Economic Comment: US Fiscal Cliff

National Australia Bank

- **The fiscal cliff refers to the large fiscal contraction that will occur early in January 2013 due to increases in taxes and reductions in spending under existing law.**
- **Given the state of the economy and the limited ability of monetary policy to respond, if the full legislated fiscal consolidation were to occur there would be a large negative impact on the economy, potentially taking it back into recession.**
- **Negotiations to scale back the size of the fiscal cliff are underway. The most likely outcome is a deferral of much of the fiscal contraction, but not all. Agreement may not be reached until early next year.**
- **Backdrop to the fiscal cliff debate is that the spending and taxation policies operating at this moment are not sustainable. It is not a question of when the U.S. will have to tighten its budget but when, at what pace, and how.**

Overview

The focus in the United States following the presidential and congressional elections switched quickly to fiscal policy, in particular the "fiscal cliff". The fiscal cliff refers to the large fiscal contraction that will occur in early January 2013 due to increases in taxes and reductions in spending under existing law.

Political negotiations to address the fiscal cliff are underway. There are a large number of possible outcomes ranging from a 'grand bargain' that address both short and long-term fiscal issues to the U.S. going over the cliff. The most likely outcome is somewhere in-between with a deferral (ranging from a few months to a year or more) of a large part, but not all, of the scheduled tax increases and spending cuts. This means that down the track the fiscal cliff may again become an issue and that the uncertainty it is generating will not go away completely. Moreover, it is quite possible that any agreement will not be reached until January (or even February).

If all the scheduled fiscal consolidation were to take place, there would be a large negative impact on the economy, potentially taking it back into recession. The two major fiscal consolidations that have occurred since the early 1960s did not produce an immediate and obvious impact on the economy. However, the circumstances were different – in 1969 the economy was much stronger, while in 1987 monetary policy was loosened to support the economy. The current circumstances of large unused capacity in the economy and constrained monetary policy mean that fiscal consolidation will negatively impact the economy. The assumption underlying our forecasts for the U.S. economy has been that fiscal consolidation in 2013 would be around the same magnitude as in 2012. In other words, while the fiscal consolidation would represent a headwind, it would not be any greater than in 2012. Such an outcome is still possible but by no means certain.

Moreover, how agreement is reached will also be important. A chaotic, disorderly process could undermine confidence in the economy (along the same line as the debt limit debate of last year).

With the focus on the immediate fiscal policy issues, it is worth remembering that the discussions on the cliff are taking place in the context of an unsustainable fiscal outlook if policies operating today were simply extended indefinitely. That is, it is not a question of when the U.S. will have to tighten its budget policy but when, at what pace, and how.

How high is the cliff?

If you have been following reporting of the fiscal cliff one thing is clear – everyone has a different view of its size. One thing to watch out is whether the estimate is on a fiscal year (October through to September) or calendar year basis. Even on a common basis there are large differences as the table below illustrates. A lot of the differences come from whether the estimate is just based on all scheduled tax increases/spending cuts (HFE) or just the major ones (JP Morgan). However, which ever way you look at it, the fiscal consolidation will be large, at somewhere between 3.5% and 5% of GDP.

Estimates of the fiscal cliff in calendar year 2013

		JP		NAB Analysis of CBO reports	
	HFE	Morgan	BoA/ML	bottom-up	top-down
Expiring payroll tax cut	127	125	120	113	
Other expiring tax provisions				441	
Expiring Bush tax cuts & AMT	329	309		329	
Income tax increase			180		
Expiring tax credits					
Alcohol Fuel Tax credit	12			12.3	
Research & experimentation	8			8.3	
Subpart F Corporate Income	13			12.5	
Partial Investment Expensing	51			51	
New Health Care law taxes	24		20	24	
Budget control act cuts		98	110		
Discretionary spending cuts for 2011 caps	23			22	
Sequester spending reductions	72			73	
Expiry of emergency unemployment benefits	35	40	40	45	
Reduction in medicare payment rates	15			13	
Other changes	121		250		
Total	**830**	**572**	**720**	**731**	**760**
% GDP	*5.1*	*3.5*	*4.4*	*4.5*	*4.6*

