



# The “Fiscal Cliff”: Macroeconomic Consequences of Tax Increases and Spending Cuts

Jane G. Gravelle  
Senior Specialist in Economic Policy

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## Summary

A major policy concern for Congress is when and whether to address the "fiscal cliff," a set of tax increases and spending cuts that would substantially reduce the deficit in 2013. In projections made in March 2012 by the Congressional Budget Office (CBO), this fiscal restraint, constituting 5.1% of output in 2013, would reduce growth to 0.5% from 4.4%. Unemployment would increase by 2 million. In August, updated estimates projected growth at a *negative* 0.5%.

Policy choices with respect to the fiscal cliff are difficult because of the conflict between short-run and long-run economic and budgetary objectives. In the short run, the reduction in demand from the reduced budget deficits could damage an already fragile recovery. In the longer run, however, deficit reduction is needed to address a projected unsustainable debt level.

For FY2013, compared with FY2012, the policy-related fiscal cliff is \$502 billion, 80% reflecting tax increases. There is an additional \$105 billion from economic changes. The expiration of the 2001, 2003, and 2009 tax cuts (extended in 2010) and the expiration of the alternative minimum tax (AMT) "patch," which indexes the AMT exemption for inflation, account for 44% of the policy-related fiscal cliff. Other tax provisions include expiration of the temporary two percentage-point reduction in the employee's Social Security payroll tax (19%); the expiration of other tax cuts, including depreciation and the "extenders" (13%); and taxes scheduled to come into effect as a part of health reform (4%). Spending reductions include the automatic spending cuts under the Budget Control Act (13%); the expiration of extended unemployment insurance benefits (5%); and the "doc fix" that will lower Medicare payments (2%). Most changes take effect after 2012, although the AMT and many of the extenders expired after 2011.

Legislative proposals up to this point have principally focused on extending the tax cuts. The Republican proposals (H.R. 8 and S. 3413) would extend the 2001 and 2003 Bush tax cuts for one year and the AMT patch for two years—45% of the policy-related cliff for FY2013. The Democrats' proposal (S. 3412), a third of the cliff, would not extend the Bush tax cuts for higher-income individuals, would extend some small provisions from the 2009 stimulus, and would extend the AMT patch for one year. Both proposals would extend depreciation provisions for small businesses. The Senate Finance Committee has approved a separate bill (S. 3521) that includes a two-year AMT patch extension, small business depreciation, and the extenders.

CBO estimates are similar to those of other forecasters. Estimates are uncertain; CBO suggests a range of potential reductions in growth from 0.9% to 6.8% if the fiscal cliff occurs. Thus, the effects could be much smaller, but they could also be significantly larger, than CBO's mid-point estimate. Different parts of the cliff have different effects per dollar of budgetary effects, with larger effects from the automatic budget cuts and ending extended unemployment benefits than from ending tax cuts for higher-income individuals. By one estimate, these two spending changes account for almost 20% of the cliff but 30% of the contraction. The so-called Bush tax cuts and the AMT patch account for 60% of the cliff and 50% of the contraction, whereas tax cuts for individuals with over \$250,000 in income account for 11% of the cliff and 7% of the contraction.

If the only policy issue were the trade-off between short-run contraction and long-run budget reduction, allowing the tax cuts to expire and replacing them with robust spending and transfer policies might be appropriate. However, there are fundamental disagreements about the role of tax increases versus spending cuts in reducing the debt, which some maintain support a temporary extension of some or all of the tax cuts while these issues are sorted out.

