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The author examines different economic and fiscal outcomes from the supercommittee's decision. | AP Photo Close

Making book on the supercommittee

By MARK ZANDI | 11/15/11 9:25 PM EST

What the congressional supercommittee does about cutting the nation's deficit in the next few days could determine the economy's course next year and conceivably long after that.

Despite its looming deadline, the committee could still take numerous paths that would lead to substantially different economic and fiscal outcomes. Let's consider some:

Gimmicky deal — 10 percent probability: On the darkest path, the committee relies on budget gimmicks — like an assumed winding down of the Iraq and Afghanistan wars — to achieve its \$1.2 trillion goal in 10-year deficit reduction. The panel could then avoid substantive government spending cuts similar in size to those that would automatically occur beginning in 2013.

Using gimmickry would signal financial markets that it is hopeless to believe Washington can address the nation's long-term fiscal problems.

It's not hard to imagine other ratings agencies ratifying Standard & Poor's downgrade of Treasury debt. This would prompt downgrades of the debt of institutions backstopped by the federal government — including Fannie Mae and Freddie Mac, the Federal Home Loan Banks, too-big-to-fail financial institutions and many state and local governments.

Financial markets would be thrown into turmoil, upending the already shell-shocked collective psyche. The economy would descend back into recession and the nation's budget deficits balloon as tax revenues fell and spending on unemployment insurance, food stamps and Medicaid increased.

No deal — 30 percent probability: Figuring that, at the very least, it should do no harm, the supercommittee may instead decide to do nothing. Inaction wouldn't roil financial markets — at least not immediately. But it might next year, when some in Congress could attempt to take back some of the automatic spending cuts. Howls over the \$600 billion in cuts slated for the defense budget can already be heard.

With the government funded by continuing resolutions, a real threat of a showdown will very likely occur next year. Either some of the automatic cuts will be scaled back, or the government won't receive funding and will be forced to close. One more unnerving political spectacle would do significant damage to the Treasury's rating, financial markets — and the economy.

Efforts to reduce some of the fiscal restraint set to hit hard next year would be another casualty of inaction. Under current law, if policymakers make no changes, federal fiscal policy will cut 1.7 percentage points from real gross domestic product growth next year.

This includes the expiration of the payroll tax holiday, emergency unemployment insurance benefits, the expensing of business investment and a range of other stimulus efforts. When combined with continued cutting at state and local governments, total fiscal drag next year will likely total more than 2 percentage points. Even a strong economy would have difficulty with this kind of headwind.

The clearest way to cut some of this fiscal drag would be to extend and the current payroll tax holiday and increase it — as proposed by President Barack Obama. This would cut the fiscal drag by almost half.

The best, and perhaps only, political window for getting this done is the supercommittee process. If it punts, this won't get done and recession looks probable.

Partial deal — 40 percent probability: A brighter path is that the committee agrees to something substantive — say roughly half its \$1.2 trillion goal. This seems doable, given the apparent agreement on at least some steps. For example, using the chained consumer price index to index Social Security, pension benefits and Tax Code parameters has broad support.

This simple change could produce more than \$200 billion in deficit reduction.

Assuming the committee could also find a way to include an extension of the payroll tax holiday for next year, the panel will have done its job. Financial markets would respond positively because their worst fears hadn't been realized.

But the response would be far from joyous because significant work would remain to put the nation on a path to long-term fiscal sustainability — a stable debt-to-GDP ratio. The economy wouldn't get much of a boost from all this, but it would ensure the recovery continues.

Agreeing to some substantive deficit reduction would also mean that the automatic spending cuts in 2013 will be smaller, more economically and politically palatable and thus more likely to occur. More important, it indicates there is political will to make tough decisions and increases the odds that policymakers will figure out a way to achieve fiscal sustainability.

Done deal — 15 percent probability: It is a stretch to think that the supercommittee will achieve its goal, but it's not unthinkable. It would require that Democrats on the committee relent on meaningful cuts to entitlements, and Republican members agree to tax revenue increases. Big changes wouldn't be necessary, so this path can't be ruled out. But both parties would be diluting key election themes, making it less likely.

Financial markets would rally in this scenario, and the economy would be better for it — but probably not by much. There would still be significant political acrimony and far more for policymakers to do to establish fiscal sustainability. S&P probably would remain steadfast on its downgrade. The economic and political payoff from a done deal thus wouldn't be much greater than from a partial one.

Big deal — 5 percent probability: A big deal would be close to \$3 trillion in 10-year deficit reduction — what's really needed for fiscal sustainability given the nearly \$1 trillion already agreed to. Because of the lack of time and the complexities involved, the committee won't be able to specify precisely how to get an agreement this big done. But it would give instructions to relevant congressional committees to come up with the necessary cuts and tax revenue increases. Given that this would require significant changes to entitlements and increased tax revenues, the odds of this are low.

It's too bad, because the economic payoff would be huge. Financial markets would rally substantially, and confidence and economic growth would surge. There might be appropriate wariness that this is too good to be true — but if it were true, our financial futures would quickly get brighter.

It is easy to be pessimistic. These are extraordinarily difficult times, and the collective psyche is teetering. But we are closer to righting the wrongs that got us into this economic mess than most of us believe. With just a bit of reasonably good policymaking by the supercommittee, progress may soon shine through.

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