 16.7% of GDP ($2.6 tn) in 2013 and 18.5% of GDP ($4.5 tn) in 2022.

Figure 2



Source: CBO

Figure 3

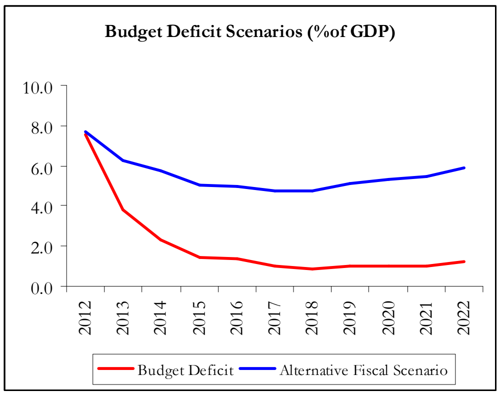


Source: CBO

Under the baseline, expenditure declines from 23.4% of GDP ($3.6 tn) in 2012 to 22.5% of GDP ($3.5 tn) in 2013. It is expected to remain unchanged at 22.4% of GDP ($5.5 tn) in 2022. In the alternative scenario, expenditure improves marginally from 23.4% of GDP in 2012 to 23% in 2013 and rises to 24.3% of GDP in 2022.

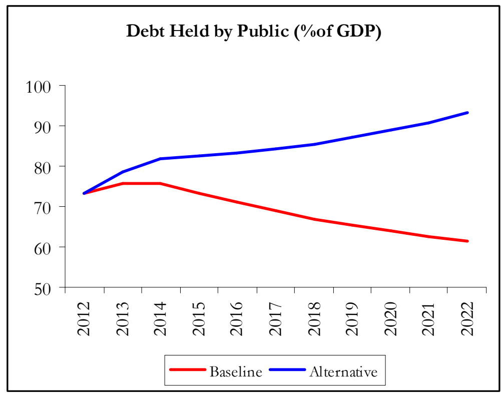
As revenues are higher and expenditure lower, budget deficit is lower in baseline scenario compared to alternative scenario. The budget deficit declines from 7.6% of GDP in 2012 to 3.8% of GDP in baseline and to 6.3% of GDP in alternative scenario. In 2013-22, budget deficit averages 1.4% of GDP in baseline against 5.3% of GDP in the alternative scenario. Debt held by the public in alternative scenario would rise to 93% in 2022 much higher than 61% under baseline. At 93% of GDP, public debt will be the highest since World War II.

Figure 4



Source: CBO

Figure 5



Source: CBO

III. Complex Trade-off between Deficit and Growth

The above analysis shows how fiscal cliff scenarios could lead to changes in fiscal position of the US government. Given the recent criticism on high US deficits, one would straight forward suggest to let the various Bush tax cuts expire and let there be a fiscal cliff. However, the prescription is not straight forward as a sharp fall in the fiscal cliff could easily lead to slower growth.

If the tax cuts are allowed to expire and thus fiscal cliff materialises, it will lead to lower growth. This will lead to lower tax revenues and higher expenditure on certain programs like unemployment. CBO estimates the economic impact to be around $47 bn in 2013 leading to total gains in fiscal declining from $607 bn to $560 bn.
CBO estimates GDP growth at 2.1% in 2012. Under the baseline scenario, growth could decline to 0.5% in 2013. However, in case fiscal restraints are extended growth could be much higher at 4.4% in 2013. The employment is also expected to rise by 2 million on average in 2013 in case of alternative scenario.

Therefore if fiscal cliff materializes, it will lead to a trade-off between growth and deficit levels. Over a short period, it will lead to lower growth but improve debt/deficit levels over a longer run. Lower growth rate in turn will lead to lower revenues and higher expenditure leading to lower fiscal benefits over a longer-run. If we extend the benefits, it will boost growth in short run but worsen fiscal prospects over a long run. The worsening fiscal prospects will lead US government to cut expenditure levels slowing growth over a long run. It clearly is a catch-22 situation for the US government with both options providing numerous challenges over the short and long run.

IV. Way Ahead

Overall, the fiscal cliff issue has again put US fiscal position under the scanner. After escaping the debt ceiling crisis, the US economy is again facing a fiscal cliff crisis. However, the fall from the cliff will be favorable for US fiscal finances but is expected to push the economy into a downhill. This is ironical as most advanced economies are struggling to lower their deficits. US economy is getting an opportunity to lower the deficits but is unable to utilize it given the short-term costs.

William Cline of Peterson Institute in a research note says that (Restoring Fiscal Equilibrium in the United States, Jun-12) it is a good thing that the United States faces a fiscal cliff. It provides a unique opportunity to lower budget deficits and raise tax revenues. It will also lead political minds to find more ways of cutting spending and limiting increases in entitlement spending.

CBO says that if policymakers want to balance this trade-off, there is a need for combination of policies. If fiscal cliff is not allowed and current law is extended, then there is a need for policies that reduce deficits at a higher pace later in the decade. Moreover, there is a need for deciding quickly on these policies. This will give markets and public more time to understand the policies and lead to better decisions.

US policymakers are most likely going to agree on extending these various Bush tax benefits. However, they should not turn this into another game of political gains between the two parties. The debt-ceiling crisis was a needless one where the need to raise the ceiling was known well in advance. But the policymakers waited till the last minute to raise the ceiling. This kept the global economy on tenterhooks amidst huge uncertainty. They have ample time once again and should let the public know of their final decisions well in advance. Ideally, a consensus should arrive before the build up to the US Presidential elections. With elections in November, there might not be much time left in December.

If we get this consensus well in time, we will be really lucky as political rivalry in nations has become a serious issue in this crisis. Politicians seem to be more interested in political rivalry even at the cost of not serving their nations for which they are elected. And in this case, it involves the whole world economy as well.

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