Fiscal Cliff: Plausible Scenarios

One of the main risks looming before the global economy in the short term is the so-called “fiscal cliff” in the United States. By the end of the year, the U.S. Congress will face a majority vote on whether to extend several major tax incentives that will otherwise automatically expire at year-end, and whether to postpone steep reductions in federal spending that will otherwise occur automatically at the beginning of next year. These automatic measures, if allowed to go into effect, would together amount to a fiscal contraction of 3.7% of GDP.

In our base-case scenario, we assume that economic rationality will prevail, motivating the Congress to avoid the fiscal cliff by extending two-thirds of the expiring measures. Nonetheless, fiscal consolidation will likely continue to delay a U.S. economic recovery in 2013. We expect U.S. GDP to decelerate to 1.8% in 2013 from 2.2% in 2012 as a result of the fiscal consolidation likely to take place in 2013.

However, if the Congress fails to extend any of the expiring measures the U.S. economy is likely to go into recession in 2013. In this scenario, we expect negative real GDP growth of -0.3% in 2013. Such a recession in the U.S. could have a global spillover effect, particularly in light of the currently weak global economic outlook.

Our base-case scenario assumes that the worst outcome will be avoided, but a temporary lapse can’t be ruled out, as: i) negotiations on the fiscal cliff will have to be carried out within a very short window of time, between the election (November 6) and December 31; ii) the outcome of the election may further complicate the negotiations; and iii) there are significant differences between Republicans’ and Democrats’ fiscal policy proposals.

Negotiations on the fiscal cliff will have to be carried out within a very short window of time.

The issue of the fiscal cliff will not be resolved prior to the November 6 election, which is right now claiming the full attention of the president and Congress. All 435 seats in the House of Representatives will be contested, as will one-third of the seats in the Senate. Furthermore, Democrats and Republicans are not likely to bend their positions prior to the election, as both parties have an incentive to differentiate themselves in the eyes of the electorate.

Congress will likely only return to Washington on November 13, after the Veterans Day holiday. The following week is short as well, as the Thanksgiving holiday is on November 22. Moreover, Congressmen will likely not work the week between Christmas and January 1. All told, then, Congress will have less than six weeks to resolve the pending issues.

The outcome of the election may further complicate negotiations.

The election results are still very uncertain. For the presidential election, recent state polls suggest that Barack Obama is likely to win enough states to obtain a majority of electoral college votes. However, many national polls show Obama in a technical tie with Republican candidate Mitt Romney. It is possible that Obama could win the election, by obtaining a majority in the electoral college, while losing the national popular vote – as George W. Bush did in 2000, in his victory over Al Gore.

As for the legislative elections, polls suggest a more intense race in the Senate than in the House of
Representatives. For the Senate, polls are pointing to the Democrats holding onto their majority, but there remains a reasonable chance that Republicans could come out ahead, due to the composition of the contested seats. The Senate is currently composed of 53 Democratic senators and 47 Republican senators. Only 33 seats are up for reelection this year, however, and these seats are currently held by 23 Democrats and 10 Republicans – meaning that the chance that Democrats lose three seats is not negligible. In the House, all seats will be contested, but recent polls indicate that here the Republicans’ advantage is more convincing.

In short, the most likely scenario appears to be a continuation of the status quo, meaning the re-election of President Barack Obama and a divided Congress, with a Democratic majority in the Senate and a Republican majority in the House of Representatives. A tight Democratic victory in the presidential election and a divided Congress may reduce its bargaining power in negotiations on the fiscal cliff.

The consequences of a victory by Republican Mitt Romney are also uncertain. In such a case, the most likely outcome is a less-intense fiscal contraction in 2013, in light of the Romney’s government program. However, a temporary period of political paralysis between the election and the end of the year should not be ruled out. Democrats will still be ruling during this period, meaning that President Obama and/or the Democratic majority in Senate could obstruct approval of Romney’s proposals. A President Romney could still avoid the fiscal cliff retroactively, by facilitating legislative action after he comes into office in 2013, but even a temporary paralysis would certainly not be welcomed by the financial markets.

There are significant differences between Republicans’ and Democrats’ fiscal policy proposals.

There are significant differences between Republicans and Democrats regarding the role of the government in the economy. Republicans favor a smaller public sector that concentrates on the areas of defense and essential regulations, promoting a flexible infrastructure for the activities of the private sector. Democrats, on the other hand, believe in a more active role for the government in fostering social welfare.

In practice, Republican candidate Mitt Romney’s proposal is that the fiscal adjustment should be carried out entirely by reducing government expenditures. The proposal would focus on reducing income tax rates (for corporations and households), with the resulting revenue loss offset by closing tax loopholes. President Barack Obama’s proposal, on the other hand, is that the fiscal adjustment should be more balanced, with a ratio of 3:1 between expenditure and revenues, less intensively penalizing the middle class.

The fiscal cliff measures and a few possible scenarios

Below, we detail the policies composing the fiscal cliff and present two plausible fiscal consolidation scenarios (base-case and alternative) for 2013. It is worth noting that this is the first step toward the adjustment of U.S. government’s total deficit (estimated at 8.7% of GDP in 2012), which is likely to last a few years.

