Fiscal cliffhanger

**Big risks from the fiscal cliff**
The US faces a potential fiscal crisis at year-end, as politicians have deferred all the tough budgetary decisions of the last several years until right after the November election. The consensus expects GDP growth to accelerate into year end and then dip slightly in Q1 2013. By contrast, in our view, the uncertainty generated by the fiscal cliff will significantly retard growth this year as well as next. All told, we expect a 2 percentage point hit to economic activity over the 12 months surrounding the fiscal deadlines. In a bit of dark irony, a shock that can only be averted with bipartisan compromise will follow an election that underscores that compromise is not possible.

**One big hole to fill**
The potential fiscal drag is historically unprecedented in size — $720 billion, or roughly 4.6% of GDP. We are skeptical that this shock can largely be avoided: neither a last-minute grand bargain nor kicking of a gigantic can down the road seems likely to us. Either of these actions would require capitulation from members of both parties on hard-fought and deeply-held philosophical positions. Instead, we expect debates over several parts of the cliff to drag on into next year. And all of this is likely to occur in the midst of hitting the debt ceiling once again.

**A challenging backdrop**
The upcoming election makes the process especially challenging, as the two parties will have incentives to highlight differences instead of areas of agreement. Polls suggest a close race, and studies report a sharp rise in negative advertising already. Pricing in election markets suggest close to a 70% chance of a split government. Even if one party were to capture both the Congress and the White House, the minority party in the Senate is likely to have the power to filibuster the majority’s fiscal agenda. Meanwhile, the fiscal deadline must be dealt with by in the lame duck session. Each of these factors makes reaching a successful compromise difficult, in our view.

**What to watch**
The uncertainty shock from the fiscal cliff only matters if and when the risk is recognized. Right now, we don’t think the markets have priced in most of the consequences. We expect corporate leaders to start voicing concern this summer, with activity starting to slow in the fall. The biggest impact will likely be on hard-to-reverse decisions: capital spending, hiring, and auto and home sales.
Fiscal cliffhanger

While the European fiscal crisis has grabbed the spotlight, the US faces its own fiscal crisis at year-end. US politicians have deferred all the tough budgetary decisions of the last several years to right after the November election. Absent new legislation — passed by the House and the Senate and signed by the President — we believe a recession-sized 4.5% of GDP fiscal tightening will occur. In a bit of dark irony, a fiscal shock that can only be averted with bipartisan compromise will follow an election that underscores that compromise is not possible.

Most discussion of the cliff focuses on the impact on growth in 2013. In the consensus forecast, GDP growth accelerates into year-end, then dips by 0.4% in Q1 2013, before accelerating again (Chart 1). However, in our view, this ignores at least half of the story. The cliff is likely to hurt growth this year as much as next year. By risking a recession-sized fiscal contraction and then offering no guidance to how it will be resolved, politicians are creating a major uncertainty shock. Hence, as the cliff approaches, we expect first firms and then households to start postponing decisions, weakening the economy in advance of the cliff. When you are approaching a cliff, in a deep fog of uncertainty, you slow down. We expect people to wait until the spring, when the cliff is hopefully resolved, before making important commitments.

In this piece we focus on the implications for the macroeconomy; in a follow-up piece, we will focus on more micro issues around winners and losers under various policy changes. Broadly speaking, our main macro conclusions are:

- In our view, most estimates reported in the press understate the size of the cliff. Under current law, unless the existing House, existing Senate and President Obama agree to new legislation, fiscal policy tightens by about 4.5% of GDP in January 2013.

- Using probabilities from the Iowa Electronic Markets, there appears to be about a 70% probability of continued split government. We will update this calculation as we get closer to the election.

- Even with a sweep by one party in the election, the fiscal cliff remains a challenge. The pressure for some significant austerity will likely remain high and the process will remain very difficult: the first decision on the cliff must be made by the current government, while in the new government the minority party will almost certainly still have the ability to block legislation in the Senate.

What will they do? Benign scenarios are possible, but unlikely:

- A lengthy postponement of all austerity measures — moving the cliff out a year— would require that fiscal conservatives, particularly House Republicans, completely give up on fiscal austerity. It would also likely trigger a credit downgrade.

- A balanced 10-year bipartisan plan seems even less likely, given the short time frame for decisions, the divisive impact of the election campaign and the failure of past such efforts.

- Our baseline forecast assumes roughly a 2% of fiscal drag, either right at the start of the year or gradually with a series of partial postponements. We
expect the payroll tax cut and extended unemployment benefits to expire; part of the discretionary cuts under the debt ceiling agreement to be implemented; and a variety of smaller, largely forgotten items, will expire.

How will the economy and markets react?

- The direct austerity effect is easy to estimate: applying an average (if conservative) multiplier of about one, we assume a roughly 2% hit to GDP spread over a four-quarter period.

- However, the bigger story is the uncertainty shock to the economy. By risking a recession-sized shock to the economy, growth is likely to slow both before and after the cliff.

- Election year politics will make it difficult to signal a compromise in advance; hence uncertainty will likely grow as the election approaches.

- It is unlikely that the cliff is fully priced into the markets. The economic consensus and markets have recognized the fiscal cliff for some time, but are only beginning to understand the size and timing of the shock to the economy. We are the only forecasters in the latest Bloomberg survey that have growth slowing sharply in the second half of this year.

