Center on Budget and Policy Priorities

820 First Street NE, Suite 510
Washington, DC 20002

Tel: 202-408-1080
Fax: 202-408-1056

center@cbpp.org
www.cbpp.org

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MISGUIDED "FISCAL CLIFF" FEARS POSE CHALLENGES TO PRODUCTIVE BUDGET NEGOTIATIONS

Failure to Extend Tax Cuts Before January Will Not Plunge Economy into Immediate Recession

By Chad Stone

The sooner policymakers enact legislation to put the budget on a sustainable long-term path without threatening the vulnerable economic recovery, the better. But, as they prepare for an almost certain post-election "lame duck" session of Congress, policymakers should not make budget decisions with long-term consequences based on an erroneous belief: that the economy will immediately plunge into a recession early next year if the tax and spending changes required under current law actually take effect on January 2 because policymakers haven't yet worked out a budget agreement.

Understanding the relationship between changes to the budget and changes to the economy is critical for making sound decisions. Policymakers, media, and others widely refer to the tax and spending changes slated to take effect at the start of January as the "fiscal cliff." Those changes will not produce an economic calamity, however, if the measures most damaging to the economy in the short term are in effect for only a few weeks or even a month or so while policymakers work toward an agreement. If current law initially takes effect — causing various income and payroll tax cuts to expire on January 1, emergency unemployment insurance (UI) to expire while joblessness remains very high, and across-the-board spending cuts to kick in on top of the discretionary cuts that the 2011 Budget Control Act caps mandate — the economy will indeed start down a slope that could ultimately lead to a recession in 2013. But that's a far cry from the economy falling off a cliff and plunging immediately into recession.

In fact, the slope would likely be relatively modest at first (and then much steeper if 2013 unfolds without a fiscal resolution). This means that if there is no agreement by January 1, policymakers will still have some (although limited) time to take steps to avoid the serious adverse economic consequences that the Congressional Budget Office (CBO) outlines in its recent analysis of what will happen if the expiring tax cuts and new spending cuts take effect on a permanent basis.[1] That is, they will have some time to work out the needed compromises and craft a budget and economic package that can support the recovery over the next few years while putting in place a balanced

[1] Congressional Budget Office, *Economic Effects of Reducing the Fiscal Restraint That Is Scheduled to Occur in 2013,* May 2012, http://www.cbo.gov/sites/default/files/cbofiles/attachments/FiscalRestraint_0.pdf.

package of spending and revenue measures that will stabilize deficits and debt (relative to the size of the economy) over the coming decade.

Recent headlines related to CBO's analysis have fueled visions of a "fiscal cliff" that produces an immediate economic disaster, but that reflects some misunderstanding of CBO's analysis. CBO *does* estimate that the budget deficit would fall by $560 billion between fiscal years 2012 and 2013 (3.7 percent of Gross Domestic Product) if policymakers let current tax and spending law take effect permanently. And because the policy changes are concentrated around the beginning of calendar year 2013, the deficit would fall by a somewhat larger amount — 4.7 percent of GDP — if measured on a calendar-year basis, from December 2012 through December 2013.

The economic impact of such fiscal restraint would be large. The economy would contract at a 1.3 percent annual rate in the first half of 2013, CBO estimates, before starting to grow again in the second half at a 2.3 percent annual rate.[2] Real (inflation-adjusted) GDP would grow by just 0.5 percent from the end of 2012 to the end of 2013, and unemployment would rise. With that outcome, the National Bureau of Economic Research would likely conclude that the economy was in recession in the first half of the year. No one should consider that outcome acceptable.

