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# SPECIAL REPORT

## TD Economics



July 31, 2012

# SEARCHING FOR A DETOUR AROUND THE FISCAL CLIFF

### Highlights

- Fiscal policy is one of the largest downside risks to the U.S. economy over the next year. Unless Congress acts to stop it, a mix of spending cuts and tax increases worth 5.1% of GDP will take place at the beginning of 2013.
- The bulk of the fiscal cliff is likely to be avoided. Even if Congress remains gridlocked after the election in November, there is enough common ground between the two political parties to avoid significant tax increases and punitive spending cuts in a weak economy.
- Some fiscal consolidation is unavoidable. We expect fiscal drag to shave 1.5 percentage points from growth in 2013, a significant speed bump to economic growth just as it is expected to show signs of acceleration.
- Unfortunately, this amount of fiscal consolidation will not be enough to put the budget deficit on a sustainable trajectory. Further attempts to bring spending and revenues closer together will continue to be a factor for the economic outlook for years to come.

There are no shortages of downside risks to the U.S. economic outlook. So, it is especially unfortunate that one of the largest risks is self-imposed. Unless Congress acts to stop it, the U.S. economy faces a mix of tax increases and spending cuts worth 5.1% of GDP in calendar year 2013. The so-called fiscal cliff is the culmination of a number of past decisions to extend temporary tax measures, as well as the imposition of automatic spending cuts triggered by the failure of the Joint Select Committee on deficit reduction.

The full weight of the fiscal cliff would be devastating to an economy struggling to grow by 2.0%. However, a large portion of the fiscal cliff should be avoided. The majority of the cliff is made up of increases in taxes that have been extended several times by past sessions of Congress. One of the larger elements – the Alternative Minimum Tax (AMT) exemption – has been patched every year since 2001. The other big ticket item – the Bush-era tax rates – is an area of relative common ground between the two parties in Washington. Neither party wants to see rates go up on income below \$250,000. Without these tax increases, the fiscal cliff is significantly smaller.

While Washington is hopelessly gridlocked and is likely to remain so even after the election in November, an eventual compromise on reducing the total potential fiscal drag is the most likely scenario. In the best case scenario this happens relatively early, but even in the worst case scenario, in which the tax hikes and spending cuts kick in, some of these will be reversed in the months following.

Our base case assumption is that the majority of the Bush tax cuts are eventually extended, but that the payroll tax rate rises and other cuts replace at least some of the automatic spending cuts in 2013. Under these assumptions, fiscal contraction will slow real GDP growth by 1.5 percentage points, lead-

2013 Budgetary Impact of Current Law		
	Calendar Year	
	\$ Billions	% of GDP
<b>Taxes</b>		
Bush-era tax rates	185	1.2
<250 income	135	0.9
250K+ Income	50	0.3
Payroll tax	125	0.8
Alternative Minimum Tax (AMT)	115	0.8
Health care taxes	20	0.1
Other expiring taxes	85	0.6
<b>Total taxes</b>	<b>535</b>	<b>3.5</b>
<b>Spending</b>		
Sequestration	85	0.6
Extended unemployment benefits	35	0.2
Medicare physician payment rates	10	0.1
<b>Total spending</b>	<b>130</b>	<b>0.9</b>
<b>Total specified</b>	<b>665</b>	<b>4.4</b>
<b>Other spending + revenues</b>	<b>105</b>	<b>0.7</b>
<b>Total change in deficit</b>	<b>770</b>	<b>5.1</b>

Source: CBO, Committee for a Responsible Budget, TD Economics

ing to a continued modest pace of economic expansion of around 2.0%.

### How big is the fiscal cliff?

There are a number of estimates of the size of the fiscal cliff, with most ranging between 3.0% and 5.0% of GDP. The range of estimates is due to different assumptions about what is included in the fiscal cliff as well as different estimates about the impact of the tax increases and spending cuts on the economy.

We take our estimate for the total potential size of the fiscal cliff from the Congressional Budget Office (CBO). The CBO estimates that on a fiscal year basis, current legislation will lead to a fiscal contraction of 4.0% of GDP in 2013. However, because the U.S. fiscal year runs from October through September and much of the legislation was written to expire at the end of December, the impact is smaller on a fiscal year than it is on a calendar year. Grossing up for the calendar year effect, the CBO estimates a total fiscal contraction of 5.1% of GDP in calendar 2013<sup>1</sup>.