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## Introduction

A major policy concern for Congress is when and whether to address the “fiscal cliff,” a set of tax increases and spending cuts that would substantially reduce the deficit in 2013 relative to 2012.<sup>1</sup> According to projections in March 2012 by the Congressional Budget Office (CBO), this fiscal restraint constitutes 5.1% of output in 2013 and is projected to reduce growth to 0.5% from 4.4%. Unemployment would increase by 2 million.<sup>2</sup> CBO’s August 2012 midyear update of economic and budget projections projected growth for 2013 at an even lower level, a negative 0.5%, with a contraction of 2.9% in the first half of the year, which would likely be considered a recession. The unemployment rate would rise to 9.1% by the fourth quarter of 2013.<sup>3</sup>

Policy choices with respect to the fiscal cliff are difficult because of the conflict between short-run and long-run economic and budgetary objectives. In the short run, the reduction in demand from the reduced budget deficit could damage an already fragile recovery. In the longer run, however, deficit reduction is needed to address a projected unsustainable debt level.

Aside from these issues of short-run stimulus and long-run deficit reductions, a variety of other issues arise, such as effects of marginal tax rates on behavior and distributional considerations. These issues are acknowledged at the conclusion of the report but are not addressed in detail.

Some legislation has already been introduced, primarily associated with a temporary extension of some or all of the 2001 and 2003 (so-called Bush) tax cuts (last extended in 2010) and with the increased taxes under the alternative minimum tax (AMT). The latter provision has been the subject of a continual temporary “patch,” largely to keep the exemption current with inflation, with the last patch having expired at the end of 2011.<sup>4</sup> Republican proposals, H.R. 8 and S. 3413, would extend the Bush tax cuts for another year and extend the patch for two years. An amendment drafted by Senator Orrin Hatch would have extended the Bush tax cuts for another year with a one-year AMT patch for 2012 (S.Amdt. 2491 proposed but not offered to S. 2237). A Democratic proposal, S. 3412, would extend the Bush tax cuts, except for the estate tax and the tax cuts for high-income individuals, while also extending some provisions originally enacted in the 2009 stimulus legislation (the American Recovery and Reinvestment Act of 2009 [ARRA]; P.L. 111-5). S. 3412 has a one-year AMT patch for 2012. Legislation has also been proposed to address other expiring tax cuts.

The first section of this report summarizes the size and composition of the fiscal cliff. The next section provides information on legislative proposals, largely relating to expiring tax cuts. The

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<sup>1</sup> Ben Bernanke, Chairman of the Board of Governors of the Federal Reserve, dubbed the coming deficit changes a “fiscal cliff” in answer to questions while testifying before the House Committee on Financial Services, February 29, 2012. See Reuters, “Bernanke’s Q&A Testimony to House Panel,” February 29, 2012, at <http://www.reuters.com/article/2012/02/29/usa-fed-bernanke-idUSL2E8DT2MG20120229>.

<sup>2</sup> CBO refers to these provisions as fiscal restraint, rather than the term “fiscal cliff” in popular use, although they acknowledge the use of that term. Congressional Budget Office, *Economic Effects of Reducing the Fiscal Restraint That Is Scheduled to Occur in 2013*, May 2012, at [http://www.cbo.gov/sites/default/files/cbofiles/attachments/FiscalRestraint\\_0.pdf](http://www.cbo.gov/sites/default/files/cbofiles/attachments/FiscalRestraint_0.pdf).

<sup>3</sup> Congressional Budget Office, *An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022*, August 2012, at [http://www.cbo.gov/sites/default/files/cbofiles/attachments/08-22-2012-Update\\_to\\_Outlook.pdf](http://www.cbo.gov/sites/default/files/cbofiles/attachments/08-22-2012-Update_to_Outlook.pdf).

<sup>4</sup> See CRS Report R42485, *An Overview of Tax Provisions Expiring in 2012*, by Margot L. Crandall-Hollick; CRS Report R42020, *The 2001 and 2003 Bush Tax Cuts and Deficit Reduction*, by Thomas L. Hungerford; and CRS Report RL30149, *The Alternative Minimum Tax for Individuals*, by Steven Maguire.

next two sections review, in turn, the aggregate economic effects and the differential effects of components of the cliff. The final section discusses policy options.

