OBSERVATION

TD Economics

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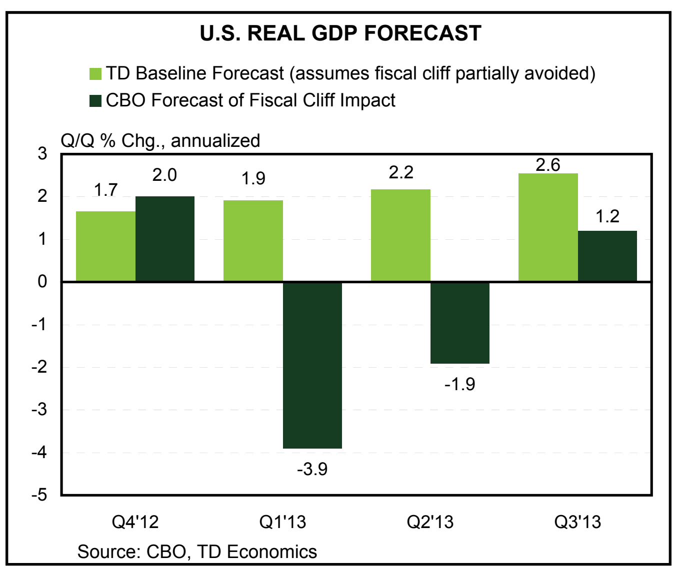
FISCAL IMPACTS UNDER NEW CONGRESS ARE NOT AN OPEN AND SHUT CASE

Now that we know who the President is for the next four years, will the fiscal cliff be avoided in 2013 and the economy spared? While the President shepherds the discussion, Congress ultimately decides the path of fiscal consolidation and the ability to reach agreement is crucial to this outcome. If everything that is legislated to expire in the New Year actually took place, many private sector forecasters and the Congressional Budget Office estimate the drag to real GDP growth next year would be in the 3-4 percentage point range. There is little debate among politicians and economists that this would return the U.S. economy to recession. So, even with a majority Republican House, a Democrat Senate and a Democrat President, the prospects of a recession should prove distasteful to all and act as a catalyst towards compromise among rational individuals. However, we remain cautious that while we view the odds of running off the cliff and remaining in complete free fall to be relatively low (at 10% or less), there are several other possibilities that could play out. One of these is a technical breach of the cliff for several weeks into the New Year until a resolution is found under the new Congress. Another, and perhaps more probable scenario, is to kick the can down the road, temporarily extending deadlines to allow for more extensive discussions within the new Congress. Of these, clearly the first carries more risk at undermining investor confidence and resulting in an economic backlash. However, the intent of this report is not to speculate on political outcomes, but rather to discuss the persistence of economic uncertainties, *regardless* of the political outcome that ultimately plays out.

Before the election results were known, we had estimated the following two economic impacts for 2013 if either of the presidential candidates were able to enact their preferred policy path. If it had been a Romney Presidency, Congress would likely haved ushered in a consolidation plan that would have lowered real GDP growth by 1.3 percentage points next year. If Obama had full scope to enact his preferred policies, we estimate a slightly larger, but not materially different, economic drag of 1.5 percentage points. The base of our assumptions is that larger consolidation through government revenue increases (i.e. tax measures) under Obama's initiatives would detract roughly 0.9 percentage points from real GDP growth in 2013, versus 0.5 percentage points under a Republican proposal. However, heftier spending consolidation under the latter would take a 0.8 percentage point toll. The divided Congress will ensure some mix of policies between these two platforms over the months ahead, which will be necessary to avoid nose diving off the fiscal cliff.



