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Testimony before the Joint Economic Committee

Fiscal Cliff: How to Protect the Middle Class, Sustain Long-Term Economic Growth, and Reduce the Federal Deficit

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The views expressed in this testimony are those of the author alone and do not necessarily represent the views of the American Enterprise Institute.

Chairman Casey, Vice Chairman Brady, and Members of the Committee, thank you for inviting me to appear today to discuss the effects of the fiscal cliff on the economy.

The "fiscal cliff," that is, the combination of automatic spending cuts and the end of multiple temporary tax cuts scheduled to expire at the end of this year, is estimated by the CBO to reduce the federal deficit in fiscal year 2013 by around $607 billion, or $560 billion after taking into account its effect on the overall economy[1]. Around two thirds of the $607 billion in savings stem from four tax increases that are scheduled to take place in 2013.

This dramatic budgetary shift would, of course, have a very large impact on the overall economy. In this testimony, I examine the potential short and long term effects of failing to address the fiscal cliff, and then relate lessons from the economics literature on the likely impact of various policy responses to the coming deadline.

What is the "Fiscal Cliff"?

Coined by Ben Bernanke in February, the "fiscal cliff" comprises multiple scheduled tax increases and spending cuts that will take place at the beginning of 2013. The chart below lists the major components of the budgetary shifts, along with the amount that they will reduce the deficit in calendar year 2013. There are different estimates as to the cost of each policy, but these estimates give a rough picture of what we are to expect at the beginning of 2013 under current law.

Scheduled Revenue Increases	
Income, capital gains, and dividend rate increases on high income earners	$52 billion
Remainder of 2001 and 2003 tax cuts	$171 billion
End of 2 percent payroll tax cut that went into effect in January 2011	$115 billion
Expiration of AMT patch	$40 billion
Increased tax rates on earnings and investment income of high-income tax payers & Medicare surtax due to Affordable Care Act	$24 billion
Estate and gift tax expirations	$31 billion
Expiration of business tax provisions, including partial expensing of investment property	$59 billion
Total:	$492 billion[2]

Scheduled Spending Cuts	
Automatic cuts in Defense spending due to Budget Control Act	$37 billion
Other cuts in spending due to Budget Control Act	$42 billion

[1] Congressional Budget Office. "Economic Effects of reducing the Fiscal Restraint that is Scheduled to Occur in 2013". May 2012. <http://www.cbo.gov/sites/default/files/cbofiles/attachments/FiscalRestraint_0.pdf>

[2] Based on: Williams, R., E. Toder, D. Marron, and H. Nguyen. "Toppling off the Fiscal Cliff: Whose taxes rise and how much?". Tax Policy Center. October 1, 2012. <http://www.taxpolicycenter.org/UploadedPDF/412666-toppling-off-the-fiscal-cliff.pdf>

Expiration of extended emergency unemployment benefits	$30 billion
Reduction in Medicare payments rates to physicians	$14 billion
Total:	$123 billion

Based on estimates by the CBO, Macroeconomic Advisors, and the Tax Policy Center

Scheduled payroll tax and income tax rate increases will affect all income earners, while higher income earners will also face the expiration of an AMT patch and increased tax rates on their income due to legislated changes in the Affordable Care Act. Meanwhile, government expenditures will decline due to provisions of the Budget Control Act.

Short -Term Effects

The economic consequences of all of that fiscal tightening would be profoundly negative. In May of this year, the CBO released a study estimating the effects of the spending cuts and revenue increases on economic growth in the short term. Their estimation predicts that real GDP will grow by .5 percent in 2013 if these scheduled budgetary changes come into effect, as opposed to their estimate of 4.4 percent growth if all current policies are continued. Further, they predict that the first half of 2013 will experience an annual rate of contraction of 1.3 percent of GDP, followed by growth in the second half of 2013 at an annual rate of 2.3 percent[3]. In an updated analysis in November, the CBO predicted that GDP would actually shrink by .5 percent over 2013 with scheduled budgetary changes[4]. This pattern of growth, they note, would likely be considered a recession by the National Bureau of Economic Research.