Stepping back, the sad fact is that the cliff is an avoidable shock. The fiscal and demographic challenges facing the US are less than for Europe and Japan. And history shows that a well-designed plan — with the whole budget on the table, bipartisan cooperation, and with a sensible phasing in of the austerity — can lower the deficit without causing a major shock to the economy. It is important to emphasize that the decision process matters as well as the policy outcome. Bouts of brinkmanship undercut confidence and growth, making deficit reduction more difficult and painful than it needs to be.

**How big is the cliff? It’s massive.**

To determine just how large the fiscal shock might turn out to be, in this section we first quantify the size of the various parts of the fiscal cliff, then estimate their impact upon the economy. In the next section we explore the potential election outcomes and how they might influence our estimates of the likely economic impact.

Estimates of the fiscal cliff are all over the map. Some articles focus only on the $165 billion or so in the Bush tax cuts. In an opinion piece in the Financial Times, former Reagan CEA chairman Marty Feldstein argued that “the most important cloud on the horizon is the large tax increase that will occur next year unless there is some legislation to block it.” He points to a set of tax increases equivalent to 2.9% of GDP. The Heritage Foundation has come up with even bigger estimates just on the tax side: a $494 billion (3.3% of GDP) hit. Neither of these calculations includes the spending cuts that are also looming at the end of the year, which total about $230 billion themselves. Alan Blinder estimated total austerity of 3.5% of GDP, which seems around the average for most estimates of the potential size of the cliff in total. However, as we compute below, the potential shock may well be a full percentage point larger, or more than 4.5% of GDP.
Top-down versus bottom-up

We calculate the fiscal cliff in two steps. First, the Congressional Budget Office (CBO) has estimated an “alternative baseline” that takes into account most of the cliff, including the AMT, the Bush tax cuts, the cuts in Medicare payments to doctors, and the “sequestration” part of the debt ceiling agreement. They calculate that “fixing” all of the above would add $309 bn to the FY 2013 deficit. Since the fiscal year includes Q4 2012, these estimates need to be bumped up about a third to come up with the calendar year impact of about $410 bn. We then add six missing parts of the cliff: (1) spending cuts under the first part of the debt ceiling agreement, (2) the continued drop in infrastructure investment from the 2009 stimulus plan, (3) the revenues that kick in to fund Obamacare, (4) tax “extenders”, (5) the payroll tax cut, and (6) extended unemployment benefits. Our total comes to about $720bn, or 4.6% of GDP (Table 1). Our estimates are consistent with a recent CBO study, which found that “the federal budget deficit will decline by 4.7% of GDP between calendar year 2012 and 2013” if the entire fiscal cliff occurs.

Why is our number higher than others? One of the challenges of the fiscal cliff is that there are so many expiring programs, it is easy to miss something. Some calculations are based on fiscal years, starting in October, and hence include three months before the cliff hits. Conservative commentators tend to focus on just the Bush tax cuts or expiring tax provisions more broadly, and ignore the sizable spending cuts. Many calculations ignore a number of “second tier” measures that we listed above. Perhaps we have double-counted somewhere and we are happy to hear alternative views, but we think the cliff is very large.

Putting this in perspective, the US is facing a historically unprecedented political business cycle. In the past, fiscal policy has occasionally been overly expansive in election years. However, never have politicians risked anything close to a 4.5% of GDP post-election contractionary fiscal shock.

Election scenarios

Before we look at how the cliff is resolved, we need to consider what the new government will look like. A key finding is that the election is unlikely to make it any easier to resolve the cliff and the fiscal drag is likely to be about the same under most political scenarios.

Houses, divided

To understand how the election may influence the fiscal cliff outcome, let’s step back and note the pre-election alignment in Washington. Even before this election, relations between the two parties were arguably the worst in modern history. Washington insiders argue that the level of personal animosity is the highest they have ever seen, with very little personal or policy interaction. The most recent attempt at bipartisan action — the Cooper-LaTourette budget — earned only 38 votes in the House.

Recent studies lend support to the idea that the Senate and especially the House are more polarized today than has been the case in many years. Chart 2 shows the results for the House, based on an analysis of actual votes by representatives in each Congress since 1879, conducted by researchers at the University of Georgia and NYU. Polarization effectively measures how often members cross party lines on votes. Chart 2 suggests that the ideological divide between the two parties in the House has widened dramatically since the early 1980s. Republicans have gotten much more conservative and Democrats somewhat more liberal.
Chart 3 repeats the exercise for the Senate, which also shows a widening divide.

We think it is unlikely that polarization will narrow dramatically following the November election. Many of those up for re-election are in relatively safe seats. In fact, as Chart 4 shows, by some estimates there are only 13 “toss up” seats of 435 in the House, with another 23 seats that are leaning Republican and 21 that are leaning Democratic — meaning those candidates currently have small leads in local polls. With Republicans currently holding a 46 seat majority, these numbers imply a small chance that the House will change hands. Intrade, which runs an election market, prices in a 76% chance that Republicans retain the House. The Iowa Electronic Markets (IEM), hosted at the University of Iowa, currently reports a 72% chance.

The story on the Senate side is much less clear. Including Independents who caucus with them, the Democrats have 53 seats to 47 for Republicans. But more than twice as many Democrats are up for re-election this year: 23 to 10. Chart 5 suggests that 7 of the 33 contested seats are “toss ups” — 1 Republican and 6 Democrats. Another 4 seats are leaning Democratic and 3 leaning Republican, so there is a very real chance that Republicans could control the Senate as well: Intrade puts the probability at 56%, while IEM suggests 50%. But Intrade also currently prices in more than a 17% chance of a 50-50 split in the Senate, and some political analysts have started to flag this possibility as well.

