Box 2

ECONOMIC IMPLICATIONS OF THE FISCAL RESTRAINT IN THE UNITED STATES IN 2013

Based on current legislation, the US economy is poised to experience a substantial fiscal tightening at the start of 2013, commonly referred to as the "fiscal cliff". This is due to the simultaneous expiration of a number of previously enacted tax cuts and emergency unemployment benefits, together with automatic reductions in public spending. This box reviews the nature of the measures behind the scheduled fiscal tightening, before presenting model-based estimates of their likely impact on the US economy.

Table A US fiscal restraint in 2013 ("fiscal cliff")

	USD billions	Percentage of GDP
From tax policies	**532**	**3.3**
Expiration of "Bush tax cuts" (Dec. 2012) 1)	295	1.8
Expiration of the payroll tax cut (Dec. 2012)	127	0.8
Other expiring provisions (Dec. 2012) 2)	87	0.5
Some tax provisions under the Affordable Care Act (Jan. 2013) 3)	24	0.1
From expenditure policies	**136**	**0.8**
Provisions of the Budget Control Act – "sequester" (Jan. 2013)	87	0.5
Expiration of the emergency unemployment benefits (Dec. 2012)	35	0.2
Reduction in Medicare's payment rates for physicians (Jan. 2013)	15	0.1
TOTAL	**668**	**4.1**

Sources: CBO and ECB staff.
Note: The CBO estimates, which are reported for the 2013 fiscal year (Oct. 2012 – Sep. 2013), have been adjusted to correspond to the 2013 calendar year.
1) Includes the expiration of certain income tax provisions originally enacted in 2001, 2003 and 2009 and of indexing for the alternative minimum tax (AMT) for inflation.
2) Largely relates to the scheduled expiration of the accelerated depreciation allowance for fixed investment property.
3) Including increased tax rates on earnings and investment income for high-income taxpayers.

Details of the US "fiscal cliff"

Under current law, the US federal budget deficit is expected to decline substantially between 2012 and 2013 owing to the scheduled increase in taxes and, to a lesser extent, reductions in spending (see Table A). Calculations based on Congressional Budget Office (CBO) estimates suggest that the size of the fiscal cliff is above USD 650 billion for the 2013 calendar year, representing around 4% of GDP. Around 80% of the tightening is scheduled to take effect via changes in tax policies, with the most notable being: (i) expiring provisions which lower individual income tax rates and expand credits and deductions, originally enacted in 2001 and 2003 (so-called "Bush tax cuts") and in 2009; (ii) expiration of the 2 percentage point payroll tax cut originally introduced in January 2011; (iii) expiration of the accelerated depreciation allowance for fixed investment property (such as machinery), the major item within the category "Other expiring provisions" shown in Table A. On the expenditure side, major items are the automatic enforcement of spending cuts under the Budget Control Act (so-called "sequester") and expiring emergency unemployment benefits.

The extent to which the legislated provisions of the fiscal cliff are likely to materialise is subject to a high degree of uncertainty and remains conditional on the outcome of the US elections in November 2012, given that most of the decisions regarding possible extensions are postponed until then. One possible outcome appears to be a scenario in which some of the provisions are allowed to expire, while others are extended.

Estimating the impact of the fiscal cliff

Estimating the economic impact of fiscal contractions is made more difficult by the uncertainty surrounding the size of fiscal multipliers. The impact of the fiscal cliff on the real economy is assessed using NiGEM.[1] In the model, a range of fiscal multipliers operate, relating to income and corporate taxes, as well as to government transfer payments and government consumption. Given the uncertainty as regards the final outcome, the estimates of the economic impact of the

1 NiGEM stands for National Institute Global Econometric Model, a model maintained by the National Institute of Economic and Social Research (http://nimodel.niesr.ac.uk/).

Table B Impact of US fiscal cliff on economic activity

(deviation of US real GDP from baseline levels in percentage points)

	2013	2014
Fiscal cliff	-1.3	-1.8
Fiscal cliff excluding "sequester"	-0.7	-1.3
Fiscal cliff excluding "sequester" and extending "Bush tax cuts"	-0.3	-0.6

Source: ECB staff.