Macroeconomics Advisors LLC has a similar analysis, stating last week that in their analysis, "GDP would contract in the first half of 2013 and grow just 1.1% over the four quarters of the year"[5]. This growth rate is slightly more optimistic than that of the CBO, but predicts a similar dynamic. The unemployment rate is also expected to increase in 2013 if all of the spending cuts and tax increases are realized.

While there is a significant amount of uncertainty regarding the exact scale of these effects, the fact that the fiscal cliff contains both tax increases and spending reductions means that even the most devout Keynesians and Supply Siders should agree that a recession would be likely next year if no deal can be struck to avoid these large and sudden changes.

The one bit of good news associated with this dire scenario is the dramatic improvement of the budgetary situation that would ensue. The CBO estimated that the deficit would be reduced by 4.7 percent of GDP between 2012 and 2013, resulting in an average annual deficit of 1.4 percent of GDP between 2013 and 2022, even when factoring in the weaker economic growth that they predict will happen in 2013.

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[3] Congressional Budget Office. "Economic Effects of reducing the Fiscal Restraint that is Scheduled to Occur in 2013". May 2012. <http://www.cbo.gov/sites/default/files/cbofiles/attachments/FiscalRestraint_0.pdf>

[4] Congressional Budget Office. "Economic Effects of Policies Contributing to Fiscal Tightening in 2013". November 2012. <http://www.cbo.gov/sites/default/files/cbofiles/attachments/11-08-12-FiscalTightening.pdf>

[5] Macroeconomic Advisors LLC. "Is the Cliff a Bargain?" Macroeconomic Advisors' Macro Focus, Volume 7, Number 2. November 29,2012.

Long-Term Effects

While the short term effects of the fiscal cliff have received wide spread attention throughout the past few months, discussion of the long term effects of high deficits that would result from an extension of current policy has been less prevalent. At the end of the CBO's November report on the economic effects of the policies comprising the fiscal cliff, after long discussion of growth effects in the short term, they conclude with a statement that:

> "Although reducing the fiscal tightening schedule to occur next year would boost output and employment in the short run, doing so without imposing a comparable amount of additional tightening in future years would reduce the nation's output and income in the longer run relative to what would occur if the scheduled tightening remained in place."

Large government deficits crowd our private resource accumulation, reducing economic growth in the medium and long terms. While a steep recession would follow from failure to make a deal, growth prospects in the medium and long term could improve if deficit reduction of that scale is accomplished.

These beneficial long term growth effects, of course, would depend on the form that the deficit reduction might take. But holding off discussion of that for a moment, research into the long term effects of high government debt has confirmed that it can negatively impact GDP growth, especially above a certain threshold. If we extend current policy and continue incurring annual deficits of close to 6 percent of GDP, then we will surely experience slower GDP growth in the long term as a consequence. Any discussion of the fiscal cliff and its consequences must include an examination of the tradeoffs between short term and long term growth, because while the short term effect of the fiscal cliff is negative, reversing it would have negative effects in the long term.

Evidence of the long term effects of high government debt to GDP ratios has been supplied by a number of recent studies. In a widely cited paper reviewing forty-four countries over about two hundred years, Reinhart and Rogoff document a strong relationship between high debt levels and slow GDP growth[6]. They find that this relationship is especially strong when countries exceed a gross debt to GDP level of 90 percent. This relationship holds true when examining all of the countries in their sample and when they restrict their analysis to developed economies.

Although the Reinhart and Rogoff analysis has been criticized for implying only correlation and not controlling for other factors that may impede growth and lead to high levels of debt, a separate IMF Working Paper by Manmohan S. Kumar and Jeajoon Woo confirmed their findings that higher levels of government debt lead to lower levels of growth[7]. They estimate that a 10 percentage point increase in Debt as a percentage of GDP is associated with an annual decrease in .2 percentage points of GDP growth. They also find some evidence that this effect is stronger with higher levels of debt.