But, much of CBO's interesting analysis is lost by focusing solely or primarily on the "fiscal cliff" scenario. CBO's report is, in fact, about the trade-offs involved in adopting policies to avoid this worst-case short-term outcome, which policymakers almost surely will do — one way or another. The question is whether policymakers will respond to frightening rhetoric about the immediate economic impacts of a "fiscal cliff" by simply extending current policies and postponing the hard decisions needed to restore long-term fiscal stability. That would be a serious mistake and an unnecessary step. As CBO states:

> If policymakers wanted to minimize the short-run costs of narrowing the deficit very quickly while also minimizing the longer-run costs of allowing large deficits to persist, they could enact a combination of policies: changes in taxes and spending that would widen the deficit in 2013 relative to what would occur under current law but that would reduce deficits later in the decade relative to what would occur if current policies were extended for a prolonged period.[3]

Ideally, policymakers would enact such a package in the next few months. But if they cannot reach agreement by the end of the year on a balanced plan of tax and spending changes that will improve both the mid- and long-term outlook, they should continue to work on it intensively early in the next year. Suppose policymakers could not work out such a package until January or even early February 2013 — because it took the intense political pressure that they would face after failing to reach agreement by December 31 to move them off some of their rigid positions, such as opposition to any tax increases to help reduce deficits. That modest delay could produce a policy

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[2] CBO also estimates that if businesses and households anticipated that these changes would take place, they would take anticipatory actions that could shave 0.5 percent off economic growth in the second half of 2012. CBO makes its baseline economic and budget estimates under the assumption that current laws generally remain unchanged. Private forecasters are unlikely to make a similar assumption because they do not expect policymakers to allow most of the changes required under current law to actually take place. Hence, their forecasts for the second half of 2012 would anticipate less fiscal restraint in 2013 than is in the CBO baseline.

[3] CBO, *op. cit.*, p.2

that is *better* for the economy over the mid- and long-term than another extension of current tax and spending policies. (In a recent analysis, the Carlyle Group reached a strikingly similar conclusion. See box on page 4.)

To be sure, no one should aspire to a debate that extends into January or early February. That will not engender confidence in our political system, and the onset of tax increases and spending cuts whose duration appears uncertain will cause confusion on the part of many taxpayers, businesses, and beneficiaries of federal benefits and services.

Nevertheless, a relatively brief implementation of the tax and spending changes required by current law should cause little short-term damage to the economy as a whole, since policymakers would surely make whatever tax and other agreements they worked out in January or early February retroactive to January 1. Thus, the delay would withdraw little aggregate demand from the economy.

Politically speaking, such a scenario would resemble in some respects the government shutdown in the winter of 1995-96, when President Clinton and Republican Congressional leaders failed to reach agreement on legislation to fund government departments and agencies. The intense political pressure that both sides faced once the shutdown ensued broke the impasse fairly quickly, and the sides reached agreement that limited the shutdown to 21 days. This time, with tax increases and spending cuts taking effect under current law on January 2 amidst a still-weak economy, the political pressure to reach an agreement quickly would likely be even greater.

To be clear, the issue of what policymakers should do later this year or early next on long-term deficit reduction is distinct from whether they should act much sooner — in fact, immediately — to provide a further stimulus to an economy that shows increasing signs of weakness. Last week's disappointing reports on economic growth and job creation, as well as growing concerns about Europe's debt crisis and an economic slowdown in China, suggest that U.S. policymakers should act through both fiscal and monetary policy to strengthen the U.S. recovery. On the fiscal front, however, they should be careful to choose policies that will be most cost effective in boosting demand for goods and services while the economy is weak without making the nation's long-term fiscal problem worse.

What Would Actually Happen in January?

The economy will not immediately fall off a cliff into recession the first week in January if the policy changes mandated by current law take effect. But what will happen? Table 1 lays out the major expiring tax and spending provisions and the scheduled spending cuts under the Budget Control Act's "sequestration" process; together, these changes will reduce the deficit by $483 billion between fiscal years 2012 and 2013, according to CBO. Other factors largely beyond policymakers' control will reduce the deficit by an additional $77 billion, CBO projects, for a total deficit reduction in 2013 of $560 billion under current law.[4]

[4] CBO estimates that the deficit would fall by $607 billion if that fiscal restraint had no effect on the economy. In fact, however, CBO estimates that the restraint would slow the economy, lowering taxable incomes (and hence revenues) and increasing spending on programs like unemployment insurance. These "economic feedback" effects add $47 billion to the deficit, resulting in a net reduction in CBO's estimate of the deficit of $560 billion between fiscal years 2012 and 2013.

