Insight

An Economic Guide to Cliff-Diving

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WASHINGTON – A new analysis from the American Action Forum finds that going over the fiscal cliff would not only have an effect on unemployment, but also on the financial markets as well. American Action Forum President Doug Holtz-Eakin and COO Cameron Smith found that "cliff diving would have significant impact on financial markets, impair asset values, exacerbate credit stringency, and amplify the direct effects on the main street economy. Moreover, contrary to what some have asserted, such impacts cannot be 'unwound' by retroactively legislating away the fiscal cliff."

Additionally, the AAF analysis finds that the fiscal cliff's impact on financial markets could result in a broader economic downturn as large as 3 percent of GDP. That downturn could "persist beyond the two quarters needed to qualify as a recession."

Introduction

The U.S. faces three distinct policy challenges that pose dangers to the nation's economic recovery and the well being of future generations. The first and most immediate danger is the fiscal cliff, a combination of $395 billion in tax increases and $145 billion in spending cuts set to take effect at the end of the year. The second issue is the need to raise the federal debt limit, which appears to be possible to defer to at least February or March of 2013. The third, and most perilous, is the fundamental unsustainability of the federal budget, which must be addressed seriously by August 2013, or risk a significant downgrade in the credit rating of Treasury securities.[1]

This short paper focuses on the fiscal cliff, the confluence of an array of fiscal policies occurring at the end of 2012. In particular, there are tax increases: (1) the sunset of the 2001 and 2003 so-called "Bush tax cuts," (2) the need to patch the alternative minimum tax (AMT) to keep it from impacting the middle class, (3) the sunset of the payroll tax holiday, (4) new taxes under the Affordable Care Act, and (5) the usual end-of-year tax "extenders" exemplified by the research and experimentation tax credit.

In addition, there are mechanistic spending cuts: (1) the across-the-board cuts ("sequester") required under the Budget Control Act of 2011, (2) cuts to reimbursement rates for physicians under Medicare, and (3) expiration of the extended unemployment insurance benefits.

While the fiscal cliff phenomenon has emerged as a near-obsession recently, considerable disagreement remains about the consequences of cliff diving – failing to avoid the fiscal cliff. In particular, some have argued that cliff diving is benign either because the cliff itself is an illusion – it is really a gentle slope – or because policymakers have the cartoon-like power to reverse going over the cliff without hitting the abyss.

Our analysis suggests that both arguments are undercut by the key role that would be played by financial markets. The reality of cliff diving would have significant impact on financial markets, impair asset values, exacerbate credit stringency, and amplify the direct effects on the main street economy. Moreover, contrary to what some have asserted, such impacts cannot be "unwound" by retroactively legislating away the fiscal cliff.

Accounting for the financial market analysis suggests that the economic downturn could easily be as large as 3 percent and persist beyond the two quarters needed to qualify as a recession as they commonly understood.