### Tax hikes make up the bulk of the cliff

As shown in the table above, the biggest single item contained in the fiscal cliff is the expiry of the Bush-era tax cuts.<sup>2</sup> These tax cuts were passed in 2001 and 2003, with a sunset clause that would have had them expire in 2010.

Before they expired, however, the tax rates – alongside other temporary tax measures brought in with the American Recovery & Reinvestment Act of 2009 – were extended to the end of 2012.

The Bush tax cuts resulted in a number of changes to the tax code. The biggest was to lower marginal tax rates across income levels. The legislation also lowered tax rates on capital gains and dividends, reduced the marriage penalty, and increased the earned income tax credit and child and college tax credits. In total, the expiry of all of these changes is estimated to cost American taxpayers around \$185 billion in 2013.

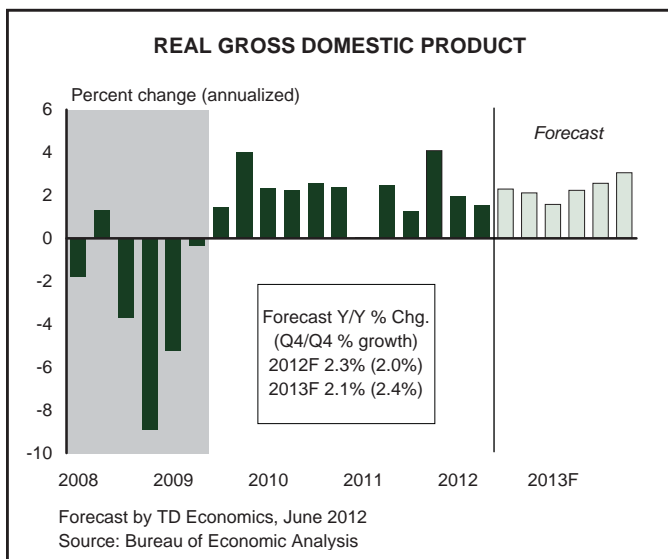
The second biggest item in terms of taxes is the 2-percentage hike in the payroll tax rate on employees. The Social Security withholding tax rate was reduced to 4.2% in January 2011 and after a one year extension is scheduled to return to 6.2% at the end of this year. This is estimated to cost \$125 billion over the full calendar year.

Following closely behind the payroll tax is the Alternative Minimum Tax (AMT) exemption. A brief explanation of the AMT is contained in the textbox below. The key message is that if the AMT exemption is not raised, it will result in more than 20 million more people paying higher income taxes than currently at an estimated total cost of around \$110 billion in 2013.

Other increases in taxes reflect the expiry of number of relatively small tax measures and the imposition of new taxes on high income earners included in the healthcare reform act. Together these will add \$85 billion to the total tax bill in 2013. All told, expiring policy provisions will result in a total tax increase of \$535 billion in calendar 2013, equivalent to 3.5% of GDP.

#### The Alternative Minimum Tax

The AMT is a tax that runs parallel to the regular income tax, but has fewer exemptions and deductions. Taxpayers must calculate how much tax they owe under the regular income tax and under the AMT. If their total tax liability is greater than the AMT exemption amount, they must pay the difference as the AMT. The problem with the AMT is that its exemption was not indexed for inflation. So, every year a greater number of taxpayers' see their nominal income rise above the AMT exemption level and therefore must pay the AMT. Congress, however, has temporarily raised the exemption every year since 2001 in order to avoid more taxpayers falling into the AMT. If the exemption is not raised again, it is set to fall from \$48,450 to \$33,750 for individual filers and from \$72,450 to \$45,000 for joint filers.<sup>3</sup>



### The economic impact of tax hikes

Estimating the amount that tax revenues will rise over the next year under current law is not the same thing as estimating their economic impact. This depends on how taxpayers respond to the tax hikes. Taxes lower disposable income and, over time, reduce incentives to work, save and invest. However, in the short run, the economic impact of higher taxes depends on how much of this lost income results in lower spending and how much is offset with lower saving. This also depends on income levels and whether households see the tax hike as permanent or temporary. Given that savings rates are higher at higher income levels, the economic impact of a tax hike on the wealthy is likely to be smaller in the short term than one on lower income individuals.