What seems very likely is that neither party is poised to capture a 60-seat majority in the Senate for 2013 and 2014. This matters, as it allows the minority party to play a blocking role and precludes the majority from quickly pushing forward their agenda. If the House and Senate are both controlled by the same party then there are ways to use the budget reconciliation process to overcome a filibuster by the minority party, but it will not be an easy process.

Down to the wire

Turning to the presidential election, both polls and the election markets suggest a close race. In recent head-to-head polls, Gallup finds a slight lead for President Obama over former Governor Romney, with the polling in a fairly narrow range since late April (Chart 6). The Gallup trial heat polls are reported daily; monthly polls from several major news organizations reported a slightly larger lead for Obama in mid-May, but still close: within 4 percentage points for most, which is barely bigger than the margin of error.

The IEM have a similar lead for Obama, at 52 to 48%. (Intrade is the outlier here, pricing in a 58% probability that Obama is re-elected versus 39% for a Romney upset.) What is interesting about the IEM results is that they can be used as a way to estimate the chances of a divided government. Table 2 lists the eight possible alignments between the two parties of the Senate, House and presidency based on the IEM, as well as an “other” case that captures the possibility that the Senate is evenly split. Working through the joint probabilities, the IEM implies a 22% chance that Republicans will sweep all three, and just a 10% chance that Democrats will. In other words, there is a 68% chance of divided government after this election, according to the IEM.
A Fair look at the election

Beyond polls and election markets, another way to project who might win the presidency is through models that link the state of the economy to the election outcome. Ray Fair at Yale has a commonly-cited model that predicts the Democratic presidential vote share based on the pre-election cumulative GDP growth rate (for the first three quarters of the election year) and cumulative inflation rate (for the full term of the sitting president). It also captures an incumbency effect.

As of late April, Fair’s model is predicting a 50.2% vote share for Obama, confirming that the election is likely to be quite close. However, this estimate assumes that Q3 2012 GDP growth will be quite strong — above 3.2% — and in his model that gives an extra kick of a full percentage point to Obama’s election chances. If that does not happen — consistent with our weak forecast—then according to this model Obama would likely get a vote share around 49%, giving Romney the victory. With the state of the economy likely to be issue number one for the election, the outcome could swing on the data flow in the months leading up to November 6.

Unfriendly timeline

Before we look at post-election scenarios, consider how the political calendar complicates the decision process around the fiscal cliff:

- From now until the election on November 6, the campaign cycle will likely increasingly emphasize the differences between the two parties. Thus it will be hard for any politician to signal to those across the aisle or to the markets that a compromise is possible.

- The fiscal cliff needs to be resolved during a lame-duck session of government prior to December 31 — by the same politicians who previously were unable to agree to a longer-term deal.

- Divisions within both the House and Senate will remain, regardless of who is inaugurated on January 20, 2013. Even if one party sweeps, the minority party will likely have enough votes (40) to slow or block legislation in the Senate. Quickly passing a budget plan early next year will be a challenge, in our opinion.

- Both the Treasury and the Bipartisan Policy Center expect the US to hit its debt ceiling around the turn of the year. Then, with “extraordinary measures”, the government should be able to keep paying its bills for another 10 weeks or so. House Speaker John Boehner recently said he would “draw a line in the sand” and “insist” on spending cuts “greater than the debt limit increase.”

Honey, can you hit the mute button?

The election campaign will likely increase concern about the ability of the two parties to negotiate. As we noted above, the race for both the Senate and the White House will likely be very close, encouraging negative campaigning. Moreover, the source of funding will add to the negativity. The Wesleyan Media Project monitors election campaigns. In a forerunner of what’s to come, they find that so far 70% of presidential campaign TV ads are “negative,” up from 9% in 2008. As Table 3 shows, the source of this switch is the surge in spending by Political Action Committees (“interest groups”). Interest groups have sponsored 60% of ads this year, up from 3% in 2008. With all these negative ads, it will be difficult for Congress to start anew and work together once the campaigning ends.
Best case scenario: learning from history

With that rather discouraging backdrop, let’s take a look at post-election scenarios. First, the good news: history shows that an economy can handle well-designed fiscal austerity plans. Here we first take a look at the lessons from the 1983-2000 experience and then look at what is likely at the end of this year. While one can imagine a benign outcome, a rocky year ahead seems much more likely.

The great irony of the US debt debate is that the deficit can be fixed without crippling the economy. It happened once before: from 1983 to 2000 the budget balance improved from a deficit of 6.0% of GDP to a surplus of 2.4%. This improvement partly reflected the cyclical state of the economy, with the unemployment rate falling from 9.6% to 4.0% over this period. Equally important, it required tough policy choices and a gradual drop in the structural deficit (Chart 7). How did the economy do during this period? Despite repeated doses of austerity, GDP growth averaged 3.7%, well above the 3.1% average growth rate of post-war period (Chart 8).

We believe there were three reasons for this success. First and foremost, the two political parties worked together to make some very tough choices. A key symbol of success was the fact that the liberal Democratic speaker of the House, Tip O’Neill, and his conservative counterpart in the White House, Ronald Reagan, were able to sit down and have cordial negotiations. Most of the major deficit reduction efforts came from bipartisan efforts. The signature deficit reduction plans — the Deficit Control Acts of 1985 and 1987 — were named after the three main sponsors: Phil Gramm (R, Texas) and Warren Rudman (R, New Hampshire) and Ernest Hollings (D, South Carolina). Each president during this period — Reagan, Bush senior and Clinton — enacted bipartisan deficit reduction legislation.

