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August 24, 2012

Fiscal Cliff Raises Specter of U.S. Recession

Stephen P. A. Brown and Kylelar P. Maravich

In late 2012, U.S. policymakers will be faced with making controversial decisions about the nation's fiscal policies. As current law stands, the U.S. government will implement a number of tax increases and spending cuts beginning in 2013. Because implementation of current law results in an abrupt change in government spending and taxation policy, the current laws are seen as creating what is known as a "fiscal cliff." According to many analysts, plunging over the fiscal cliff is likely to push an already weak U.S. economy back into recession.

On the other hand, postponing or cancelling implementation of current laws will leave the U.S. government with a large deficit and a growing debt. A failure to reduce the deficit to a sufficiently small percentage of the nation's gross domestic product (GDP) will lead to a growing debt-to-GDP ratio. Over time, a high debt-to-GDP ratio will weaken the long-term prospects for economic growth.

In what follows, we examine the size of the fiscal cliff and assess its effects on U.S. economic activity. Our assessment suggests that policymakers can reduce the near-term risk of recession and gain most of the benefits of reducing the U.S. government debt-to-GDP ratio by taking a gradualist policy. Under such a policy, the U.S. government would gradually bring its budget deficit as a percent of GDP below the growth rate of U.S. economic activity.

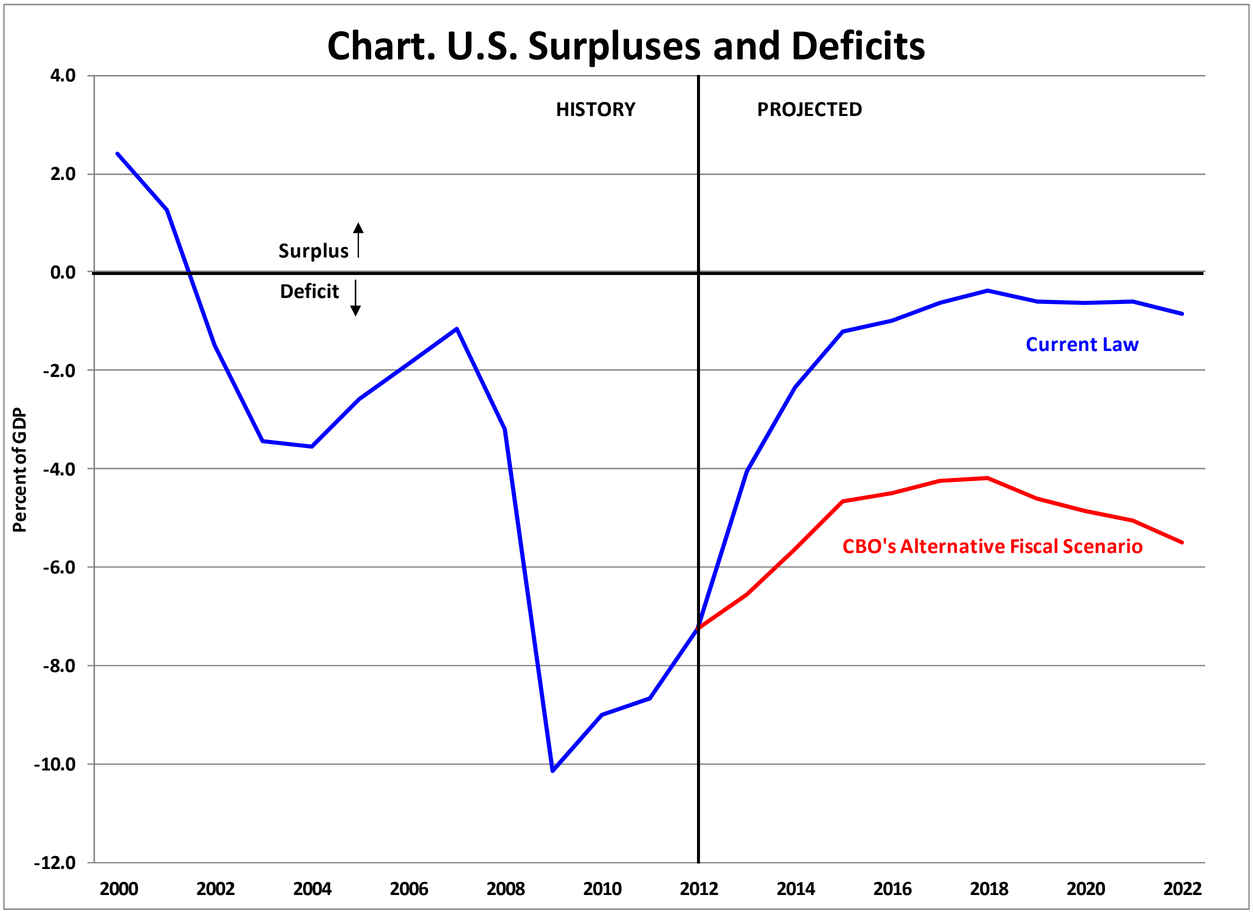
How Big Is the Fiscal Cliff?

