It’s a Slope, Not a Cliff

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By Chad Stone

Will the bell toll on the economic recovery at midnight December 31st if policymakers allow the tax and spending changes required under current law to kick in — that is, if we go over the so-called “fiscal cliff”? We’ve said no, and a new analysis by Goldman Sachs (GS) economists Alec Phillips and Jan Hatzius reaches broadly similar conclusions.

Policymakers still would have some time in early 2013 to work out a responsible long-term budget deal that reduces deficits in a way that does not wreck the recovery.

If the scheduled tax and spending changes take effect, the economy will start down a slope that would likely be relatively modest at first, but then much steeper if 2013 unfolds without a budget deal. Thus, if policymakers strike a deal before the economy has gone very far down that slope, any harm to the recovery is likely to be much smaller than if there is no agreement and all the “fiscal cliff” measures stay in effect.

Here’s how GS sees it:

> It is likely that if Congress were to fail to address this issue before the end of the year [2012], lawmakers would return in January and reach an agreement fairly quickly. The debt limit, which Congress must raise no later than early March according to our projections, might serve as a deadline for action on the fiscal cliff if public pressure hasn’t already forced an agreement. If, for example, an agreement were reached in January, we assume it would reinstate most policies retroactively, meaning that much of the effect would be reversed before the end of the quarter, reducing the overall economic effect.

Both sides of the political aisle have proposed extending President Bush’s “middle-class” tax cuts for another year. The sticking point is the upper-income Bush tax cuts. GS argues that it might be easier to reach agreement once all the tax cuts have expired, “since lawmakers could claim that setting tax rates and/or revenue levels higher than 2012 would nevertheless constitute a ‘tax cut’ compared with the policies that would be in effect in January 2013.”
GS goes on to argue that if policymakers appear likely to extend at least some of the tax cuts retroactively, the Treasury Department might have the flexibility to maintain tax withholding at 2012 levels for a while, which “would cushion the effect of a short lapse.”

Similarly, GS observes, government agencies might be able to phase in the automatic spending cuts (the “sequester”) that the Budget Control Act requires in 2013 if a budget deal appeared likely.

The fact that the economy will start down a slope in January, not plunge over a cliff, gives policymakers an opportunity to craft a responsible budget agreement in January or February if they can’t do it before then. If they seize that opportunity, the economy will be little the worse for wear as a result of the delay — and the budget outlook may be greatly improved.