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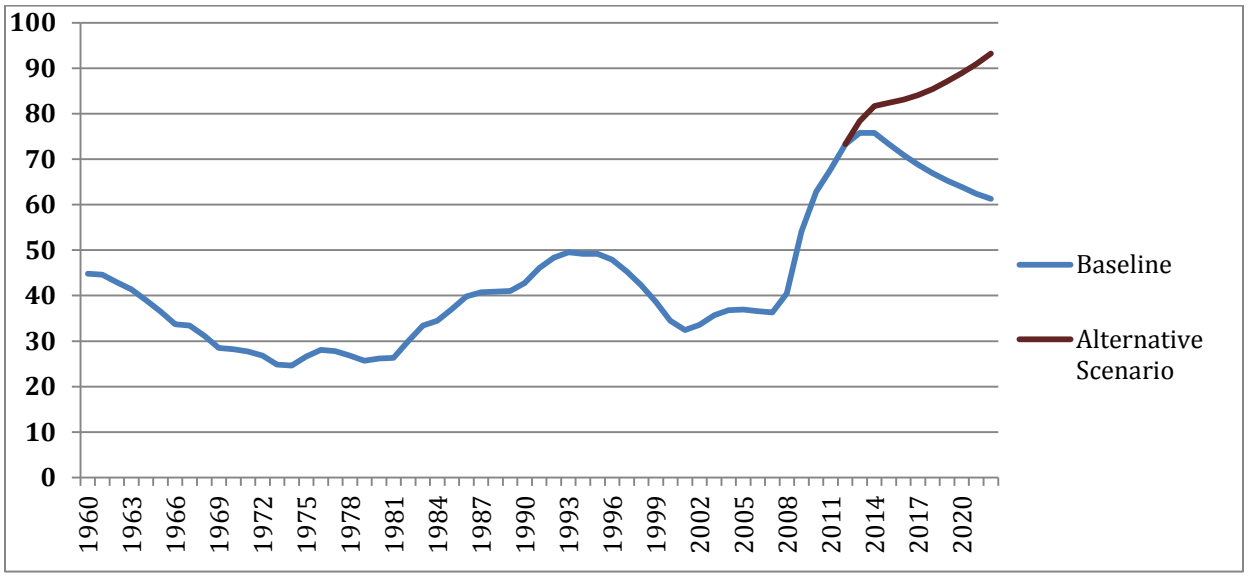
[6] Carmen M. Reinhart and Kenneth S. Rogoff, "Growth in a Time of Debt." National Bureau of Economic Research Working Paper 15639. January 2010. <http://www.nber.org/papers/w15639>

[7] Manmohan S. Kumar and Jaejoon Woo, "Public Debt and Growth." IMF Working Paper WP/10/174. July 2010. <http://www.imf.org/external/pubs/ft/wp/2010/wp10174.pdf>

These results are further corroborated in a study by Mehmet Caner, Thomas Grennes, and Fritzi Koehler-Geib which tries to identify a "tipping point" in debt to GDP ratios that leads to lower growth[8]. In their estimate, debt to GDP ratios above about 77 percent lead to slowed annual GDP growth, with an increase in each percentage point of debt reducing annual growth by about .017 percentage points.

A simple calculation can help provide some intuition for this result. If we were to, all else equal, run deficits of 6 percent of GDP for the next 10 years, then the debt to GDP ratio would climb by nearly 60 percentage points. That increase would be enough, at the end of the decade, to reduce annual growth forecasts by around 1 percentage point per year.

Taken together, these studies suggest that the United States is headed down a path to lower annual growth if we maintain our current policies. A simple chart of the growth in the Debt to GDP ratio shows why.