As shown in the Chart (page 2), the changes in fiscal policy brought about by current law will sharply reduce the U.S. government budget deficit—from 7.3 percent of GDP in 2012 to 4.0 percent and 2.4 percent of GDP in 2013 and 2014, respectively. To provide a contrast with current law, the Congressional Budget Office (CBO) developed an alternative fiscal scenario, in which some current laws would be changed so that fiscal policy remains relatively unchanged. The alternative scenario shows a much larger deficit—6.5 percent and 5.6 percent of GDP in 2013 and 2014, respectively.

As shown in Table 1 (page 2), current law will bring big changes to both U.S. government taxation and spending policies beginning in 2013. Some of the changes brought about by the current tax laws are the expiration of provisions that reduce income, estate and gift taxes (commonly known as Bush-era tax cuts). In addition, the reduction in the employee's portion of the payroll tax will expire. The Affordable Care Act also will bring tax increases.

Among the changes to spending policies are sharp reductions in Medicare payment rates for physicians' services and the expiration of some unemployment benefits. The automatic enforcement procedures established under the Budget Control Act of 2011 also will cut spending across a number of programs including defense.

In contrast, CBO expects both reduced revenues and higher expenditures if the laws are changed to sustain current policy. The result is a larger deficit—an additional 2.5 percent of U.S. GDP in 2013.



Source: Congressional Budget Office

Table 1. Projected U.S. Government Deficits as a Percent of GDP

	2012	2013	2014	2015	2020
Current Law					
Revenues	15.7	18.4	19.6	20.3	21.1
Outlays	22.9	22.4	21.9	21.5	21.7
Deficit	-7.3	-4	-2.4	-1.2	-0.6
Debt Held by Public as a Percent of GDP	72.8	76.1	76.6	73.8	61.4
CBO's Alternative Fiscal Scenario					
Revenues	15.7	16.3	17.2	17.8	18.5
Outlays	22.9	22.8	22.9	22.5	23.3
Deficit	-7.3	-6.5	-5.6	-4.6	-4.8
Debt Held by Public as a Percent of GDP	72.8	78.6	82.3	82.5	85.7

Source: Congressional Budget Office

With the smaller deficits found under current law, the U.S. government's debt-to-GDP ratio is projected to decline gradually (Table 1). With the larger deficits found under CBO's alternative fiscal scenario, the U.S. government's debt-to-GDP ratio is expected to rise.

What Are the Implications for the Economy?

Reducing the U.S. government budget deficit by the amount expected under current law seems likely to promote long-term economic growth. Under current law, the deficit as a percent of GDP is expected to fall below the growth rate of U.S. real GDP. Economists see that development as advantageous to long-term economic growth because the debt-to-GDP ratio will fall.

With a change in laws to permit the continuation of current policies, however, the deficit as a percent of GDP will be higher than the growth rate of U.S. GDP. Consequently, the debt-to-GDP ratio will grow. In countries with high debt-to-GDP ratios, economic activity is strangled by high interest rates and a lack of investment. Reducing deficit spending contributes to a higher trajectory of economic growth by avoiding the problems associated with a high debt-to-GDP ratio.

Not So Fast!

Unfortunately, an abrupt resolution of the budget deficit also removes what many see as a short-term fiscal stimulus to economic activity during a period in which the economy is already performing poorly. That is, government deficit spending is seen as boosting short-term activity. Removing the stimulus could yield a near-term slowdown in economic activity or a recession.