Additional information on elements of the fiscal cliff is available in CRS Report R42654, *Major Fiscal Issues Before Congress in FY2013*, coordinated by Mindy R. Levit; CRS Report R42622, *An Overview and Comparison of Proposals to Extend the "Bush Tax Cuts": S. 3412, S. 3413, H.R. 8*, by Margot L. Crandall-Hollick; and CRS Report R42485, *An Overview of Tax Provisions Expiring in 2012*, by Margot L. Crandall-Hollick.

## The Size and Composition of the Fiscal Cliff

The Congressional Budget Office defines the fiscal restraint as being composed of the following:<sup>5</sup>

- The expiration of tax cuts originally enacted in 2001 and 2003 (popularly referred to as the Bush tax cuts), and extended in December 2010, which will expire at the end of 2012. The 2001 tax cuts include the 10% rate bracket (lowered from 15%) and the lower rates for higher-income individuals (25%, 28%, 33%, and 35%, compared with 28%, 31%, 36%, and 39.6%); the elimination of the phase-out of itemized deductions and personal exemptions (PEP and Pease); the increase in the child credit; the provisions reducing the marriage penalty (increasing the standard deduction and width of lower rate brackets for joint returns); the reduction in the estate tax; and some other smaller provisions. The 2003 tax cuts are the lower rates for dividends (15% rather than ordinary income tax rates) and capital gains (15% rather than 20%).<sup>6</sup>
- The expiration after 2012 of some smaller tax provisions enacted in the 2009 stimulus legislation—generally more beneficial provisions for education (American Opportunity Credit) and greater refundability of the child credit.
- The AMT “patch,” a temporary increase in the exemption for the alternative minimum tax to reflect inflation, along with some smaller changes to continue allowing certain credits against the tax. The AMT patch has already expired at the end of 2011.
- The temporary two-percentage-point reduction in the employee’s share of the Social Security payroll tax that expires at the end of 2012.
- Other tax provisions that expired at the end of 2011, or are scheduled to expire at the end of 2012, the largest of which is the expiration of bonus depreciation (end of 2012). Also included are expensing provisions for small business (Section 179 expensing) and the “extenders,” a series of temporary provisions that are normally reinstated whenever they expire.

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<sup>5</sup> From Congressional Budget Office, *Economic Effects of Reducing the Fiscal Restraint That Is Scheduled to Occur in 2013*, May 2012, at [http://www.cbo.gov/sites/default/files/cbofiles/attachments/FiscalRestraint\\_0.pdf](http://www.cbo.gov/sites/default/files/cbofiles/attachments/FiscalRestraint_0.pdf). See CRS Report R42654, *Major Fiscal Issues Before Congress in FY2013*, coordinated by Mindy R. Levit, for more detail on the composition of the fiscal cliff.

<sup>6</sup> For additional detail on these and other expiring tax provisions, see CRS Report R42485, *An Overview of Tax Provisions Expiring in 2012*, by Margot L. Crandall-Hollick. Also see CRS Report R42020, *The 2001 and 2003 Bush Tax Cuts and Deficit Reduction*, by Thomas L. Hungerford.

- Taxes imposed beginning in 2013 by the Affordable Care Act (health reform), including the additional "Medicare" tax<sup>7</sup> and other taxes, such as those on medical devices.
- The automatic spending reductions in the Budget Control Act (BCA) adopted in 2011.
- The lapse of extended unemployment benefits at the end of 2012.
- Reductions in payments to physicians under the Medicare Sustainable Growth Rates that have been overridden only on a temporary basis and will take effect automatically. Increasing these payments is referred to as the "doc fix."<sup>8</sup>

**Table 1** lists the effects on the deficit of those provisions for FY2013 compared with FY2012, with the first three bulleted items listed above combined. Because most provisions change on a calendar year basis, the effect on FY2013, which ends at the end of September, reflects the effects for the first three quarters of the calendar year and not the full year's effect. The share of the calendar year effect reflected in the fiscal year varies, however, from one provision to another. For example, the rate changes in the 2001 tax cuts would be reflected in withholding at the beginning of 2013, so that the FY2013 changes would generally capture less than a year's effect. The effects of the lapse of the AMT patch in 2011 would largely be reflected in FY2013, because it is not generally captured in withholding, but would be collected when tax returns are filed by mid-April of 2013. Effects of the estate tax would generally be small because of the lag in filing estate tax returns.