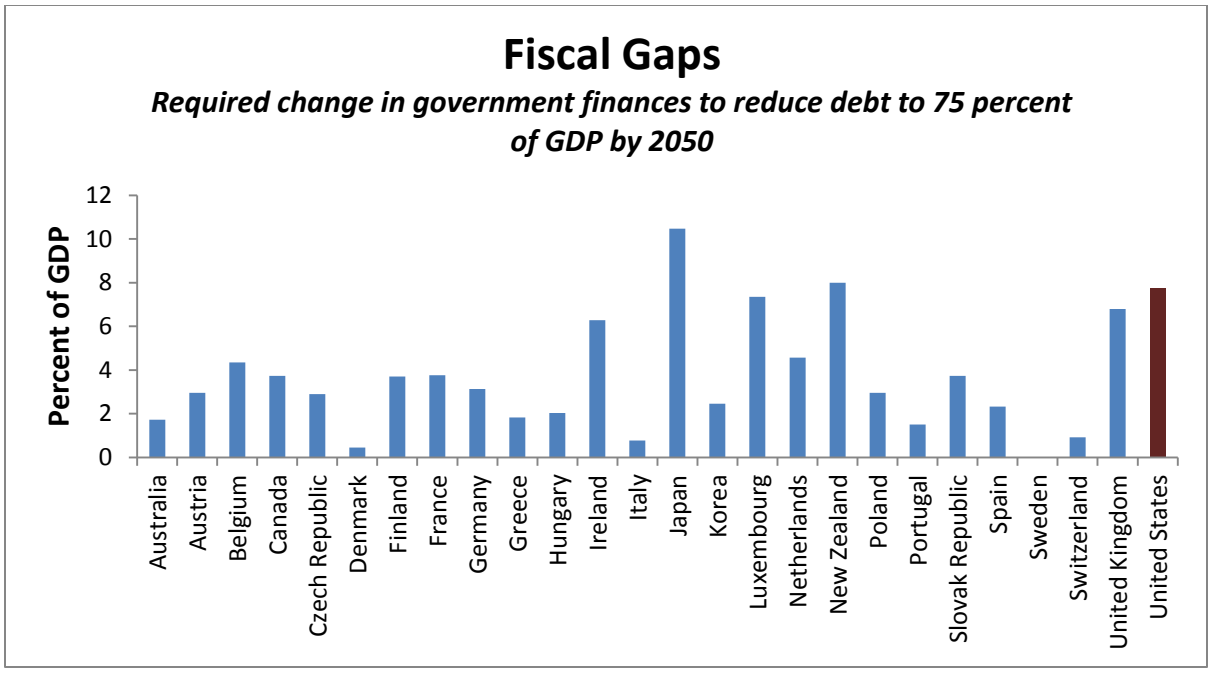


Source: CBO

Under the CBO's "Alternative fiscal scenario" projection, which assumes that all current tax levels are extended, with the exception of the payroll tax holiday, the AMT is indexed for inflation, Medicare's payment rates are held constant and the sequester required by the Budget Control Act does not happen, deficits between 2013 and 2022 will average 5.3 percent of GDP. This would lead to an increase in the deb to 93 percent of GDP within ten years. In its "baseline" projections, the debt as a percentage of GDP would decrease to 61.3 percent by the end of 2012[9].

[8] Mehmet Caner, Thomas Grennes and Fritzi Koehler-Geib, "Finding the Tipping Point – When Sovereign Debt Turns Bad." May 19,2010. Available at SSRN: http://ssrn.com/abstract=1612407

[9] Congressional Budget Office. 'Updated Budget Projections: Fiscal years 2012 to 2022." March 2012. <http://www.cbo.gov/sites/default/files/cbofiles/attachments/March2012Baseline.pdf>



Source: Merola, R. and D. Sutherland (2012) OECD.

