Take Five (with Bill Emmons)

"Will We Go Over the Fiscal Cliff?"

Recorded on Monday, November 19, 2012

William R. Emmons
Assistant Vice President and Economist
Division of Banking Supervision and Regulation
Federal Reserve Bank of St. Louis

Take Five® is a service provided by the Federal Reserve Bank of St. Louis

Will We Go Over the Fiscal Cliff?

- What is the “fiscal cliff?”
- How is this likely to play out?
- What are some “silver linings” of going over the cliff?

What Is the Fiscal Cliff?

- The fiscal cliff is a set of federal tax and spending changes scheduled to take effect on January 1, 2013.

- The total impact is approximately $600 billion at an annual rate, or about four percent of the gross domestic product.
  - This is due mostly to the expiration of temporary tax cuts.
  - In addition, there will be a smaller amount of spending cuts resulting from sequestration agreed in August 2011.

- Not all impacts will hit on January 1. The total effect ramps up over time.

- Nonetheless, most economists expect a recession in 2013 if all the changes take effect.

How Is This Going to Play Out?

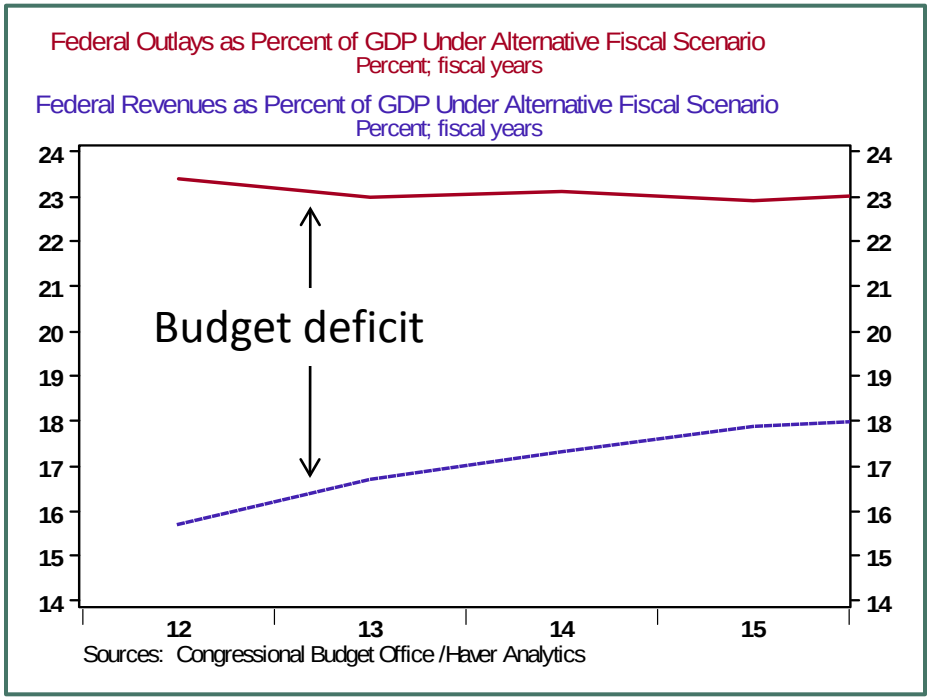
- Scenario 1: A compromise is reached in the lame-duck session of Congress and accepted by the President, postponing some provisions, allowing others to go into effect.
  - There may be some slowing effect on economy, but no recession; little change in the budget deficit will occur.
  - How likely? There is a 50-50 chance, in my opinion.

- Scenario 2: An agreement is reached to postpone all of the changes except for payroll-tax holiday.
  - This is referred to as "kicking the can down the road." No recession will occur, but no deficit progress will be made.
  - How likely? There is a 25 percent chance.

- Scenario 3: No agreement will be reached.
  - This would be "going over the cliff." Recession would be likely, but significant progress on deficit will occur.
  - How likely? There is a 25 percent chance.

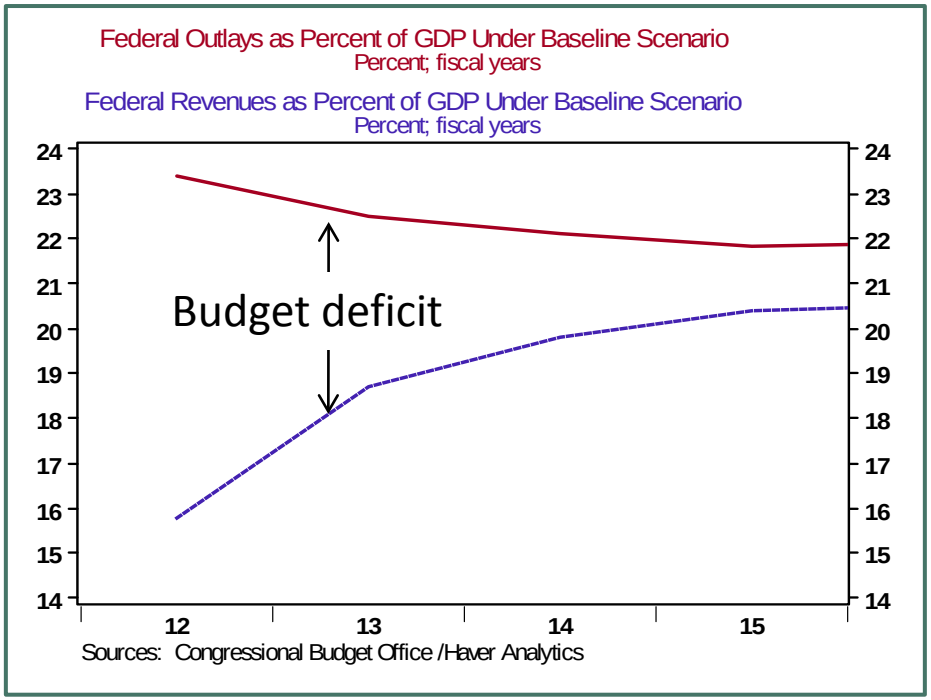
A Silver Lining of Going Over the Cliff: Significant Progress Toward Budget Balance

- Federal outlays and revenues:
  - "Kick the can down the road" (scenario 2)



- This will avoid a recession in 2013, but make no progress toward solving the deficit problem.

- Federal outlays and revenues:
  - "Going over the fiscal cliff" (scenario 3)



- This would cause a recession in 2013, but make progress toward solving the deficit problem.

Annual data, fiscal years

Don’t Panic About the Fiscal Cliff!

- We probably won’t go over it.

- Even if we do, there are silver linings:
  - It will make significant progress toward long-term budget balance.
  - It would reduce the uncertainty that has been depressing business and consumer confidence.

- Fears of drastic economic harm may be exaggerated.
  - The Fed would likely respond.
  - Congress can offset sequestration cuts with other spending.
  - Most of the changes are expiring tax cuts.
  - We have known since 2001 that these cuts were going away!
  - Evidence shows that tax rate changes for high-income taxpayers at current levels have minimal effects on economic growth.

For More Information

- Congressional Budget Office, "An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022," August 21, 2012: www.cbo.gov/publication/43539

- Congressional Budget Office, "Choices for Deficit Reduction," November 8, 2012: www.cbo.gov/publication/43692

- Congressional Budget Office, "Economic Effects of Policies Contributing to Fiscal Tightening in 2013," November 8, 2012: http://www.cbo.gov/publication/43694