Equally important were two bipartisan commissions. The Social Security Commission of 1983, headed by Alan Greenspan, helped put Social Security back on a more sustainable path by recommending both tax increases and spending cuts via later retirement ages. The Military Base Closure Commission recommended several up or down votes for multiple base closings, allowing Congress to get around local resistance to closures.

The second key to success, in our view, was that the austerity happened gradually, without sudden shifts or brinkmanship. Chart 9 shows the change in the structural budget deficit each year. Note the string of small positive numbers in the 1990s. This steady chipping away at the deficit is easily manageable for the economy. As the government slowly scaled back, it allowed time for resources to shift into the private sector. Moreover, the government did not attempt serious cuts during periods of economic vulnerability. Other than the brief shutdowns in 1995-96, the policy process also did not generate dramatic bouts of uncertainty for private sector decision makers.

The final key to success, in our opinion, was a willingness to put everything on the table. Every major area of the budget came under pressure, including cuts in both defense and nondefense discretionary spending, reforms to social security and several moderate tax increases. This approach of sharing the pain made the cuts both politically palatable and less damaging to the economy. It wasn’t easy, but it worked.
Hoping that history repeats

In our view, the best-case scenario is that politicians take a page from this recent history. The plan could have the following components:

- As a “down payment” on deficit reduction, allow the payroll tax cut to expire — it is a relatively ineffective stimulus program with a small “multiplier” effect — but postpone all other austerity plans.

- Extend unemployment benefits, but with a trigger that phases out the program if the unemployment rate falls below 7%.

- Phase in the cuts in discretionary spending over several years, rather than imposing them immediately.

- Postpone the decision on the Bush tax cuts and form two commissions to develop comprehensive tax and entitlement reform.

These commissions would be responsible for coming up with reforms that meet rigorous goals for deficit reduction. For tax reform, that means a combination of base broadening and perhaps (small) rate cuts that, on net, raises revenues. For entitlement reform, that means a plan that sharply slows the growth in outlays. Presumably this would require some kind of quantity or price rationing of health care. The plans would also need to be scored by the CBO and preferably presented as an up or down vote.

One can easily quibble with the details, but in our view such a plan combines several necessary ingredients. First, it involves reasonable political compromise — serious deficit reduction is very difficult if major parts of the budget are off-limits. Second, it phases in fiscal austerity in a way that is credible in terms of debt sustainability, but does not shock the economy. Third, it shifts the two most contentious issues — income taxes and entitlements — to commissions that can do significant bipartisan work out of the limelight.

In our view, such a budget plan would have a very small negative impact on near-term growth, allowing the post-crisis economic healing process to continue. It would also likely boost confidence in the outlook for both the economy and debt sustainability, sparking a rally in the stock market.

Can we side step the cliff?

So much for the ideal outcome; what is likely in practice? Implicit in the consensus forecast is a fairly benign outcome at the end of the year: more like tripping over a curb than falling off a cliff. Here we consider three scenarios which would minimize the shock to growth early next year.

What doesn’t kill you makes you stronger?

Perhaps the most optimistic view of the fiscal cliff is that it is so dangerous it will prompt an effective policy response, similar to what we outlined above. For example, the Committee for a Responsible Federal Budget argues that there is a middle course between a “mountain of debt” and the “fiscal cliff.” They refer to it as a “potentially action-forcing moment” that could bring about a third option: replace current policies with “a gradual and thoughtful plan to stabilize and then reduce the debt.”

The problem with this scenario is that, when faced with smaller fiscal cliffs, policymakers have consistently chosen paths that have not resolved the issues. Faced
with the end of the Bush tax cuts, rather than reach a compromise such as working on tax reform they put in the first building block for the fiscal cliff, extending the cuts to right after the election. Faced with the expiring payroll tax cut and unemployment benefits, they added another building block to the cliff. During the debt ceiling debate last summer a popular view was that the prospect of default would force a long-term solution. Instead, we got another building block for the fiscal cliff: huge, delayed spending cuts. Moreover, the Super Committee was supposed to find program-by-program spending cuts given the unpalatable alternative of across-the-board cuts. Sure enough, after endless negotiations, they failed to reach an agreement, adding further to the cliff.

Another problem with the “comprehensive plan” scenario is that the hoped-for solutions are almost impossible to do in a short period of time. Both tax and entitlement reforms are part of most comprehensive budget plans. However, both require strong bipartisan support, a long period of tough negotiation, and an education of the public about the true tough choices. In theory, both parties have agreed that such reforms are needed. In practice, neither has fully explained the tough choices involved.

For example, the recent “Ryan budget” calls for comprehensive tax reform. It offers precise detail on tax rates, which will be cut to two brackets of 10% and 25%. But it offers no details on how the lost revenue will be made up by closing unspecified tax loopholes. The problem is that the loopholes that are big enough to matter are very popular. They include the deductibility of state and local taxes, mortgage interest and charity. Perhaps the politically easiest loophole to close would be to tax carried interest as income. That would generate only $2 bn in annual revenue. There is a similar problem for liberal Democrats who argue that the government should not touch Medicare even though the program is on an unsustainable long-run path.

**Back-filling the cliff**
Another optimistic scenario is that we may drive over the cliff temporarily, but then the new Congress and administration will retroactively restore tax cuts and increase spending to reduce the shock of hurdling over the cliff. This scenario might may be seen as having the best chance of occurring if one party were to sweep all three contests — securing majorities in the House and Senate while capturing the White House — and then decide to wait until after the inauguration to implement their program.