As **Table 1** shows, the fiscal cliff is largely composed of tax increases, which account for 80% of the total associated with specific legislative changes, and two-thirds of the total when including changes arising from non-policy sources. CBO also analyzes a subset of these provisions that are part of its alternative baseline. While CBO's baseline reflects current laws (and hence assumes the Bush tax cuts expire at the end of 2012), the alternative baseline assumes that all tax cuts except the payroll tax reduction will be extended, the AMT patch occurs, the doc fix is made each year, and the Budget Control Act automatic spending cuts do not occur, although the discretionary spending caps remain.<sup>9</sup> This scenario, therefore, assumes that the payroll tax cuts would not be extended, that the health taxes would occur as scheduled, and that the extended emergency unemployment benefits would not be continued. The provisions that are retained as part of the alternative baseline account for \$362 billion of the \$607 billion total in **Table 1**, or 60% of the total, and 72% of policy-related changes. Within the \$362 billion, 79% of this amount covers extensions of expiring tax cuts, 3% the doc fix, and the remaining 18% spending effects.

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<sup>7</sup> This tax is popularly referred to as the Medicare tax because it increases the Medicare rates and extends Medicare rates to unearned income for high-income individuals. The revenue, however, does not go to the Medicare trust fund, but is part of the financing of the health reform provisions.

<sup>8</sup> See CRS Report R40907, *Medicare Physician Payment Updates and the Sustainable Growth Rate (SGR) System*, by Jim Hahn and Janemarie Mulvey.

<sup>9</sup> See Congressional Budget Office, *Updated Budget Projections: Fiscal Years 2012 to 2022*, March 2012, at <http://www.cbo.gov/sites/default/files/cbofiles/attachments/March2012Baseline.pdf>. See CRS Report R42654, *Major Fiscal Issues Before Congress in FY2013*, coordinated by Mindy R. Levit, for more detail on the composition of the fiscal cliff.

**Table 1. CBO Estimates of the Fiscal Cliff—Reductions in the Budget Deficit in FY2013 Compared with FY2012**  
(\$ billions)

Provision	Decreases in the Deficit
Tax Increases	\$399
Individual Income Tax Cuts and Estate and Gift Tax (from 2001, 2003, and 2009) extended in 2010, and AMT Patch	221
Temporary Payroll Tax Reduction	95
Other Expiring Provisions	65
Affordable Care Act	18
Spending Reductions	102
Automatic Spending Cuts	65
Unemployment Insurance	26
Doc Fix	11
Other Changes (Not Associated with Policy Changes)	105
<b>Total</b>	<b>607</b>

**Source:** Congressional Budget Office, *Economic Effects of Reducing the Fiscal Restraint That Is Scheduled to Occur in 2013*, May 2012, at [http://www.cbo.gov/sites/default/files/cbofiles/attachments/FiscalRestraint\\_0.pdf](http://www.cbo.gov/sites/default/files/cbofiles/attachments/FiscalRestraint_0.pdf). CBO has reported some of these provisions in their August updates with minor changes. See *An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022*, August 2012, at [http://www.cbo.gov/sites/default/files/cbofiles/attachments/08-22-2012-Update\\_to\\_Outlook.pdf](http://www.cbo.gov/sites/default/files/cbofiles/attachments/08-22-2012-Update_to_Outlook.pdf).