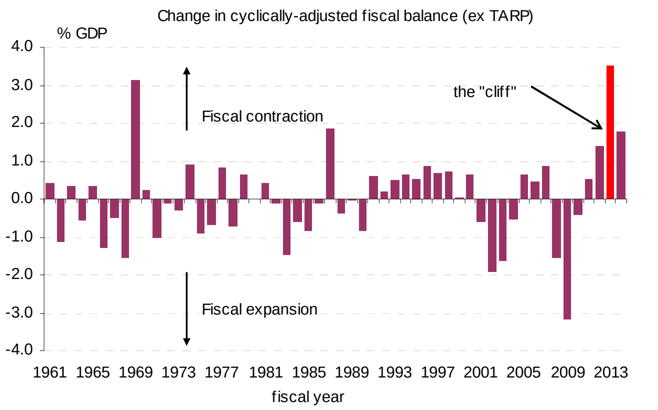
Sources: High Frequency Economics (HFE), JP Morgan, Bank of America Merrill Lynch (BoA/ML), Congressional Budget Office, NAB. The bottom-up CBO estimates are based on fiscal year estimates provided in various reports for the different items, scaled up by a factor of 4/3. The top-down approach is based on CBO January 2012 estimates of the cyclically-adjusted deficit, adjusted for changes in CBO projections since then (but excluding changes due to economic reasons) and excluding the Troubled Asset Relief Program (TARP); the estimate is scaled up by 4/3 to convert to a calendar year basis.

Apart from adding up each scheduled tax/spending change, an alternative is to look at the change in the cyclically adjusted measure of the budget balance. Major reasons for changes in the budget position include deliberate policy changes, change in take-up or use (e.g. more elderly leading to more medical treatment) or because of changes in the economy (e.g. a weaker economy will mean lower tax revenues). The cyclically adjusted measure attempts to remove the impact of the latter factor. The problem with such a measure is that it is not directly observable and must be estimated. An advantage is that it is comprehensive (all changes in the budget position other than those due to the economy) are included. On this basis, using CBO estimates of the cyclically adjusted deficit, we estimate a fiscal cliff of 4.6% of GDP, which is within the range of other estimates.

The chart below shows the change in the cyclically adjusted GDP for each year since financial year (fy) 1962 (the period for which

CBO estimates are available). The projected fiscal tightening for fy2013 is the largest over this entire period. There was only one other year with a tightening in fiscal policy of similar magnitude – fy1969.

Cliff represents an historically large fiscal contraction



Source: Congressional Budget Office, NAB Group Economics

Impact of the "fiscal cliff"

If the U.S. 'went over the cliff' what would be the impact? The CBO has estimated that it would detract over 2ppts from growth over the year to the December quarter 2013 (relative to a scenario which assumes a fiscal contraction of around one-third of the full 'cliff'). Under their projections, this would take the country into recession over the first half of the year. This is a viewed shared my many private sector forecasters as well.

The impact of fiscal policy on the economy remains a subject of much debate. Estimated fiscal multipliers range from -1 to 3 (i.e. a 1% fiscal contraction will either increase the economy by 1% or decrease it by 3%)[1]. Some studies have found that the multiplier is not fixed across time but is dependent on the state of the economy and monetary policy settings (as well as the nature of the fiscal changes – i.e. the mix of tax or spending measures). These studies suggest that the impact of fiscal policy is likely to be greater when there is a negative output gap (i.e. high unemployment) and monetary policy is operating at its zero bound – both of these factors are in play right now in the United States.

This conclusion is supported by a review of past major fiscal consolidations. As we noted before, the last time there was a tightening in fiscal policy, in a single year, of similar magnitude to the fiscal cliff was back in fy1969. There was also a large fiscal consolidation (of around 2% of GDP) in fy1987. The table below compares some key economic variables in these years, as well as the year immediately before and after.

In 1969, the economic environment was very different to that of today as unemployment was low (around 3½%). Quarterly CBO data suggest that the fiscal tightening in fy1969 occurred at the start of calendar 1969. Interestingly, while the NBER considers that the U.S. entered into recession that same year, it only occurred at the very end of the year. This may be because there was not just a fiscal policy headwind, but there was also a significant tightening of monetary policy in calendar 1969. From the start of the year to the end, the Fed funds rate was increased by around 3ppts. Rather than moderating fiscal policy, monetary policy was itself highly contractionary.