We see several problems with this scenario. Most important, neither party is likely to have a filibuster-proof majority in the Senate. As a result, the minority party will still be able to block or at least slow down legislation in 2013. That means that some compromises will have to be made — regardless of which party wins the election. The other problem is that the uncertainty shock would be extended for another few months. As we show below, this could be very damaging to the economy, regardless of what they finally decide.

**Kicking one very big can**
A third “favorable” outcome is that after extensive negotiations, the two parties could agree to defer all decisions for another 6 or 12 months. If the alternative is for everything to expire at once, this could be the approach party leaders settle on. Indeed, in a recent op-ed piece Alan Blinder argued that two outcomes are possible: “(a) find a solution to the long-running fiscal battle or (b) kick the can down the road again.” He concludes: “Bet on (b).”
Sounds plausible at first sight — isn’t kicking various cans what got us here in the first place? However, past kicks involved postponing decisions so that hard-fought and strongly-felt philosophical positions wouldn’t have to be compromised. The very large kick needed this time around would entail the opposite.

Specifically, we are skeptical that fiscal conservatives would agree to kick everything down the road, with no down payment on deficit reduction. The recent House budget included $20 bn more in cuts than under the debt ceiling agreement. Members of the Republican Study Committee are arguing for an additional $116 bn in cuts for the 2013 budget. And recently Representative Boehner promised that his caucus would use the looming debt ceiling as a lever for extracting further spending cuts. In other words, this capitulation on spending cuts would require fiscal conservatives to give up on the original debt ceiling agreement, give up on their requests for bigger cuts in the 2013 budget, and ignore the new debt ceiling. Similarly, after running on the platform that higher-income earners need to pay a higher share of taxes, would President Obama suddenly back off and agree to extend all of the Bush tax cuts? We find this outcome rather unlikely.

Of course, deferring all these policies simply creates a new set of headaches. It will only postpone the day of reckoning — and builds up greater interest expenses in the process. It would also kick the can right into the lap of S&P and Moody’s. The US government credit rating would likely be downgraded since there would be no actual or credibly planned austerity. And it would set the two parties up for one big battle after another: each stage of budget negotiations: annual budgets, appropriations, continuing resolutions and debt ceiling increases would all spark a battle. Thus, it is difficult to imagine more than a short kick — of 2 or 3 months — to buy time for further negotiation.

**What will they do?**

The parties are far apart on many issues. The rhetorical split will likely grow much wider during the election. It is hard to get agreement on any one item, let alone the whole cliff. Let’s take a close look at each decision.

**Mini cliffs**

It is useful to divide the cliff into three components: “mini cliffs,” “under the radar screen” and “core points of contention.” The “mini cliffs” are items that have been regularly fixed each year either at the last second or retroactively (Table 4). They exist because they make the 10-year deficit look lower than it really is. They include:

- The Alternative Minimum Tax (AMT): The AMT is supposed to ensure that taxpayers don’t make overly aggressive use of deductions. However, the tax thresholds are not indexed for inflation and for some time now a one-year “patch” has been applied to avoid a sharp increase in taxes for many middle-income earners.

- Tax extenders: A series of 50 or so tax breaks that are also “patched” every year.

- Doc fix: Under current law, doctors who treat Medicare patients will face a 27% cut in fees unless the fee schedule is adjusted.

Based on past history, this $160bn shock will be kicked down the road for another year. Nonetheless, these items matter mainly because they will have to be added
in to whatever other agreements are made, making fiscal hawks more resistant to extending other items.

**Under the radar screen**

At the other extreme, three items have been largely forgotten in the discussion and are very likely to lapse (Table 5). The first part of the debt ceiling agreement included $20 bn in spending cuts in 2012 and $40 bn in 2013. These cuts have already started to kick in and have been forgotten as the debate focuses on the bigger $110 bn "sequester" following the failure of the Super Committee. Second, the $10 bn in accelerated business expensing seems to also fall under the radar screen. And third, about $40 bn in spending remaining from previous stimulus packages is expiring. That's $90 bn in cuts that will likely happen without a fight.

**Core points of contention**

This leaves us with the bulk of the cliff — $470 bn in partisan-charged spending cuts and tax increases (Table 6). Let's take a close look at the prospects for each. As will become clear, for each of these items politicians have made campaign promises that suggest little room for compromise. Hence the outcome may come down to which political group ultimately concedes more ground.

As we go through the items, keep in mind the four major impediments to decision making: (1) the current Congress and President will have to make the initial decisions during the lame duck session, (2) the US will likely hit the debt ceiling again during the course of the debate, underscoring the need for deficit cuts and emboldening deficit hawks, (3) a bipartisan agreement will have to be forged right after a contentious election, and (4) even if one party sweeps it is unlikely that they will have a 60-vote filibuster-proof majority in the Senate.

**The payroll tax cut and extended unemployment benefits.** Under most scenarios we would expect both of these programs to expire. It took two months and the pressure of an election year to get both extended for one year. With the election over we would expect both of these temporary programs to expire. That's a total of about $150 bn in fiscal drag.

**The tax cuts formerly known as Bush.** While Republicans have not wavered from their position that all cuts should be extended, President Obama seems to have softened his position, limiting the tax increase to just the top 1% of earners through some kind of Buffet rule. However, the rhetoric around these views is getting more heated over time. This disagreement is likely to be at the center of the election campaign, making very hard to find a compromise after the election. We expect between zero and $40 bn in austerity.

**Obama Care Taxes.** Republicans are looking to repeal Obama Care, including the taxes used to fund it. However, this was arguably the signature legislation of Obama's first term. Hence he is unlikely to cancel either the plan or its funding. If Obama wins re-election we would expect the taxes to go through as planned. If he loses then after the lame duck session is over, Republicans will likely try to cancel the program, but could face a big fight from Senate Democrats. If and until Obama Care is rescinded, that's about $22 bn in austerity.