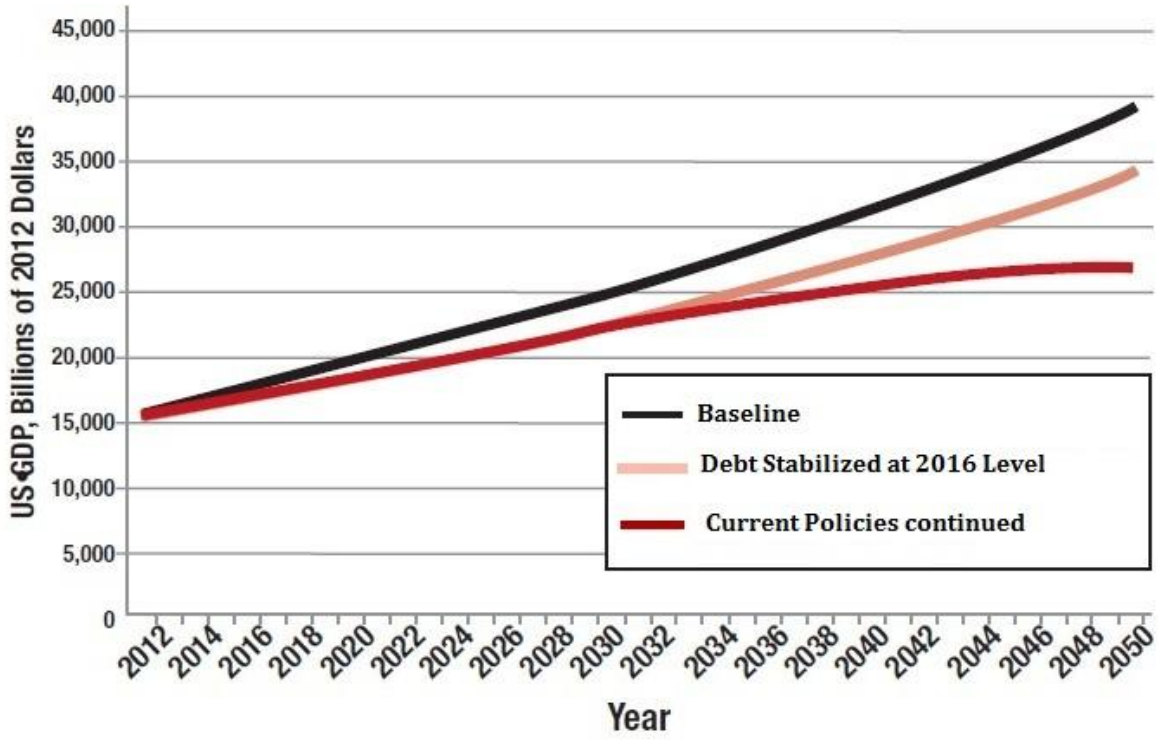
That growth story might be alarming, but the picture looks even worse when we compare ourselves to our developed trading partners. This year, much of Europe has been in turmoil because of the Greek debt crisis, but in many ways, the sickest European nations are actually in better shape than us. While the US debt may seem manageable to many who look at struggles in other countries and take consolation in our relative stability, the situation of the US today, when taken in the long run, is actually further from debt stability than many other developed countries. A recent study by Merola and Sutherland of the Organisation for Economic Co-operation and Development (OECD) examined long-term projections for OECD countries' debt burdens[10]. Taking into account growth in the cost of pensions and health care in the future (but including assumptions that policies will be put in place to control their quickly rising costs), the researchers calculate how much governments would need to immediately and permanently change their fiscal patterns to reduce their debt to 75 percent of GDP by 2050. For the US, this number is 7.78 percent of GDP – the third highest in the sample.

As bad as the medium growth outlook becomes, if we look past the medium term, the story gets even worse. For most of us, we have grown accustomed to living in an America that can be expected to post positive economic growth each year. Our irresponsible fiscal policies suggest our children may expect no such thing.

Given that previous research has estimated the effect that higher debt to GDP ratios have on economic growth, it is possible to theorize about how a continuation of today's policies could hurt

[10] Merola, R. and D. Sutherland (2012), "Fiscal Consolidation: Part 3. Long-Run Projections and Fiscal Gap Calculations", *OECD Economics Department Working Papers*, No. 934, OECD Publishing. http://dx.doi.org/10.1787/5k9h28p42pf1-en

growth in the future. Michael Boskin, in a recent SIEPR policy brief[11], did just that. Using both the IMF Working Paper's estimates and estimates from Reinhart and Rogoff's work, Boskin calculates the effect on GDP if current policies are continued and compares it to a scenario in which deficit reduction is started and the debt is stabilized at its 2016 level and a baseline in which growth is not affected. The chart below is a representation of GDP growth factoring in the effect of debt as estimated in the IMF Kumar and Woo study.