It may be surprising to some that Obama's more numerous tax increase proposals – heath care, high income earners, dividends, capital gains – results in only an additional 0.4 percentage point GDP drag relative to Romney. The reason is twofold. First, the majority of Obama's tax measures hit higher income households

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FIRST-YEAR FISCAL MULTIPLIERS: SUMMARY OF EXISTING LITERATURE		
U.S. Government Spending Multipliers		
	VAR	DSGE
Mean	1.0	0.7
Median	0.9	0.7
Mode	0.6	0.0
Maximum	2.0	1.6
Minimum	0.4	0.0
U.S. Government Revenue Multipliers		
	VAR	DSGE
Mean	0.7	0.3
Median	0.7	0.2
Mode	0.7	0.2
Maximum	1.4	1.0
Minimum	-0.7	0.0
Source: IMF Fiscal Monitor April 2012		
Note: VAR and DSGE are econometric model types		

and historical analysis suggests that tax multipliers here are lower than those that impact the entire income spectrum and tax base. In other words, the economic drag from a tax hike on an individual earning $500,000 is less than that of one earning $50,000. The reasons are numerous, but a key factor is that consumption among high income earners tends to be less sensitive to changes in income than middle and low income earners. Second, mathematically, high income earners make up a smaller portion of the population. Thus, the biggest single economic drag from taxes next year comes from the expiration of the temporary two percentage point reduction in payroll taxes that affects all workers and tops out at $110,000 in labor income.

For the purpose of this analysis, we have assumed that this tax rate will rise, but it is definitely a likely candidate for the horse trading that will occur between Republicans and Democrats in the race to find a compromise to avoid running off the fiscal cliff at year-end. The Wall Street Journal recently reported that an Obama White House may be open to the possibility of new middle-class tax breaks to replace the payroll tax cut. Republicans may find this agreeable. However, this speaks to the larger issue at hand that is worth repeating – it remains to be seen what the ultimate mix of policies will be for 2013. As much as the President can put forward a wish-list, he will be working within the confines of a divided Congress.

And, once the policy mix is known, a different type of uncertainty is ushered in from an economic perspective. The economics community is highly divided on precise estimations of fiscal and tax multipliers. [1] There is plenty of research to inform us on both, but not a consensus on exact estimations. For instance, as noted in the April IMF Fiscal Monitor [2], the median first-year fiscal multiplier for spending measures is 0.9 versus 0.5 for revenue measures (i.e. taxes). However, multipliers will vary depending on the model used for estimation and where we are in the business cycle. In regards to the latter, by varying the time period under analysis, multipliers can become magnified when significant economic slack exists (as is the case today) in comparison to periods of stronger expansions. Thus, depending on the chosen period and analytical approach, the many credible research papers in this area result in a wide range of spending multipliers from 0 to 2.0. This basically means government cuts can have a negligible or substantial impact on the real economy. Not very helpful. The range is also wide for revenue-based measures.

The IMF does note that in spite of standard multipliers, there is research that supports a lower impact to real output from expenditure-based policies over revenue-based approaches during periods of consolidation. However, this may be because central banks have shown a tendency to ease monetary policy to a greater extent in response to government expenditure cuts versus tax hikes. There's less scope to do so today in a zero-policy environment.

Thus, as economists, we must humble ourselves to the notion that real economic impacts from changes in fiscal policy are not fully understood and carry a heavy dose of uncertainty. Caution is warranted in being too single minded. Fiscal consolidation in the U.S. is absolutely necessary and unavoidable, but the dispersion of forecasts among students of fiscal policy argue strongly in favor of a go-slow approach. Europe serves as a cautionary tale, where there is now a growing consensus for this tactic after having been victim to strong negative feedback loops from heavy handed approaches. Thus, the first order is to avoid the fiscal cliff, which presents its own challenges in navigating the new political landscape. But, the second order is to evaluate the economic impact of the policies that will ultimately be put in its place. This too comes with a heavy dose of uncertainty, which will surely preoccupy economists for years to come.

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Endnotes

1. Fiscal and tax multipliers: The ratio of the change in real economic activity to a change in government spending and tax measures
2. Fiscal Monitor: Balancing Fiscal Policy Risks, International Monetary Fund, April 2012