**Spending cuts under the debt ceiling agreement** As we noted above, the first tranche of the debt ceiling agreement is likely to go through nearly unnoticed. For the second tranche, an intense battle is likely. Many liberals want to reverse many of the cuts, particularly for domestic programs. By contrast, many conservatives want the opposite: fewer defense cuts and greater nondefense cuts.
The fight within the Republican Party could be even more dramatic. Last summer, many fiscal conservatives argued for no rise in the debt ceiling at all. They agreed to the debt ceiling increase only under severe pressure from the markets and party leaders and they view the agreed cuts as the minimum acceptable under duress. Ultimately, we expect fiscal conservatives to compromise, reducing the discretionary spending cuts to about $50 to $75 bn.

Clearly getting agreement on all of these items before hitting the cliff will likely be difficult. Table 7 shows three scenarios depending on the election outcome. Our baseline scenario is that there will be a sequence of partial agreements and delays. At the end of December, we expect the mini-cliffs to be extended, payroll and unemployment benefits to expire and the “under the radar screen” programs to expire. That’s a total tightening of $250 bn. We expect a compromise on both the Bush tax cuts and the debt ceiling cuts to occur after several delayed deadlines and bouts of brinkmanship. Note that while the exact composition of cuts differs across scenarios, the total amount is roughly the same — as is the need for compromise.

### Multipliers amid the division

Measuring the economic impact of tax increases and spending cuts requires estimates of the fiscal “multipliers.” Table 8 lists a range of estimated multipliers for several fiscal policies, as collected by the CBO. After reviewing the literature, our own assumption is that the government spending multiplier is slightly greater than one, while the tax multiplier is slightly less than one. To a first approximation, an aggregate fiscal multiplier is roughly one, although in a depressed economy there are good reasons to suspect that the multipliers are higher.

Keep in mind that a multiplier has two stages: the first-round impact, and then its ripple through the economy. For example, government spending reductions would directly reduce current GDP dollar-for-dollar. Since that results in less income for government contractors or employees, they would likely cut back on a portion of their spending as well. This second-round effect likely would be smaller than the initial decline in spending, but would itself spawn third-round effects, and so on. The cumulative impact is what economists mean by the multiplier.

Tax multipliers work in a similar way, although the first-round impact of a dollar increase in taxes is typically seen as less than a dollar reduction in consumption; the rest would be felt as a reduction in savings. Second-round and beyond effects would again ripple thought the economy, but most economists find that tax multipliers are not as large as spending multipliers.

Sorting through the literature, there are a few key findings about multipliers that are relevant for our results:

- Table 8 lists short-run multipliers, which are typically larger than long-run multipliers. While the latter may be close to zero, many of the former are estimated to be larger than one. These short-run multipliers are most relevant to determining the 2013 economic impact of the fiscal cliff.

- Permanent policy changes tend to have larger multipliers than transitory ones. For example, a temporary tax cut should not change one’s expected lifetime earnings very much, and so should have a limited impact on the behavior of forward-looking consumers. Ending such a tax cut therefore should have relatively small effects on spending and growth.
Multipliers tend to be larger for consumers who are unable to smooth their behavior over time. Transfer payments to those who are income- or credit-constrained, such as the unemployed, typically have high estimated multipliers.

Similarly, there is a growing body of research that suggests that tax and spending multipliers are larger when the economy is in recession or below potential growth than when it is booming or above potential. Chart 10 shows estimates from a recent IMF study of G7 economies. Note that when the economy is operating below potential, spending shocks have relatively large multipliers — in the range of 1.2 to 1.4. As noted above, the tax multipliers are smaller but still are significant with negative output gaps; they are effectively zero with a positive output gap.

Recent research also notes that when interest rates are stuck at very low values, and are likely to stay there for a time, the “crowding-out” effect of higher interest rates is not active, and multipliers tend to be larger. Indeed, some economists have argued that when the economy is in a liquidity trap, fiscal policy can have a “crowding-in” effect that boosts aggregate demand.

While we don’t want to overplay this last effect, the literature does point to higher than average multipliers in the current below-potential and low interest rate environment. Thus, we see our assumption of an aggregate multiplier for the fiscal cliff of around one as a conservative estimate, and it may be a lower bound.

**Economic impacts**

We assume that in the absence of the fiscal shock, growth would average about 3%. Relative to this baseline, we assume the fiscal shock cuts GDP by about 2% over four quarters. As we explain below, we assume the slowdown starts before the cliff as businesses and households anticipate the shock. This places us at the very bottom of the consensus forecasts according to the May Blue Chip Consensus report: our forecast of 1.4% growth in 2013 is well below the average of 2.5%, and noticeably less than the next lowest, at 1.7%.

Our forecast assumes an otherwise benign backdrop: Europe remains in crisis, but there is no “meltdown” and there is no major disruption to oil supplies. Hence, in our view, the risks to our below-consensus forecast are to the downside. Specifically, we see a roughly one-in-three chance of a recession starting in the four quarters surrounding the cliff.

**Acrophobia**

A key part of our forecast is that both the actual austerity and fear of the fiscal cliff weaken the economy. A “fiscal fog” or thick layer of uncertainty precedes the end-of-year cliff. This uncertainty shock is virtually absent from the current discussion about the fiscal cliff. A notable exception is Marty Feldstein, a Harvard economist and former CEA chair under Reagan. In a recent op-ed he argued that, “the risk of dramatic tax increases and an economic downturn next year affects the behavior of businesses and households today,” causing reluctance to invest in capital or buy big ticket items. We agree that the risk of the cliff itself should start to restrain growth as it moves from the opinion and business pages to become front page news by the summer.