"full" fiscal cliff are complemented by two additional scenarios. Under the first scenario, the so-called "sequester" is avoided and possibly replaced with less abrupt deficit reduction measures, meaning that almost all of the fiscal tightening occurs via changes in tax policy measures. Under the second scenario, in addition to avoiding the "sequester", the "Bush tax cuts" are extended, while all other provisions are allowed to expire as scheduled. The results are reported in Table B. In 2013 the entire fiscal cliff is estimated to lower US real GDP by 1.3 percentage points, while in 2014 US GDP is estimated to remain 1.8 percentage points below its baseline level. The magnitude of this impact reflects the fact that the largest portion of the fiscal cliff relates to income tax measures, which carry a rather low fiscal multiplier of about 0.3.[2] At the same time, only about 12% of the fiscal cliff relates to government spending measures (the "sequester" in Table A), which is given a significantly larger multiplier of about 1.0.

For 2013, however, a greater downward impact could be expected since, according to the CBO, an additional drag of almost 1% of GDP will occur in that year, mostly related to revenues (hence carrying a low multiplier), which is "not linked to specific policies" and has not been included in the simulations as the size of these measures could not be quantified for 2014, given the lack of details provided. Under the scenario in which the "sequester" is avoided, the impact on GDP is reduced by almost one-half in 2013 compared with the full fiscal cliff scenario, while under the second scenario, where the "Bush tax cuts" are extended in addition, the fiscal drag is estimated to reduce GDP by 0.3 and 0.6 percentage points in 2013 and 2014, respectively.

Overall, the results based on NiGEM for 2013 are somewhat below externally available estimates. For example, in its 2012 Spillover Report, the IMF estimates US output losses in 2013 stemming from the fiscal cliff to lie in a range between 2.0 and 4.8 percentage points, although the upper range of these estimates also incorporates adverse confidence effects adding to the fiscal restraint. The CBO has estimated that the fiscal cliff could reduce US output in the fourth quarter of 2013 by 3.9 percentage points relative to a baseline with no fiscal restraint, with a wide range around that point estimate (from 0.9 to 6.8 percentage points), which underscores the uncertainties regarding the size of fiscal multipliers.[3] Adding to the uncertainty of estimates, the size of the impact is likely to depend also on the speed with which households react to a potential increase in taxes, and on whether they will perceive the change in policies as transitory or permanent. Moreover, the results shown in Table B might be subject to downside risk as they do not take into account possible adverse confidence effects that may arise if businesses and consumers start to perceive the risk of an abrupt fiscal withdrawal and restrain their spending plans. In conclusion, as the discussion above implies, the size of the impact depends significantly

2 The fiscal multiplier on US income taxes is 0.3 in NiGEM, which is broadly in line with the multipliers implied by models used at the OECD and the European Commission. See *National Institute Economic Review*, No 213, July 2010.

3 For details on alternative estimates, see Chapter 3 of IMF, *2012 Spillover Report*, July 2012 and CBO, *Economic Effects of Reducing the Fiscal Restraint that is Scheduled to Occur in 2013*, May 2012.

on whether it is mainly tax or spending measures that drive the fiscal cliff, given the large differences in the associated multipliers.

Conclusions and risks

Under current legislation in the United States, a fiscal tightening of about 4.1% of GDP can be expected in 2013. The likelihood of the entire fiscal cliff materialising, however, is relatively small, given that, barring a political gridlock in the upcoming elections, a number of measures are likely to be extended, at least in the short term, in line with the various political proposals that have been put forward. At the same time, given the large magnitude of the fiscal cliff, there is a risk to the US economic growth outlook. A model-based assessment finds that the impact on the US economy is large, but remains substantially below the 4.1% magnitude of the fiscal shock, owing to the fact that the largest portion of the fiscal cliff relates to income tax measures, which tend to have rather low fiscal multipliers.