The Philadelphia Inquirer

# What will happen at the edge of the fiscal cliff?

Mark Zandi, November 25, 2012

President Obama's reelection started the countdown for lawmakers to address the fiscal cliff and the statutory debt limit. Unless the president and House Republicans can agree on changes to current law, the U.S. economy will be in recession by spring.

Concern about Washington's ability to manage the crisis already appears to be taking a toll. Nervous businesses have pulled back on investment and advertising in recent months. Firms' staffing decisions haven't been affected, but this may not last if uncertainty continues to mount.

The fiscal cliff is daunting. Tax increases and spending cuts scheduled to take effect with the new year add up to about $700 billion, enough to lower gross domestic product next year by close to 3.5 percent. This would undermine the recovery, particularly given that the Federal Reserve could not respond effectively.

Adding to the threat is the approaching debt ceiling. The law currently caps federal debt at $16.4 trillion. Based on recent expenditures and receipts, the Treasury will near that limit late this year and be forced to use extraordinary accounting to avoid crossing it. The Treasury can do this for only so long; by early March, the administration will be forced to make some difficult decisions.

It could allow a U.S. default, but that would produce unacceptable financial chaos. It could stop paying some bills, cut payments to Social Security recipients or Medicare providers, and shut down some operations. Some 40 percent of U.S. spending relies on borrowing, however, necessitating dramatic cuts that make this course highly unlikely, too. Obama's other option would be to ignore the law and order the Treasury to continue issuing debt, but that would prompt a constitutional crisis.

Going over the cliff or breaking the ceiling would have widespread negative economic impacts. Given the suffering that would occur if policymakers don't act, the most plausible outcome is that they will.

Lawmakers will probably amend some of the tax and spending changes that constitute the fiscal cliff. They're most likely to extend Bush-era tax rates for households making less than $250,000 a year; eliminate automatic across-the-board cuts in last year's debt-ceiling agreement, known as sequestration; and repeat extensions of "temporary" rules such as the inflation adjustment to the alternative minimum tax and Medicare's payment schedule.

This would still leave big tax hikes and cuts on next year's calendar. The payroll-tax holiday would expire; emergency unemployment benefits would phase out; Bush-era tax cuts for households making more than $250,000 a year would end; and taxes on upper-income households would rise to help pay for health-care reform.

These changes would represent a significant economic headwind, but it would be manageable. We would avoid another recession, with real GDP growing at about the same pace as this year.

As part of any fiscal-cliff agreement, the debt ceiling should be increased enough to last beyond the 2014 elections. But this won't happen without the consent of House Republicans. They will happily jettison sequestration, including defense cuts, but will insist on other cuts in return. The result will probably be broader deficit reduction, including reform of entitlements and perhaps even taxes.

Doing all this will be impossibly complex in the time available. Lawmakers are therefore likely to lay out a broad framework and leave it to congressional committees to hash out the details next year.

For example, a framework based on the Simpson-Bowles commission's 2010 proposal would require a 10-year budget deal that raises $1.5 trillion more in tax revenue and cuts $2.5 trillion in spending, including on entitlements. If Congress can pull this off, future deficits will be small enough to stabilize the debt-to-GDP ratio and even begin lowering it in a decade. This would please markets and keep credit-rating agencies at bay.

It's easier said than done, of course. To generate the necessary political will, negotiations may have to go into 2013. The economy won't suffer immediately, particularly if the Treasury doesn't change withholding schedules on the grounds that a deal is imminent. Agencies could also delay the most draconian budget cuts.

But the damage would mount each day as businesses, investors, and consumers come to doubt that lawmakers will reach an agreement. Within a few weeks, stock prices would slump, and business and consumer confidence would slide. The political pressure to act would be intense, but this is precisely the stress needed to forge a substantive, durable agreement.

Thought it's hard to tell, the economy has righted a lot of the wrongs that got us into this mess. We are one piece of legislation away from much stronger growth and employment.

It won't be easy for the president and Republicans to sign on the dotted line, and the inevitable political vitriol will raise uncertainty, causing growth to nearly stall out in coming weeks. But the odds are that they will eventually come together, putting the economy on a better track in 2013.

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http://articles.philly.com/2012-11-25/news/35348863_1_fiscal-cliff-bush-era-tax-debt-ceiling-agreement