Factoring in lowered GDP growth, Boskin calculates that if current policies are continued GDP will be 30.4 percent lower in 2050 than if there were no effect of debt on growth. Even if the debt is stabilized in 2016, GDP will still suffer in the future; its level in 2050 would be 12.1 percent lower compared to the baseline. According to his calculations, growth will essentially stagnate by the 2040s.

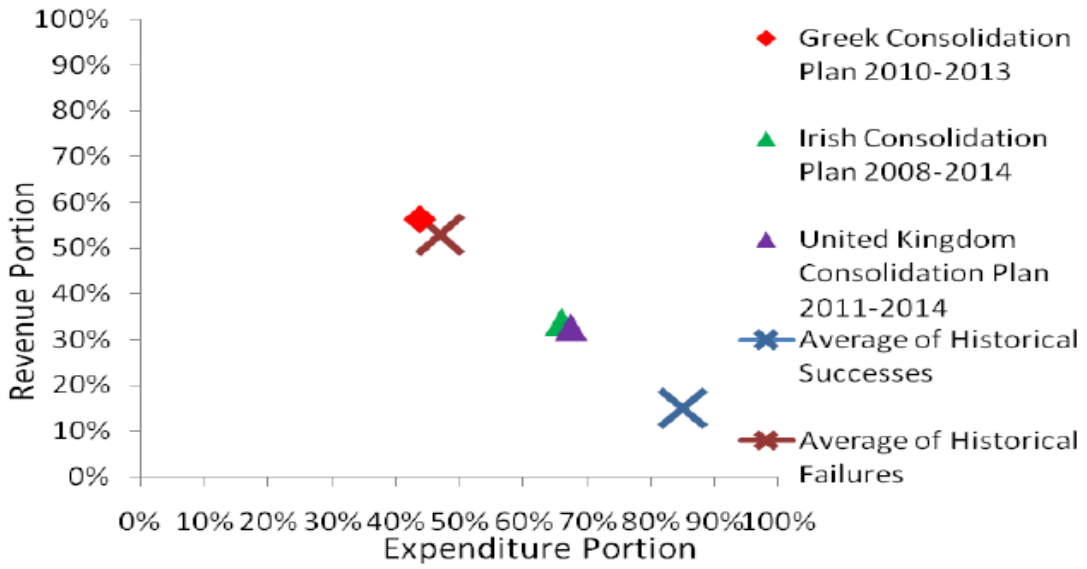
What can we do?

While the fiscal cliff may lead to smaller economic growth in the short term, it may also provide us with an opportunity to discuss the deficit reduction that will become necessary to prevent further stagnation in the future. The path of current policy is clearly not sustainable in the long term, and a change is needed in order to stabilize the debt in the long run and provide ourselves a path to economic prosperity in the coming decades.

[11] Boskin, Michael. "A Note on the effects of the Higher National Debt on Economic Growth." SEIPR Policy Brief. Stanford University. October 2012. <http://siepr.stanford.edu/?q=/system/files/shared/pubs/papers/briefs/pb_11_2012.pdf>

Luckily for policy makers here, other countries have undergone fiscal consolidation in the past, providing us examples of what policies are successful and which ones have failed. Along with two colleagues, I have written an analysis[12] exploring policy mixes in successful and failed fiscal consolidations in 21 OECD countries. Based on the evidence that we found, along with previous economic literature on the subject, we have concluded that fiscal consolidations based more heavily on expenditure cuts than revenue increases are more likely to be successful at producing lasting reductions in debt.