Carlyle Group Report Sees "Worse Fates than Walking Off the Fiscal Cliff"

In the Carlyle Group's May 31, 2012, *Economic Outlook*, "There Are Worse Fates than Walking off the Fiscal Cliff," analysts Jason M. Thomas and David M. Marchick conclude the following:

> 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.

As they say in their report:

> 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.
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> ...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."

Income, Estate, and Gift Taxes and the AMT "Patch"

Policymakers in 2010 extended through December 31, 2012 the Bush-era tax cuts, along with the 2009 Recovery Act's expansions in several tax credits. They also limited the reach of the alternative minimum tax (AMT) in 2011 but did not similarly "patch" the AMT for 2012. Altogether, the scheduled expiration of these provisions accounts for nearly half (46 percent) of the $483 billion reduction in the deficit between 2012 and 2013 that is due to the expiration of various tax cuts and spending increases plus sequestration (and almost 40 percent of the total $560 billion reduction in the deficit in 2013).

But these individual income tax changes will not reduce taxpayers' cash flow on January 1 by anything like the full revenue increase they would produce over the course of the year. As CBO states, the immediate impact on most households' cash flow will be limited to an increase in taxes withheld from their weekly or monthly paychecks, while those taxpayers newly falling within the reach of the AMT in 2012 will not actually pay those higher taxes until they file their returns in subsequent months.[5]

[5] CBO states that the non-AMT changes to individual income taxes "will affect tax payments beginning in calendar year 2013, when withholding schedules will reflect those expirations," and the increase in AMT liabilities for 2012 "will not be paid by most taxpayers until calendar year 2013, as they file their 2012 returns." CBO, *op. cit.*, p. 3.

Table 1 Reduction in the Budget Deficit Under Current Law Between Fiscal Years 2012 and 2013			
Provision	**Reduction in deficit (billions of dollars)**	**Percent of expiring tax cuts and spending increases, plus sequestration**	**Percent of total reduction in deficit**
Expiration of 2001, 2003, and 2009 tax cuts and indexing of the Alternative Minimum Tax (AMT) for inflation	$221	46%	39%
Expiration of 2% payroll tax cut	$95	20%	17%
Expiration of federal emergency unemployment insurance (UI)	$26	5%	5%
Other expiring tax provisions	$65	13%	12%
Across-the-board spending cuts ("sequestration") under Budget Control Act of 2011	$65	13%	12%
Reduction in Medicare payment rates for physicians	$11	2%	2%
Total from expiration of tax cuts and spending increases, plus sequestration	**$483**	**100%**	**86%**
Other changes in revenue and spending, including effects of economic feedback[a]	$77		14%
Total reduction in deficit	**$560**		**100%**

Source: Congressional Budget Office

[a] Includes $105 billion of other changes in revenues and spending *not* due to specific policy changes (apparently primarily reflecting the effects of economic growth) plus $18 billion from revenue measures in the Affordable Care Act that take effect in 2013, minus $47 billion from the effects of "economic feedback" on the deficit (the fact that substantial fiscal restraint will slow the economy, reducing revenue and increasing spending on programs such as unemployment insurance) , and correction for rounding.