In terms of the economic environment, fy1987 was more similar to today; unemployment was high – it averaged 7.1% in fy1986 and had been high for a while due to a double dip recession in the early 1980s. The fiscal consolidation had no obvious impact on the economy; with GDP growth in fy1987 essentially unchanged from the previous year (and in 1988 it accelerated). However, in this case monetary policy was loosened, countering any effects from the fiscal consolidation.

Comparison of tightening episodes

Fiscal year		year of tightening: year -1	actual year	year +1
1969	Fiscal consolidation (% GDP)	-1.6	3.1	0.2
	GDP growth (yoy%)	5.3	3.0	0.4
	Unemployment rate (year average %)	3.7	3.5	4.4
	Fed Funds rate (%)	5.2	7.3	7.9
	10 yr Tsy Bond (%)	5.6	6.3	7.5
	Core inflation yoy% (e.p.)	4.5	4.7	4.6
1987	Fiscal consolidation (% GDP)	-0.1	1.9	-0.4
	GDP growth (yoy%)	3.1	3.0	4.1
	Unemployment rate (year average %)	7.1	6.4	5.6
	Fed Funds rate (%)	7.3	6.5	7.2
	10 yr Tsy Bond (%)	8.3	7.9	8.9
	Core inflation yoy% (e.p.)	3.8	3.9	4.5
2013	Fiscal consolidation (% GDP)	1.4	3.5	1.8
	GDP growth (yoy%)	2.3	?	?
	Unemployment rate (year average %)	8.3	?	?
	Fed Funds rate (%)	0.1	?	?
	10 yr Tsy Bond (%)	1.9	?	?
	Core inflation yoy% (e.p.)	1.7	?	?

Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, Congressional Budget Office, Federal Reserve

A reduction in the Fed funds rate is not an option today as it is just a little above zero, its lower bound. The Fed would undoubtedly initiate additional 'unconventional' monetary policy stimulus (such as asset purchases or extended forward guidance) if the U.S. went over the cliff. However, given the extent of such measures already undertaken, the stimulus to the economy from these measures is likely diminishing with each new announcement. With the scope for monetary policy easing limited and with a large amount of excess capacity still in the economy, a fiscal contraction will negatively impact the economy and, given the size of the fiscal consolidation in prospect, the impact would be substantial.

One of the debates surrounding the response of European policy makers to their sovereign debt crisis was whether austerity can promote and encourage growth (so-called 'expansionary austerity'). This is a hotly contested proposition. Moreover, even supporters of this proposition consider that it only occurs in certain circumstances. In particular, importance is placed on the composition of the fiscal consolidation – which should primarily in the form of spending cuts (and even accompanied by tax cuts) – and it should also signal a decisive policy change (to the operation of fiscal policy and, possibly, other structural economic reforms). However, the conditions necessary for this optimistic view of fiscal consolidation are not in place. Firstly, the fiscal cliff mainly reflects tax increases not spending cuts (70-80% of the scheduled fiscal consolidation is from the former). Further, while going over the cliff would represent a major shift in the trajectory of U.S. deficits and debt going forward the arbitrary nature of many of the spending cuts suggest there will be pressure to reverse some or all of them. The poor policy process (with the leadership of both major political parties signalling the need to scale back the cliff) would also fail to engender confidence about policy settings going forward.

Even if the fiscal cliff spending cuts/tax increases are significantly scaled back it could well be at the last minute or even retrospectively in January/February. This may have economic repercussions through a loss of confidence and precautionary cut-backs in spending and investment (in fact, the latter is probably already occurring).

The impact of such confidence impacts are difficult to predict, but can be significant. For example, if the U.S. were to go over the cliff, there could be a very different impact between a situation where the parties are known to be close to agreement (with

[1] Wilson, D., FRBSF Economic Letter, *Government Spending: An Economic Boost*, 2012-04, 6 February 2012

retroactive measures to be implemented to reverse tax increases etc) and a situation where talks have broken down and what will happen next is unclear (i.e. something similar to last year's debt ceiling debate).