In **Table 1**, many of the estimates are in broad categories. Expirations of individual income tax cuts are largely combined into one major category that accounts for 44% of the policy-related fiscal cliff of \$502 billion. Extension of these tax cuts has been the major focus of legislative efforts to substantially reduce the fiscal cliff.<sup>10</sup> Note also that, by combining these provisions, there are no separate estimates of the three expiring provisions listed in the second line in **Table 1**. In particular, the AMT patch, which may be the most likely of the provisions to be adopted and might be altered earlier than other provisions (because it relates to tax returns being filed as early as January 2013), does not have a separate estimate. However, CBO has elsewhere reported separate estimates that indicate that the estimate for the AMT patch is \$89 billion, making it 40% of the total for the sum of the AMT plus the 2001, 2003, and 2009 tax cuts.<sup>11</sup> Note, however, that interactions between provisions means that it will make a difference whether the AMT is patched by assuming the Bush tax cuts expire or are made permanent. The patch costs more when the tax rates are lower because more taxpayers fall under the AMT. The cost of the AMT patch would be larger if it was estimated by assuming the tax cuts are made permanent.

While not an official "score," **Table 2** provides detailed estimates for FY2013 and FY2014 of the deficit effects of the provisions in the fiscal cliff by the Committee for a Responsible Federal

<sup>10</sup> In addition, H.R. 5652, passed by the House, would replace the current sequester in the Budget Control Act with specific cuts and make minor reductions in the FY2013 deficit, with larger deficit reductions in the future. There are other proposals as well. See CRS Report R42654, *Major Fiscal Issues Before Congress in FY2013*, coordinated by Mindy R. Levit for a discussion.

<sup>11</sup> See supplementary tables for CBO's *The Budget and Economic Outlook: Fiscal Years 2012 to 2022*, January 31, 2012, at <http://www.cbo.gov/publication/42910>.

Budget (CRFB).<sup>12</sup> This table estimates the increase in the deficit compared with current law due to a permanent extension of expiring tax cuts, AMT patch, and extenders, and a permanent elimination of most spending cuts, including the doc fix. It also assumes that the Affordable Care Act taxes will not take effect. However, it assumes that the payroll tax and additional unemployment benefits are extended for one year. These estimates have more detail on the components of the cliff as compared with **Table 1**. They can also be calculated for both FY2013 and FY2014. The estimates for two fiscal years provide some insight into timing effects. These effects are important because, the earlier the effects occur, the greater the contraction in short-run demand. The estimates in **Table 2** differ from **Table 1**, which reports the projected decreases in the deficit, including changes outside of policy choices. Hence, the total CRFB estimates are about \$500 billion, the rough total of policy-related provisions in **Table 1**, and do not include the additional \$105 billion from economic and technical factors not related to policy.

If all taxes were reflected only in withholding, the FY2014 costs would be slightly more than a third the size of the FY2013 cost because FY2013 is only three-fourths of calendar year 2013. This pattern is seen in the rate reductions at higher-income levels. For many of the tax changes, outside of rate reductions, effects are less likely to be fully captured in withholding, and they occur when tax returns are filed. Thus a smaller effect occurs in FY2013, and effects for calendar year 2013 would in part appear with the filing of tax returns in 2014. Capital gains revenue patterns appear to measure the effect of not extending the lower rate and presumably include the expectation that gains would be realized in the last quarter of 2012 in advance of the tax rate increase (and thus reflected in 2013 with the filing of FY2012 tax returns). Very little of the estate tax revenues would be reflected in FY2013 because estate tax returns do not need to be filed until nine months after death (so that no estate tax returns would be required in FY2013 for calendar year 2013 decedents); these returns are also sometimes allowed extensions.

Because the AMT patch has already expired for 2012 and is in part reflected when returns are filed, more tax increase occurs in FY2013 than in subsequent years. Note also that the AMT patch costs more if the lower tax rates are extended, and there is also then a different distribution across fiscal years. If the tax cuts expire, the higher regular tax rates mean that fewer individuals will be on the AMT. Thus the \$90 billion figure for FY2013 is the cost if current law remains in place (and higher tax rates come into play), whereas \$125 billion is the cost if tax cuts are extended. In revenue estimates presented for legislative proposals, the AMT is scored last and so reflects the rate changes included in the bills. Note that some proposals would provide a two-year AMT patch, and the second year would largely appear in FY2014.

Because the Social Security payroll tax and unemployment benefits are assumed to be extended for only a year, the costs of those policies are concentrated in FY2013.