In addition, there is broad bipartisan agreement that most of the middle-class income-tax cuts should *not* expire in 2013 and that the AMT should continue to apply only to more affluent households. Thus, middle-class taxpayers might reasonably expect that they would not ultimately bear any additional burden in 2013 from higher tax rates or an expanded AMT. As long as they have reason to expect that Congress will rescind the increase in the tax rates and patch the AMT before March or April, many affected taxpayers, especially those with savings, might well maintain most (or all) of their spending over the first couple of months.[6]

For the health of the economy in 2013-14, the important issue with respect to the tax cuts is to ensure that tax cuts for low- and moderate-income households do not expire; the fate of the Bush tax cuts for the top 2 to 3 percent of taxpayers should be of little economic consequence in 2013 and 2014. Moreover, if only the tax cuts for lower- and middle-income households are extended, high-income taxpayers will still benefit from the reduced tax rates on the full portion of their income that falls in the lower tax brackets. CBO's analysis indicates that a cost-effective way to continue using the tax cuts to shore up the weak economy would be to extend the middle-class tax cuts for a year or two, allow the upper-income tax cuts to expire, and extend the tax-credit expansions targeted on low- and moderate-income households. Such an approach would provide the most "bang-for-the-buck" in terms of supporting the economic recovery in 2013-14 without seriously compromising long-term fiscal sustainability.

- As CBO says in its analysis of how different policies affect spending in a weak economy, allowing the rate increases for the top brackets to go into effect while deferring the other scheduled rate increases would be "more cost-effective in boosting output and employment in the short-run" — i.e., it would do more to increase growth and jobs per dollar of cost — than deferring *all* of the scheduled tax-rate increases.[7] The reason is that higher-income households would spend a smaller fraction of any increase in their after-tax income than the typical household would. In other words, the cost in terms of forgone short-term stimulus from allowing the top rates to rise in order to reduce the deficit would be much smaller than the cost of allowing the rates for middle- and lower-income households to increase.

- For analogous reasons, a higher tax rate and lower exemption level for the estate tax would almost surely exert even less restraint on growth and have even less effect on the economy in 2013-14 than the very small effect from allowing the increase in upper-bracket income tax rates to take effect.

- CBO goes on to suggest that it is far more cost effective to provide (or continue) tax cuts to lower-income households, who would be more likely than both middle-class and high-income households to spend a large share of any additional after-tax income they receive.

The Payroll Tax Cut and Emergency Unemployment Insurance

Legislation enacted this February extended through this year the two-percentage-point cut in the payroll tax that first went into effect in January 2011 (replacing the Making Work Pay tax credit enacted in the Recovery Act). The same legislation extended federal emergency unemployment

[6] They would be even more likely to maintain their spending if changes to the withholding tables required by the expiration of the tax cuts were delayed or some other administrative change were taken that would leave households' cash flow unaffected in anticipation of an extension of the middle-class tax cuts. At the moment, it's not clear that such steps would be feasible.

[7] Congressional Budget Office, "Policies for Increasing Economic Growth and Employment in 2012 and 2013," Statement of Douglas W. Elmendorf, Director, before the Committee on the Budget, United States Senate, November 15, 2011, p. 33, http://www.cbo.gov/sites/default/files/cbofiles/attachments/11-15-Outlook_Stimulus_Testimony.pdf.

insurance (UI) through the end of 2012 but provided fewer weeks of UI benefits to the long-term unemployed than were available between late 2009 and the end of 2011.[8] Both provisions expire at the end of this year, and those expirations account for about a quarter of CBO's estimated $483 billion reduction in the deficit between 2012 and 2013 that is due to expiring tax and spending provisions plus sequestration (and a fifth of the total $560 billion reduction in the deficit).

Expiration of the payroll tax cut and federal emergency UI would affect households' cash flow in much the same way as expiration of the middle-class tax cuts. A worker's weekly or monthly paycheck would be smaller due to the higher payroll tax deduction; an unemployed worker's weekly income would be lower without UI. The impact in the first month or so would be only a fraction of the year-long impact.

CBO estimates that the effects on output and employment of the payroll tax cut's expiration would be fairly similar to those of the middle-class tax cuts' expiration. The payroll tax cut is somewhat better targeted as stimulus than individual income tax cuts — a higher proportion goes to moderate-income workers, who likely will spend rather than save most of it — but not as well targeted as the refundable tax-credit expansions targeted to low- and moderate-income taxpayers that Congress enacted in the Recovery Act and extended in 2010.