Moreover, if policymakers simply defer much of the fiscal consolidation by three or six or twelve months then it will simply be setting up a similar debate down the track. This would mean the concerns over the cliff – and its potential impact on business investment – would not go away although it is possible that they would moderate for a period of time.

A range of outcomes are possible

Discussions between lawmakers have already started and markets have already varied between pessimism and optimism. A range of outcomes are possible including (but not limited to):

- 1) A 'grand bargain' – agreement on a long-term fiscal plan between the parties. This would address not only the fiscal cliff but also include a range of future revenue and spending measures sufficient to address (or make significant progress towards) longer-term budget pressures. The chances of this are almost zero in the current 'lame duck' session of congress; if the fiscal cliff is deferred for the new congress to deal with then there is a small chance that such a bargain could be reached. In the short-term, however, there may be agreement on some broad targets and goals to guide (or force) future progress.
- 2) A substantial part of the 'fiscal cliff' is deferred (e.g. tax changes) or rescheduled (the sequester cuts[2]), however, the longer-term fiscal problems remain largely unresolved. The deferral could be by as little as three months (to allow the new Congress to have the final say) or by as much as one to two years. Any such agreement could occur before the end of 2012 or, alternatively, in January/February as the U.S. goes temporarily over the cliff but the pressure this generates leads to an agreement (with retroactive changes for those policy measures that are ultimately extended).
- 3) No agreement is reached and the U.S. goes over the cliff permanently. While there is a lot of speculation about this scenario and discussion of its implications – we think the likelihood of this scenario is very low (but not zero). There is actually bi-partisan agreement that many of the measures that make-up the fiscal cliff should be prevented – e.g. this is true of the income tax increases (with the exception of higher income earners) and indexation of the alternative minimum tax (AMT), the single most important component of the cliff.

Another issue is that the U.S. federal government is set to hit its debt limit shortly (the latest indications are February). The chaotic process in July /August of last year to increase the debt limit helped undermine confidence in the economy. This time around, resolution of the debt limit is likely linked to the fiscal cliff talks; although in the event that the U.S. goes over the fiscal cliff (permanently) another avenue will need to be found (and it could be just as ugly as last year).

It should also be clear that when we talk about averting the fiscal cliff, we do not mean cancelling (or deferring) all of the spending cuts/tax increases. Rather, we mean a cancelling or deferring a *substantial* part of the fiscal consolidation. Our assumption has been that fiscal consolidation in fy2013 would be around the same magnitude as in fy2012 (around $260-300 billion in 2013 calendar year terms). In other words, while the fiscal consolidation would represent a headwind, it would not be any greater than in 2012.

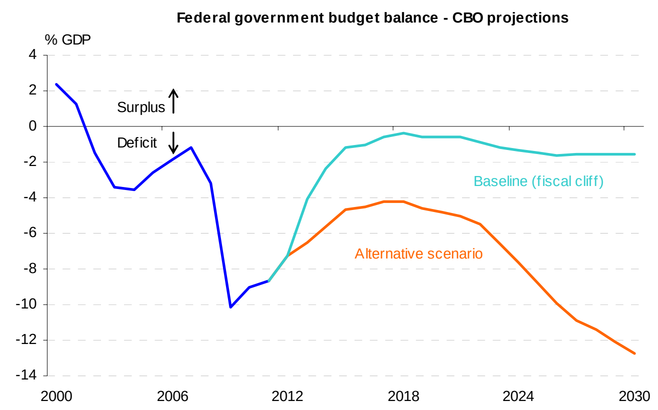
[2] Automatic spending cuts triggered by the Budget Control Act of 2011 following the failure to enact legislation to achieve an estimated $1.2 trillion in deficit Reduction.