This uncertainty has both a micro and a macro dimension. At the micro level, all the changes in taxes and spending make rational spending decisions very difficult. At the macro level, in a worst-case scenario the cliff could cause a
recession. All of this is on top of the usual pre-election uncertainty about future regulatory and fiscal policy. Businesses and individuals are left to wonder what the tax code, or regulatory environment, or spending priorities of the government will look like.

If this were not an election year, politicians would likely react to the rising concerns with visible negotiation efforts. However, in an election year, the uncertainty is likely to increase over time. As the campaign gathers intensity, compromise should become less likely rather than more likely. Moreover, as noted above, even the election is unlikely to remove much of this uncertainty. Partisanship during the lame duck session may well persist into the 113th Congress, leaving the nature and timing of any agreement unclear.

When in doubt, do nothing

The cliff is a dramatic “natural experiment” on the impact of policy uncertainty on the economy. Never before have politicians threatened cuts that come close to the size of the cliff. Moreover, the election makes it nearly impossible to signal to the public what, if anything, is going to be done about the cliff. Not only does the election preclude bipartisan negotiation, but it is likely to encourage the idea that the two will never agree on anything. These indirect effects of uncertainty on confidence and activity also are powerful — even if much of the cliff is ultimately avoided.

The fiscal cliff makes the stakes around this election—in terms of winners and losers—much bigger than normal:

- For upper-income taxpayers, are major tax increases coming or am I about to get a major tax break as specified under, say, the House budget proposed by Rep. Paul Ryan? How should I plan my taxes and estate?
- For the typical payroll employee, should I expect my $1000 or so payroll tax cut to disappear?
- If I am a long-term unemployed worker, are my benefits going to end?
- As a defense contractor, should I be preparing for big cuts — and if so, will it be in my areas?
- If I am a Federal employee, what cuts in pay, benefits or jobs are likely?
- If I am a local government, which Federal transfers are disappearing and hence which programs will be scraped or supported with additional local taxes? If I’m a beneficiary of those programs, will I lose my benefits?
- As a doctor providing services to Medicare patients, will I face a 27% cut in payments?

And for everyone, there is the macro risk: how will others behave, and hence the overall economy perform, in the face of first the uncertainty shock and then the actual austerity shock?

While it has been largely ignored by the business press, there is a large and rapidly growing academic literature on the impact of uncertainty on the economy. The seminal work was written by none other than Ben Bernanke back in 1983. In his piece, “Irreversibility, Uncertainty and Cyclical Investment,” Bernanke argues that if an investment is difficult to reverse and if the investor expects to get new
information on its profitability, they will delay the investment to gather more
information. “The more disparate are the probable information outcomes, the
more likely it is the investor will defer commitment,” he wrote. The cliff fits very
well into this literature: it is a potentially major shock, it is highly uncertain, and it
occurs at a specific point in time so the cost of delay — waiting 6 months or so —
is low.

The academic research focuses mainly on business spending. Firms are likely to
alter behavior before households, but the cliff should impact all hard-to-reverse
decisions. Home purchases are very hard to reverse due to high transactions
costs and the trauma of moving. On a similar vein, a new car loses about 20% of
its value the day it drives off the lot. Hence we expect capital spending and hiring
to start slowing in the summer and consumer spending on durable items like cars
and homes to start weakening in the fall. The timing of the slowdown depends
heavily on press and other coverage of the story.

The tougher question is gauging the magnitude of the slowdown. Perhaps the
most relevant research is from Nick Bloom of Stanford, who has constructed a
measure of policy-related economic uncertainty. It has three parts: (1) an index of
newspaper references to policy uncertainty, (2) a measure of expiring
components of the tax code, and (3) a measure of forecast disagreement among
economists on fiscal policy and inflation. Chart 11 shows the index updated
through April along with key events that have helped trigger spikes in the index.
We have been using this index and earlier incarnations since 2008. Consistent
with the commentary in the press, uncertainty has been about twice as high as
normal since 2008. There are also been notable spikes in the index, including
around last year’s debt ceiling debate.

Bloom plugs his policy uncertainty index into standard “VAR” models to test its
impact on the macro economy. Looking at the 2006 to 2011 period, he estimates
the peak shock to real GDP was 3.2%, to investment 16%, and to employment
2.3 million. Last summer, when the debt ceiling debate was in full “bloom,” he
argued, and we concurred, that the confidence shock was hurting growth but
would only trigger a recession if prolonged. In other words, policy uncertainty has
already had a big negative impact on the economy.

Another approach is to look at specific episodes in history where a risky event
loomed. There is no precedent for what is happening in Washington now, but we
believe the uncertainty in the run-up to the war in Iraq is a good recent example of
an uncertainty shock. At that time, the risk was that the war would trigger either a
terrorist attack (9/11 and its economic aftermath was still a vivid memory) or an oil
price spike. As the perceived probability of the war surged, the economy went into
wait-and-see mode. Payrolls fell for three months in a row as hiring slowed and
the usual attrition lowered employment, and the stock market weakened (Chart
12).

As we see it, the uncertainty ahead of the fiscal cliff will reduce growth by around
2 percentage points annualized in the second half of this year. However, the
range of potential outcomes is quite wide — anything from about 1 to more than
3 percentage points of drag seems plausible — and the probability distribution is
relative flat, meaning the chances that any one of these outcomes happens is
about as likely as any other from where we sit today.