As for letting federal emergency UI expire, CBO judges UI to be one of the most cost-effective policies for boosting output and employment in a weak economy. Although the amount of UI spending that would be lost is much smaller than the amount of the payroll tax cut, the bang-for-the-buck of UI spending is higher.

Unfortunately, there appears to be less support in Congress for extending the payroll tax cut (or enacting a better-targeted temporary tax cut) than for extending the middle-class tax cuts. As a result, if there is no agreement by December 31, middle-income households will be more likely to adjust their spending immediately in response to the higher deduction of payroll taxes from their paychecks than in response to a rise in income tax rates that they expect will soon be rescinded.

Although Congress has extended federal emergency UI several times since enacting it in 2008, support among lawmakers for recent extensions has been mixed, and another extension is likely to prove difficult to achieve — even though the highest unemployment rate at which federal unemployment benefits have been cut off in the past was 7.2 percent,[9] a rate no one expects the economy to be close to at the end of 2012.

In sum, expiration of both the payroll-tax cut and federal emergency UI will likely exert more of an immediate restraint on the economy than expiration of the income and estate tax cuts will. This is because expectations will be much lower that Congress would reinstate the former in a new budget deal and because the people receiving UI and the payroll tax cut are, on average, much more

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[8] For details, see Hannah Shaw and Chad Stone, "Conference Agreement Far Better for Unemployed Workers and UI System Than Original House Bill," Center on Budget and Policy Priorities, February 17, 2012, http://www.cbpp.org/cms/index.cfm?fa=view&id=3686.

[9] Chad Stone and Hannah Shaw, "Emergency Unemployment Insurance Benefits Remain Critical for the Economy," Center on Budget and Policy Priorities, November 10, 2010, http://www.cbpp.org/cms/index.cfm?fa=view&id=3320.

likely to spend much or most of any additional income they receive. Even here, however, only a fraction of the ultimate economic impact of those expirations will be felt in the first month or two.

Across-the-Board Spending Cuts Mandated by the Budget Control Act

In addition to imposing caps on discretionary programs that will reduce their funding by about $1 trillion over the ten years from 2012 through 2021, the Budget Control Act (BCA) of 2011 established an automatic enforcement procedure called sequestration — a form of automatic spending cuts that apply across a substantial part of the budget — that is scheduled to first take effect in January 2013. CBO estimates that sequestration will account for about 13 percent of the $483 billion reduction in the deficit between 2012 and 2013 that is due to expiring tax and spending provisions plus sequestration (and about 12 percent of the total $560 billion reduction in the deficit).

Sequestration calls for a reduction in spending authority of $109.3 billion each year from 2013 through 2021, split evenly between defense and non-defense programs.[10] While the limit on spending *authority* will be imposed at the beginning of the year, the *actual reductions in spending* will occur over the course of the year and into subsequent fiscal years. Once again, only a fraction of the impact occurs in the first month or so, although expectations of the cutbacks can affect the behavior of government contractors and others in advance of the actual cuts.

Policymakers designed sequestration to prompt the Joint Select Committee on Deficit Reduction created by the BCA to propose legislation that would reduce deficits by at least $1.2 trillion over ten years, but the Joint Select Committee failed to come up with such legislation. While sequestration is highly unpopular with lawmakers, there is no agreement at this point on what to put in its place. The President's 2013 budget proposes eliminating all sequestrations through 2021; instead, it would achieve more than the scheduled savings through a mix of revenue increases and reductions in mandatory programs that wouldn't have a substantial impact on the most vulnerable families and individuals and would largely take effect after 2013, when the economy is expected to be stronger. The House of Representatives has passed a bill to eliminate sequestration just for 2013 (and just for discretionary programs), replacing it with a package that hits hard at programs for low- and moderate-income people while failing to raise any revenue.[11]

Thus, government agencies, government contractors, and others face uncertainty about how sequestration will play out. Much will depend on the signals policymakers send about the kind of longer-run budget deal they are likely to strike and the guidance agency officials receive about how to conduct business in the meantime.