Using historical data, the CBO estimates that for every \$1 in budgetary cost spent on permanently extending the Bush tax cuts, economic activity would rise by between \$0.1 and \$0.6 over the next two years. For the payroll tax cut, every \$1 in budgetary cost is estimated to generate a range of economic activity between \$0.1 and \$0.9. Finally, for every \$1 spent on the AMT patch, output would be raised by \$0.2 to \$0.9.<sup>4</sup> Taking the mid-points of the CBO's estimates and assuming that taxpayers react to income losses the same way as to income gains, implies that if the \$535 billion in added taxes takes place, this would cut economic growth by 2.0 percentage points over a two year period, with the majority of it occurring within the first year.<sup>5</sup>

In addition to the policy induced changes, the CBO estimates that other revenues and spending will cut the deficit by an additional \$105 billion. The CBO notes that

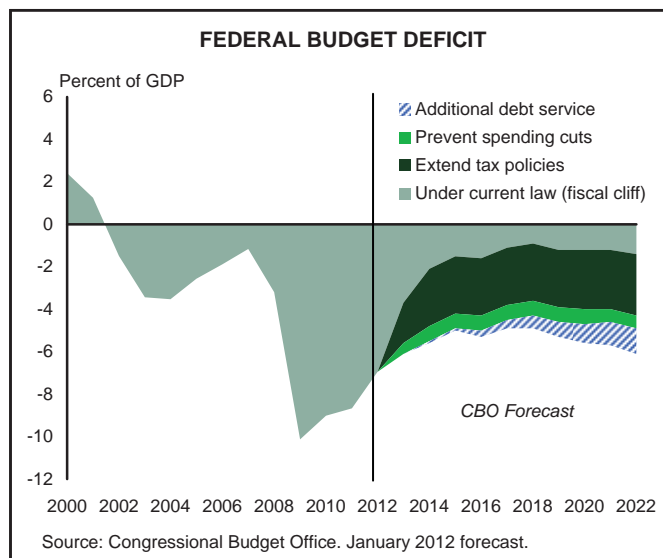
the majority of this represents increased revenues that would occur irrespective of policy changes. Given that these revenue increases occurs naturally, it is fair to assume that the economic impact would likely to be relatively small.

### Spending cuts less significant, but still costly

The other side of the fiscal cliff is cuts to government outlays. The biggest item here is the automatic enforcement procedures (also known as the sequester) contained in the Budget Control Act (BCA) that arose after the debt ceiling negotiations in 2011. The BCA sequester calls for spending reductions to be split evenly between defense and non-defense spending. However, on the non-defense side, the vast majority of mandatory spending is shielded from the sequester and cuts to Medicare providers are limited to 2% per year. This leaves the majority of the non-defense cuts to fall on non-defense discretionary spending.

Relative to their 2012 budgets, sequestration would reduce defense spending by 7.5% and non-defense discretionary spending by 8.5%.<sup>6</sup> However, because there are also areas within each of these that will escape cuts, the burden will be even greater on those areas that are not shielded. For example, within defense spending, the BCA allows the President to shield military personnel funding. The Bipartisan Policy Center estimates that once the parts of defense spending that are likely to avoid sequestration are taken out, the remainder would have to be cut by 15%.<sup>7</sup>

Achieving this magnitude of savings in such a short period of time is likely to be very difficult. Moreover, the economic impact of spending cuts in the near term is likely to be greater than the impact of tax hikes. First, since gov-



ernment spending on goods and services is counted directly as a part of GDP, every \$1 dollar cut in spending is likely to reduce GDP by relatively close to \$1. While not all of the money spent by government is to purchase goods and services, a significant portion of the parts under sequestration is. Of the parts that are not, the vast majority is made up of transfers to low-income individuals, who are the most likely to spend this money.

Second, in an economy that is operating well below potential and with interest rates at historically low levels, reductions in government spending are less likely to be offset by increases in private investment. Instead, it is more likely that the indirect effects of the reduction in government spending will lower private spending even further.

The CBO estimates that every \$1 in government spending generates between \$0.5 to \$2.5 in economic activity over the next several quarters. Taking the mid-range of these estimates and including the other spending cuts scheduled to take place in the calendar year; the total impact of a \$130 billion reduction in government spending is a hit to economic growth of 1.3 percentage points.

### Routes around the fiscal cliff

Now that we have laid out the geology of the fiscal cliff, all that is left is to figure out what part of it will actually take place and what Congress will decide to change. Easier said than done, but we'll give it a try.