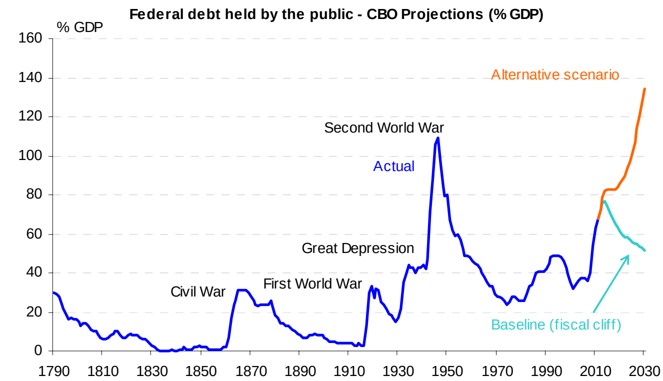
While it is still to be determined, there is speculation that the payroll tax cuts, emergency unemployment insurance benefits and partial investment expensing of investment property won't be extended. Moreover, the tax increases legislated as part of the health care act ('Obamacare') will almost certainly go ahead.

Longer-term fiscal issues remain if cliff averted

The debate over the fiscal cliff, and how to address it, is complicated by the underlying fiscal problems facing the United States. Simply scaling back the fiscal cliff may address concerns over the short-term impact on the economy, but would mean that U.S. fiscal policy remains on an unsustainable path. To illustrate this, the charts below show the CBO's projections under two different scenarios. In the 'baseline' scenario – which is based on all legislated tax and spending changes occurring as scheduled – the U.S. goes over the cliff. In contrast, in the CBO's 'alternative' scenario most current policy is extended (notable exceptions are the payroll tax cuts and emergency unemployment benefits which are assumed to end). This 'alternative' scenario has a similar degree of fiscal consolidation in fy2013 to which we assume in our forecasts for the U.S. economy.

Federal deficit and debt projections with or without cliff





Sources: CBO and NAB. Up to 2022 the data are taken from the CBO's August 2012 'An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022'. Beyond 2022 the data are based on the CBO's June 2012 report 'The 2012 Long-Term Budget Outlook', and have been spliced with the August projections.

If the United States allows the scheduled fiscal consolidation to go through permanently, the silver lining will be a marked reduction in the outlook for the size of the budget deficit. The deficit would shrink significantly in coming years, moving from around 7% of GDP in fy2012 to 1% of GDP or less by fy2016. Long-term factors which are a negative for the budget outlook include the ageing of the population and the rapid growth in the cost of health care services. Because of these factors, there is some deterioration in the deficit towards the end of the decade, but it still projected to remain below 2% of GDP.

Under this scenario the federal debt as a percentage of GDP would slowly decline. However, it would remain above pre-recessions levels and by 2030 it would still be higher than in any other period except for World War II. This means that the US fiscal position would remain highly exposed to future shocks, possibly limiting policy options in any future downturns.

Moreover, it is unclear how sustainable the current legislated fiscal policy is. Apart from the tax increases on the middle-class which would be very unpopular, on the spending side most of the restraint is focussed on what is called 'discretionary' spending. This includes defence, federal agencies and associated programs, including science and technology research, natural resources, disaster relief, foreign aid, energy, justice and education. Resources directed to these activities are projected to fall to their lowest level in decades. As the effect of shrinking these programs and the services they provide becomes apparent – political pressures will mount to reverse them. This is particularly so given the indiscriminate, across the board nature of the cuts under the sequester. In contrast, spending on Medicaid, Medicare and other health care programs and social security will continue to grow strongly, partly due to demographic reasons, but also underlying growth in costs and policy decisions.

If, as expected, the congress scales back the size of the cliff along the lines of the CBO's alternative scenario, then the deficit – while down from recent highs – would remain elevated through this decade. As the longer-term demographic and health cost dynamics take over and interest servicing costs rise – the deficit would start to worsen rapidly. With deficits, in-time, of over 10% and getting worse, this is not sustainable, and at some point the markets would lose confidence in the ability of the U.S. to repay its debt (without resorting to inflation). As a result, interest rates would rise and government would have to enact severe budget cuts and/or tax increases. Events in the Euro-zone illustrate how unpleasant such a market enforced belt-tightening can be.

This is why the idea of a 'grand bargain' holds such allure, as it would not only moderate the short-term path of fiscal policy, but at the same time put it on a more sustainable footing. Simply by doing the latter, may itself improve expectations and confidence which could boost the economy. However, as noted previously, the chances of this occurring should not be oversold. The difficulties in reaching agreement in past attempts represents not just politicking but genuine differences of opinion, and with the senate dominated by Democrats and the House by Republicans one side cannot easily impose its preferred options.

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