Using a range of different methodologies, we find that the average unsuccessful fiscal consolidation relied upon 53 percent tax increases and 47 percent spending cuts, while a typical successful consolidation consisted of 85 percent expenditure cuts. We also found that cuts to social transfers were more likely to reduce deficits than other expenditure cuts. The chart below shows the composition of average successful and unsuccessful consolidation plans, along with a few measures taken recently by other countries.



Other research has reported similar findings, most notably and earlier paper by Alesina and Perotti[13], which found that consolidations successful in reducing debt consisted of 64 percent spending cuts and 36 percent tax increases. Similarly, McDermott and Wescott[14] found in a survey

[12] Andrew G. Biggs, Kevin A. Hassett, and Matthew Jensen, "A Guide for Deficit Reduction in the United States Based on Historical Consolidations That Worked," AEI Economic Policy Working Paper 2010-04 (2010) http://www.aei.org/paper/100179.

[13] Alberto Alesina and Roberto Perotti, "Fiscal Adjustments in OECD Countries: Composition and Macroeconomic Effects," *NBER Working Paper* 5730 (1996)

[14] McDermott, C. John and Wescott, Robert, An Empirical Analysis of Fiscal Adjustments (June 1996). IMF Working Paper, Vol. pp. 1-26, 1996. Available at SSRN: http://ssrn.com/abstract=882959

of fiscal consolidations that expenditure-based consolidations had a 41 percent chance of success; while revenue-based consolidations have only a 16 percent success rate.

Recently, Alesina, Favero, and GiaVezzi have produced an analysis[15] of the effect of fiscal consolidations on growth. In examining evidence from seventeen OECD countries between 1980 and 2005, they find that consolidations consisting mainly of tax increases generally have a more negative effect on growth than policy mixes dominated by cuts in expenditures. This is important, as one great concern of deficit cutting policies is their effect on short term growth. What their research suggests is that we may be able to avoid some of the expected effects of fiscal consolidation if policy is designed correctly. Indeed, a recent analysis by Cogan, Taylor and Wolters underscores how important fiscal consolidation will be for growth in the US, even in the short term[16]. The economists studied the potential effect of a gradual reduction in spending on growth in the overall economy. Even in the short term, implementation of this debt reduction strategy, they found, would lead to an increase in GDP, and the level of the overall economy remains higher than a baseline without deficit reduction in the long run.

Alesina and Ardagna added to this research by looking at how other policies adopted with fiscal consolidation can help or harm growth. Along with confirming that cutting expenditures was preferable to increases in taxes, they find that pro-growth reforms, such as labor market liberalization, can mitigate some negative outcomes of fiscal consolidation policies[17]. These lines of research, based upon previous fiscal consolidations and their outcomes, can inform the debate today about what policy mix we should aim for in addressing the growing debt.

Under current law, the fiscal cliff consists of about 80 percent revenue increases, with an estimated increase of $492 billion dollars in tax increases and $123 billion in spending cuts. This differs greatly from those consolidations that the economics literature identifies as successful. The proposal put forward by President Obama is even more unattractive and, indeed, would be guaranteed to fail given our past experience.

It is easy for an economist to design a reform that puts the U.S. back on a positive and sustainable economic path. I understand how difficult the politics of spending reduction can be, but if deficit reduction is pursued with a "balanced approach" that is weighed heavier on tax increases than about 15 percent, then the consolidation will almost surely fail. At that point, the pessimistic growth outlook discussed above would become a reality, and our children would live in a fundamentally different America than the one we are accustomed to. The stakes could not be higher.

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[15] Alesina, Alberto, Carlo Favero and Francesco GiaVazzi, "The output effect of fiscal consolidations", August 2012. NBER Working Paper 18336.

[16] Cogan, John F., John B. Taylor, Volker Wieland, and Maik Wolters, "Fiscal Consolidation Strategy" September 21, 2012

[17] Alesina, Alberto and Silvia Ardagna, "The Design of fiscal adjustments", October 2012. NBER Working Paper 18423.