The best policy would be to replace sequestration with at least an equivalent amount of deficit reduction that occurs with much less force in the first few years and more in the later years, in order to minimize the restraint it imposes on the economy in 2013-14.

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[10] For details see Richard Kogan, "How the Across-the-Board Cuts in the Budget Control Act Will Work," Center on Budget and Policy Priorities, revised April 27, 2012, http://www.cbpp.org/cms/index.cfm?fa=view&id=3635.

[11] Robert Greenstein and Richard Kogan, "House Budget Bills Would Target Programs for Lower-Income Families While Breaking Last Summer's Bipartisan Deal," Center on Budget and Policy Priorities, updated May 10, 2012, http://www.cbpp.org/cms/index.cfm?fa=view&id=3767.

Other Tax and Spending Changes

The policies just discussed account for 85 percent of the $483 billion reduction in the deficit between 2012 and 2013 that is due to expiring tax and spending provisions and sequestration. In CBO's accounting, the remaining 15 percent of that reduction comes from:

- other expiring tax provisions, popularly known as "extenders" (13 percent), the largest of which is the scheduled expiration at the end of 2012 of partial expensing of investment in plant and equipment; and

- the scheduled reduction in Medicare's payment rates for physicians (2 percent).

In addition to the above $483 billion, another $77 billion of deficit reduction in 2013 comes from:

- what CBO calls "other changes in revenues and spending not linked to specific policies" ($105 billion), which appears to primarily reflect changes in revenues associated with the underlying growth in the economy from 2012 to 2013 and is partially offset by $47 billion in higher deficits due to the adverse economic impact from the scheduled tax increases and spending cuts; and

- $18 billion of new revenues that will result from a few revenue-raising provisions of the Affordable Care Act taking effect in January 2013, primarily an increase in Medicare taxes on high-income taxpayers.

The only potentially large one of these changes under policymakers' control is the scheduled expiration of partial expensing of certain business investments at the end of 2012. CBO does not analyze the effects of this particular policy on economic growth and employment, but it argues that extending *full* expensing (which expired at the end of 2011) through 2012 would have had a bang-for-the-buck comparable to the payroll tax cut. CBO also notes, however, that firms are less likely to increase investment when they have idle capacity, as they do now, and that the largest effect of this policy in spurring increased investment is likely to occur just before it expires.

The expiration of partial expensing at the end of 2012, whether on a temporary or a permanent basis, would likely impose little restraint on the economy in early 2013. Firms hoping their business might pick up in 2013 might move up new investments to late 2012 if they expect the expiration to be permanent. Conversely, if firms expect Congress to extend partial expensing into 2013, they might defer investments until later in 2013, waiting to see if business does indeed pick up.

Conclusion

The federal budget is expected to shrink dramatically between 2012 and 2013 if the laws governing revenues and spending remain largely unchanged. With no action from policymakers, that sharp reduction in the deficit would slow the economy dramatically, likely creating a mild recession in 2013.

Even under that scenario, however, the economy will not go over a cliff and immediately plunge into another Great Recession in the first week of January. Rather, most households will begin to receive somewhat smaller paychecks due to higher income tax rates and the expiration of the payroll tax cut, but the impact on their cash flow would play out over the year rather than being concentrated in January. More important, there is bipartisan support for extending most of the middle-income tax cuts through 2013, so the impact of a temporary expiration of the tax cuts on consumer spending is likely to be modest, given the very high likelihood that lawmakers will end up extending them retroactively to January 1, 2013 if they haven't acted by New Year's Day.

The greater danger is that misguided fears about the economy going over a "fiscal cliff" into another Great Recession will lead policymakers to believe they have to take some action, no matter how ill-conceived and damaging to long-term deficit reduction, before the end of the year, rather than craft a balanced plan that supports the economic recovery in the short term and promotes fiscal stabilization in the intermediate and longer run.