#### Scenario 1: Avoiding the cliff altogether

In the best case scenario, Congress will come to an agreement on a relatively large package of tax and spending reforms that reduce the deficit over the longer term without posing an immediate threat to economic growth. There are already several guidebooks upon which this kind of bipartisan compromise could be based. The National Commission on Fiscal Responsibility and Reform (also known as the Bowles-Simpson Commission) or the similarly bipartisan Dominici-Rivlin plan offer useful templates. The broad thrust of these plans was to freeze spending levels in the near term and raise revenues mainly by removing the \$1 trillion in tax expenditures from the tax code. This combined with more long-term fundamental reforms to entitlement spending offer the best path to stabilizing the debt.

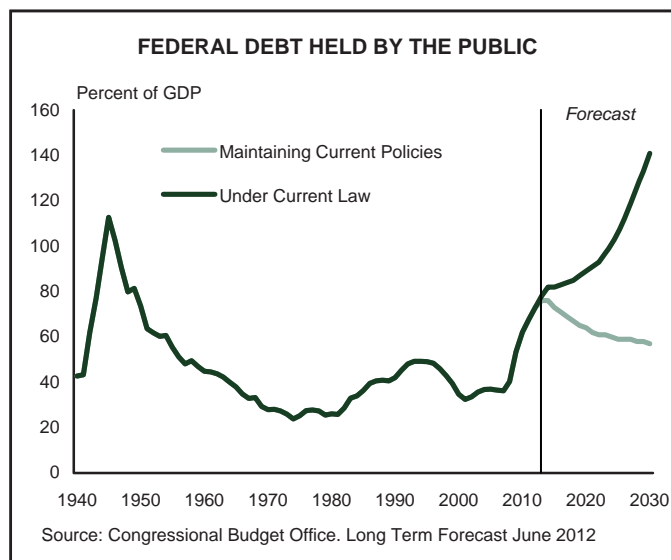
Unfortunately, the actions of Congress over the last couple of years make the chance of this kind of grand bargain very low. We have already witnessed the failure of the Joint Select Committee intended to reach exactly this outcome.

Instead, what would be more consistent with Congress' recent actions would be to extend tax cuts and leave more fundamental reforms to sometime in the future. While this will do nothing to change the long-term trajectory of the budget deficit, it could result in a modest upside to near-term economic growth. However, if Congress simply decided to push the tax hikes and spending cuts forward a year, the cloud of uncertainty that currently afflicts the economy would continue. The hit to confidence could offset some of the gains of avoiding the fiscal cliff.

#### Scenario 2: Gridlock...gridlock...grudging agreement

Politics makes it difficult for progress to occur until after the election. While anything is possible come election day, it appears likely that the House of Representatives will remain in Republican hands, but the Senate and Presidential elections are simply too close to call. Right now, the most likely outcome appears to be a divided Congress, which makes negotiations and compromise key.

However, while gridlock may disable government from making decisions in the short-term, both parties agree on avoiding the most destructive parts of the fiscal cliff. This makes it more likely that if there is not an agreement in place to avoid the tax hikes and spending cuts before they take place, they will be reversed in relatively short order afterwards. If, for example, the Democratic proposal to extend the tax cuts on income below \$250,000 and retain a number of the other tax credits is enacted, it would reduce the total cost to around \$50 billion and the economic impact to just 0.1 percentage points. The AMT patch is also an area of relative agreement between the two parties in Washington



TD Economics Forecast Assumptions				
	Budgetary Impact		Fiscal Multiplier	Economic Impact (percentage points)
	\$ Bill.	% of GDP		
<b>Taxes</b>				
250K+ Income	50	0.3	0.4	-0.1
Payroll tax	125	0.8	0.5	-0.4
Health care taxes	20	0.1	0.4	-0.1
Other taxes	85	0.6	0.4	-0.2
<b>Total Taxes</b>	<b>280</b>	<b>1.8</b>	<b>0.4</b>	<b>-0.8</b>
<b>Spending</b>				
Extended UI	35	0.2	0.8	-0.2
Other spending cuts	65	0.4	1.2	-0.5
<b>Total Spending</b>	<b>100</b>	<b>0.7</b>	<b>1.1</b>	<b>-0.7</b>
<b>Total</b>	<b>380</b>	<b>2.5</b>	<b>0.6</b>	<b>-1.5</b>

Source: CBO, CFRB, TD Economics

and is likely to be enacted before it hits taxpayers.

Similarly, on the spending side, both parties are in agreement that steep cuts to defense spending are unlikely to be in the country's best interest. As a result, as long as Congress can eventually agree on a plan, even if it takes into early next year, the size of the fiscal is likely to be much smaller than the total potential.