The cliff also increases the risk of a recession. We would not be surprised to see
payroll employment and capital goods orders to dip in front of the election. If the
uncertainty shock is extended into the New Year, that weakness could continue. We would be particularly concerned if the acute phase of the European and US debt crises overlap. Overall, we see about a one-in-three chance of recession in the 12-month period surrounding the cliff.

**What could the Fed do?**
Fed officials appear to be well aware of the dangers of the cliff. The baseline forecasts of FOMC members are relatively optimistic, but Bernanke was the first major public figure to point out the dangers of a “massive fiscal cliff,” and more recently a number of his committee members have been talking about the risks of the cliff. Unfortunately, the Fed can’t solve the problems created by the rest of Washington. A recent study from the San Francisco Fed found that successive rounds of unconventional policy have had smaller market impacts. Moreover, monetary policy is poorly equipped to address the confidence shock of the cliff. We think additional Quantitative Easing (QE) will provide only a partial offset to the negative confidence, market and economic impact of the cliff.

As with QE2 and Operation Twist, we expect the Fed to wait to see significant signs of weakness — particularly in the job market — before adopt QE3. Since they are sensitive to the dangers of the cliff, we would expect the Fed to be a bit quicker on the QE trigger this time. Our baseline forecast assumes that by August or September they announce about $800 bn in Treasury and MBS purchases, carrying them through the following summer.

Some commentators argue that the Fed will extend Operation Twist, but we think this is very unlikely unless combined with a bigger QE program. By the end of Twist the Fed will have only a $175 bn or so of short term debt available to sell (they will want to retain some liquidity) and extending unconventional policy by a couple months doesn’t do much for an economic shock that will be building into year-end. On a similar vein, we do not expect the Fed to “sterilize” its QE by doing reverse repos. Such a policy could push up short-term borrowing costs, undercutting the effectiveness of QE. Plus, Fed officials expect to undershoot their long-run inflation target, which undermines the rationale for sterilization.

**What have the markets priced in?**
A common question from investors is whether the cliff is already priced into the markets. After all, the cliff story has gotten plenty of attention in the business press for the last month. And the risk premium in the equity markets is quite high, suggesting some bad news is discounted. In our view, there is strong circumstantial evidence that the market does not understand the full dimensions of the cliff and therefore most of the risk is not yet priced in.

While many economists talk about the cliff, very few have incorporated it into their forecast. Of the all the economists in the latest Bloomberg and Blue Chip surveys, we are the only ones who forecast a sharp slowdown in growth leading into the cliff. Indeed, despite all the talk about the cliff, in the latest Bloomberg survey the consensus forecast for this year and next rose by a tenth. As we noted above, the Fed expects solid growth this year and next. Even in the CBO baseline, which by the rules must assume no legislative change, the economy weakens sharply next year, but the prospect of going over the cliff has a small 0.5 pp dent on growth this year. In sum, the cliff remains very much of a “tail risk.”
One way to gauge the impact of the cliff on the stock market is to look at what news has driven the market since Bernanke first spoke of a “a massive fiscal cliff” in testimony on February 29th. Table 9 shows moves of more than one percentage point in the S&P 500 since Bernanke spoke and the Bloomberg market wrap that day. The cliff fails to show up in this commentary. Indeed the market only fell 0.5% on the day Bernanke first mentioned the cliff and the Bloomberg market wrap that day noted his downbeat assessment of growth, rather than cliff concerns. The cliff doesn’t seem to be casting a shadow on economic forecasts or the market — so far.

Conclusion
We first put the year-end uncertainty shock into our forecast last fall (we have made only minor tweaks to our quarterly GDP pattern since then). So far the story is developing as expected. The Cliff was largely ignored until recently, as economists focused on Europe and the political press focused on the Republican primary. Then as Mitt Romney started to clinch the Republican nomination, the press started to look out to the election and the looming cliff. This is why the story has finally caught momentum.

The interesting thing about the uncertainty shock is that it only matters if and when people see a problem coming. We expect the markets to react as the importance of the cliff — in terms of size, timing, intractability and economic impact — becomes clear. We are watching how quickly the cliff moves out of the business pages and into the front page. We are monitoring the consensus to see when the cliff moves out of the alternative risk scenarios and starts to impact the baseline. And we will be watching for anecdotal evidence of the cliff starting to first impact business planning and then household spending decisions.

Specifically, we are monitoring corporate news, feedback from our equity analysts, the Fed’s Beige Book, and other early indicators.

Since we are expecting a slowdown in growth, not a recession, we expect the evidence to accumulate slowly over the summer. However, the timing of the uncertainty shock is itself quite uncertain. On the one hand, people may largely ignore the cliff until the election is looming. On the other hand, if the cliff moves onto the front page of the paper and if politicians appear oblivious to the risk, a quicker pricing in is possible.

In forecasting it is always important to stress test your view and ask what would prove you wrong. We will be watching for several things. First, is the momentum in the economy stronger than we assume? We assume the cliff slows growth from an underlying trend of 2.5% to just 1%, but what if the underlying trend is say 4%? Second, the shock to confidence could come later than we expect, perhaps only hurting growth in Q4, rather than starting in Q3. Third, weakness in the economy and markets could prompt some response from Washington before the election — some indication that the leaders recognize that ultimately they do need to compromise. Hope for the best, plan for the worst.

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**Table 9: Lots of Europe, no cliff**

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Source: BofA Merrill Lynch Global Research, Bloomberg
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