The “cost” of all measures comprising the fiscal cliff is estimated at USD 595 billion (3.7% of GDP) in 2013, comprising USD 445 billion in tax increases and USD 130 billion in reduced government spending (expenditures and transfers). The table below presents our base-case scenario, in which about one-third of the measures will not be renewed, resulting in a fiscal consolidation of USD 195 billion. Furthermore, we present another plausible alternative scenario.
Fiscal Cliff: Scenarios

<table>
<thead>
<tr>
<th>#</th>
<th>Tax</th>
<th>Total (USD bn)</th>
<th>Base-Case (USD bn)</th>
<th>Alternative (USD bn)</th>
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</thead>
<tbody>
<tr>
<td>1</td>
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<td>-126</td>
<td>-126</td>
</tr>
<tr>
<td>2</td>
<td>Emergency Unemployment Compensation</td>
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<td>-20</td>
<td>-20</td>
</tr>
<tr>
<td>3</td>
<td>Healthcare Reform</td>
<td>-24</td>
<td>-24</td>
<td>-24</td>
</tr>
<tr>
<td>4</td>
<td>Bush Tax Cut (&gt; $250k)</td>
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<td>-56</td>
</tr>
<tr>
<td>5</td>
<td>Bush Tax Cut (&lt; $250k)</td>
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<td>6</td>
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<td>7</td>
<td>Alternative Minimum Tax</td>
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</tr>
<tr>
<td>Total</td>
<td></td>
<td>-595</td>
<td>-195</td>
<td>-251</td>
</tr>
</tbody>
</table>

% of GDP | -3.7% | -1.2% | -1.6%

Source: Congressional Budget Office; Office of Management and Budget; Tax Policy Center.

What does each measure mean? What is the political context? What is the rationale for our base-case scenario?

Payroll tax cut: USD 126 billion (0.8% of GDP). Mandatory employee contributions to Social Security were reduced to 4.2% from 6.2% as part of President Barack Obama’s post-crisis economic stimulus package. Despite Republicans being against tax hikes, none of the proposals by neither party presented in 2012 (during the election period) would extend this lower payroll tax rate. Extending the Payroll tax cut has caused some concern among legislators, as this tax is tied to the financing of the Social Security trust fund. In our base-case scenario, we assume that this tax will not be renewed, and we believe that the likelihood of a renewal is low in either election scenario.

Emergency unemployment compensation: USD 40 billion (0.3% of GDP). In his post-crisis fiscal package, as an emergency measure, President Obama lengthened the period in which the unemployed are eligible to receive compensation. The compensation eligibility period started to normalize last year, and there were no statements by neither party contrary to the gradual continuity of its normalization. In our base-case scenario, we assume that in 2013 the unemployment compensation eligibility period will continue to be normalized, resulting in total unemployment compensation being reduced by half for the year. We believe that the likelihood of a wholesale renewal of this provision is low in either election scenario.

Healthcare reform (Affordable Care Act): expected to raise taxes by USD 24 billion (0.2% of GDP). According to the Tax Policy Center, in order to finance the healthcare reform package promoted by President Barack Obama and narrowly approved by Congress, Republican presidential candidate Mitt Romney has repeatedly criticized the healthcare reform legislation, but it is unlikely that these reforms will be repealed in the short term. Our base-case scenario assumes that the reforms will be implemented, causing a fiscal tightening of USD 24 billion in 2013.

Bush tax cuts (for the middle and upper classes): in 2001 and 2003, President George W. Bush reduced tax rates corresponding to a USD 192 billion relief to households annually. The U.S. tax code is progressive, with households falling into different tax rate classes, or “brackets,” depending on their income level. On an annual basis, it is estimated that USD 56 billion of these cuts benefit households with annual incomes exceeding USD 250,000, while the remaining USD 136 billion benefit households with annual incomes below USD 250,000. President Barack Obama has taken a position against extending the reduced rates for households with annual incomes exceeding USD 250,000, but there is a general consensus between Democrats and Republicans on extending the Bush tax cuts for middle-class taxpayers. In our base-case scenario, we assume that the Bush tax cuts will be renewed for at least one year for all income levels, as Republicans insist on maintaining low tax rates for high earners and we believe that Obama will again accept...
such an extension (as he did last year) as a bargaining chip in the year-end negotiations. In our alternative scenario, the President will not withdraw his proposal to raise tax rates for wealthy households, leading to a higher fiscal drag in 2013.

Sequestration: this term refers to the USD 110 billion in annual spending reductions, half in defense and half in discretionary spending, slated to go into effect at the beginning of 2013 absent legislative action. In the medium-term fiscal adjustment plan approved last year, Congress approved a provision for the automatic sequestration of expenses in the above-mentioned proportion in the event that a special commission (the so-called Super Committee) failed to reach an agreement on an alternative budget package. The composition and schedule of the automatic spending cuts do not please either party. Mitt Romney and many Republicans are strongly opposed to the reduction of defense spending. President Obama says he intends to cut excess defense spending, but in the last debate he showed himself to be flexible in terms of the schedule for implementing defense-spending cuts. Therefore, in our base-case scenario, we assume that the sequestration of defense spending will be postponed and that the government will end up carrying out only a partial cut of discretionary expenses (USD 25 billion) in 2013.

Alternative minimum tax (AMT): the impact of a non-renewal of AMT exemptions is estimated at USD 103 billion per year (0.6% of GDP). The alternative minimum tax is an alternative income tax rate owed by certain taxpayers who would otherwise have an average rate below the legal minimum threshold for their respective income level. Last year, a number of tax brackets were exempted from the alternative minimum tax. In our base-case scenario, we expect that the Congress will maintain these exemptions from the alternative minimum tax for the time being.

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