### Our base case: fiscal drag enough to feel

The exact contours and timing of government policy are difficult enough for a Washington policy analyst to figure out, never mind an economist. However, as policy choices have such a big economic impact and we're in the business of forecasting the economy, we are left to make assumptions.

On the tax side of the equation, we assume the Bush tax cuts are extended on income below \$250,000, but are allowed to rise on income above that threshold. This is expected to happen early enough that the direct economic impact will be limited to 0.1 percentage points. We also assume that the payroll tax cut will expire at the end of this year. This will result in a hit to economic growth of 0.4 percentage points. Finally, we assume that health care taxes and other taxes subtract an additional 0.3 percentage points for a grand total of 0.8 percentage points in fiscal drag due to tax increases.

On the spending side, we assume that the cost of sequestration proves too big to be allowed to take effect in full. However, in order to assuage a likely Republican dominated Congress, we believe that other spending cuts

worth at least \$65 billion take its place. This, alongside the expiry of emergency unemployment benefits, will result in a reduction in outlays enough to cut economic growth by 0.7 percentage points.

All together, this implies a fiscal drag of 1.5 percentage points, constraining economic growth to just 2.1% in 2013. Moreover, even if the majority of the potential fiscal cliff is avoided, the impact of policy uncertainty will continue to hang over the economy. Over the second half of this year, this is expected to cut growth by 0.5 percentage points, on par with the CBO's estimate. Taking into account productivity, this is equivalent to almost 400,000 jobs that will not be created.

### Bottom Line

Political gridlock has been a reality in Washington for much of the past two years. In this time we have seen a raucous debate over the U.S. debt ceiling that resulted in a U.S. debt downgrade by S&P and a broad loss in confidence that weakened an already moribund recovery. As a result of that debate we saw the Joint Select Committee on Deficit Reduction, tasked with finding a long-term solution to U.S. budget deficits. We then saw the failure of that committee and the potential triggering of steep automatic spending cuts. To this mix we add a stream of temporary tax provisions that have been written so as to avoid permanently raising deficits, but as a result have threatened to expire on a nearly annual basis.

The fiscal cliff is no trifling matter – added it all up it represents a fiscal contraction of 5.1% of GDP. In our estimation this would be enough to reduce real GDP growth by 3.2 percentage points and pull the economy into a recession. However, while Washington is gridlocked there little chance that the bulk of the fiscal cliff will take place. Even if many of the provisions are allowed to expire, they are likely to be reformed, extended or removed before they become a significant drag on economic growth.

Nonetheless, some fiscal drag is coming and will act as a brake on growth. Unfortunately, the amount of fiscal consolidation expected to take place will not be enough to put the budget deficit on a sustainable trajectory. This means that further attempts to bring spending and revenues closer together, and all of the uncertainty that comes with it, will continue to be a factor for the economic outlook for years to come.

## Endnotes

1. Congressional Budget Office. "Economic Effects of Reducing the Fiscal Restraint That Is Scheduled to Occur in 2013." May 22, 2012. <http://www.cbo.gov/publication/43262>
2. Component estimates on a fiscal year basis grossed up to calendar year by TD Economics. Taken from the Congressional Budget Office and the Committee for a Responsible Budget document "Between a Mountain of Debt and a Fiscal Cliff: The Smart Path Forward." July 16, 2012. [http://crfb.org/sites/default/files/Between\\_a\\_Mountain\\_of\\_Debt\\_and\\_a\\_Fiscal\\_Cliff.pdf](http://crfb.org/sites/default/files/Between_a_Mountain_of_Debt_and_a_Fiscal_Cliff.pdf)
3. Tax Policy Center. "TPC Tax Topic: Alternative Minimum Tax." <http://www.taxpolicycenter.org/taxtopics/amt.cfm> (accessed July 30, 2012).
4. Congressional Budget Office. "Policies for Increasing Economic Growth and Employment in 2012 and 2013." November 15, 2011. <http://www.cbo.gov/publication/42717>
5. Health care and other taxes are assumed to have the same fiscal multiplier as income taxes.
6. Kogan, Richard. "How the Across-the-Board Cuts in the Budget Control Act Will Work." Center on Budget and Policy Priorities. April 27, 2012. <http://www.cbpp.org/cms/?fa=view&id=3635>
7. Bipartisan Policy Center. "Indefensible: The Sequester's Mechanics and Adverse Effects on National and Economic Security." June 7, 2012. <http://bipartisanpolicy.org/library/report/sequester>

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