According to CBO estimates, a continuation of the current laws will lead to a mild recession in which U.S. real GDP declines by 0.5 percent from fourth quarter 2012 to fourth quarter 2013. CBO also estimates that the policies in their alternative scenario will result in the U.S. real GDP growing by 1.7 percent from fourth quarter 2012 to fourth quarter 2013. Combined, these estimates indicate that CBO sees the fiscal cliff built into current law as resulting in a 2.2 percent reduction in GDP during 2013.

Other economic perspectives suggest that a 2.5 percentage point reduction in the U.S. government deficit as a share of GDP will yield an estimated GDP loss for 2013 that ranges from 0.0 percent to 3.0 percent (Table 2). For instance, application of the Ricardian equivalence theorem suggests no loss in GDP. In contrast, application of Keynesian multipliers similar to those used by Zandi (2008) suggests a GDP loss of 3.0 percent.[1]

Table 2. Estimated GDP Loss

Source	**Estimated GDP Loss**
CBO	2.2%
Keynesian Multipliers	3.0%
Ricardian Equivalence	0.0%
Imperfect Ricardian Equivalence	0.8%

Sources: Congressional Budget Office; Authors' estimates

Keynesian Multipliers. According to Keynesian thinking, an autonomous increase in spending leads to subsequent rounds of spending in the economy with a multiplied effect. An increase in

[1] Mark Zandi (2008), "A Second Quick Boost From Government Could Spark Recovery," Testimony before the U.S. House Committee on Small Business (July 24).

government spending represents such an autonomous increase. The increase in private spending stimulated by tax reductions also represents such an autonomous increase. Using multipliers suggested by Zandi (2008), we estimate that a 2.5 percentage point reduction in the U.S. government deficit as a share of GDP will yield a 3.0 percent loss in GDP.

CBO. Implicitly, CBO estimates rely on a total multiplier effect of less than one. According to CBO estimates a 2.5 percentage point reduction in the U.S. government deficit as a share of GDP yields only a 2.2 percent loss in GDP. Those figures imply a multiplier of 0.9.

Ricardian Equivalence. According to what is known as the Ricardian equivalence theorem, individuals in the private sector understand that a government's deficit spending must lead to future taxes. Therefore, the private sector will cut its spending by the amount of the deficit to pay for the future taxes. In such a case, each dollar increase in deficit spending is exactly offset by a dollar loss in private spending, and the deficit provides no stimulus. Accordingly, a 2.5 percentage point reduction in the U.S. government deficit as a share of GDP would yield no loss in GDP.

Imperfect Ricardian Equivalence. In practice, individuals may not fully respond to an increase in government deficit spending by increasing their saving by an equal dollar amount.[2] As a consequence, Ricardian equivalence may not hold perfectly. Using an imperfect equivalence rate of 70 percent, we estimate that a 2.5 percentage point reduction in the U.S. government deficit as a share of GDP will yield a loss in GDP of 0.8 percent.

Taking a Precautionary Approach

Most economists agree that reducing the U.S. government deficit below the growth rate of U.S. real GDP is good for long-term economic activity. Therefore, measures to reduce the deficit—such as those found in current tax and spending laws—are likely to provide a long-term benefit to the U.S. economy.

Nonetheless, current laws are expected to result in an abrupt reduction of the U.S. government deficit. This sharp reduction in the deficit, commonly known as the fiscal cliff, could reduce U.S. GDP by 0.8 to 3.0 percent in 2013. CBO estimates the reduction in GDP at 2.2 percent. Given an already weak economy, an abrupt shift in fiscal policy runs the risk of creating a recession. That risk can be avoided by taking a more gradual approach in reducing the U.S. government budget deficit. A gradualist policy may take as many as five years to achieve the necessary reduction in the U.S. government deficit.

Stephen P. A. Brown, Ph.D.
Director
Center for Business and Economic Research
University of Nevada, Las Vegas

Kylelar P. Maravich
Graduate Assistant
Center for Business and Economic Research
University of Nevada, Las Vegas

[2] See W. Michael Cox (1985). "The Behavior of Treasury Securities: Monthly 1942-84." *Journal of Monetary Economics* (September) and Fred C. Graham and Daniel Himarios (1996), "Consumption, Wealth, and Finite Horizons: Tests of Ricardian Equivalence," *Economic Inquiry* (July).