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<sup>12</sup> Committee for a Responsible Federal Budget, *Between a Mountain of Debt and a Fiscal Cliff*, updated July 16, 2012, at [http://crfb.org/sites/default/files/Between\\_a\\_Mountain\\_of\\_Debt\\_and\\_a\\_Fiscal\\_Cliff.pdf](http://crfb.org/sites/default/files/Between_a_Mountain_of_Debt_and_a_Fiscal_Cliff.pdf).



**Table 2. Increases in the Deficit Due to Changing the Fiscal Cliff, FY2013 and FY2014**  
(\$ billions)

Provision	FY2013	FY2014
2001, 2003, 2009 Tax Cut Extensions	\$110	\$230
10% Rate	30	50
Other Rates	40	55
Pep/Pease (phase outs)	6	14
Child Credit	7	33
Marriage Penalty	5	5
Child Credit Refundability	0	10
American Opportunity Credit	3	12
Capital Gains/Dividends	15	10
Estate Tax	5	30
Other 2001 Minor Provisions	1	4
AMT	125	100
Without Extensions	90	40
Interaction with Extensions	35	60
Social Security Payroll Tax (1 year)	90	30
Unemployment (1 year)	25	5
Doc Fix	10	20
BCA Spending Cuts	65	95
Medicaid	5	5
Other Mandatory	5	5
Defense	30	50
Nondefense Discretionary	25	30
Tax Extenders	30	30
Subpart F Financing Income	5	5
Research Credit	5	5
Alcohol Fuels Credit	10	0
Affordable Care Act Taxes	25	25
"Medicare" Tax	20	20
Other	5	5
Total	~500	~500

**Source:** Committee for a Responsible Federal Budget, *Between a Mountain of Debt and a Fiscal Cliff*, updated July 16, 2012, at [http://crfb.org/sites/default/files/Between\\_a\\_Mountain\\_of\\_Debt\\_and\\_a\\_Fiscal\\_Cliff.pdf](http://crfb.org/sites/default/files/Between_a_Mountain_of_Debt_and_a_Fiscal_Cliff.pdf).

**Notes:** All estimates report the effects of the fiscal cliff assuming a permanent extension of tax cuts, elimination of spending cuts, and elimination of Affordable Care Act taxes. The payroll tax and unemployment benefits are assumed to be extended for one year. Approximations of totals are from the original table.

## Legislative Proposals

The focus of legislative change that would affect the fiscal cliff has so far largely been on the expiring tax cuts. Although spending cuts have been the subject of legislative proposals, these proposals are largely about reordering spending rather than affecting the magnitude of the cuts.<sup>13</sup> Proposals in both the House and Senate address the expiring tax cuts from 2001, 2003, and 2009, which had been extended in 2010, along with the AMT patch, which together contribute \$221 billion (44%) of the policy-related fiscal cliff. A separate bill to address the AMT patch and the "extenders" has also been approved by the Senate Finance Committee.

Democrats and Republicans have offered alternative plans to address the 2001, 2003, 2009 rate cuts and the AMT, as shown in **Table 3** and **Table 4** (S. 3412; H.R. 8, and S. 3413).<sup>14</sup> The main difference between the plans is that the Republican proposal contains \$49 billion of income tax cuts for higher-income individuals (generally married couples and single individuals with \$250,000 and \$200,000, respectively, or more in income) and \$31 billion of estate tax cuts that also benefit higher-income deceased taxpayers, that are not in the Democrats' plan (a total of \$80 billion). The Democrats' plan extends \$27 billion of tax cuts (primarily the expanded education, child, and earned income credits) in the 2009 legislation that are not in the Republicans' plan. These latter provisions are phased out as incomes rise and tend to benefit lower- and moderate-income taxpayers. The Republican plan also proposes a two-year AMT patch, whereas the Democratic plan has a one-year patch.<sup>15</sup> The Democratic proposal would eliminate about a third of the policy-related fiscal cliff for FY2013, and the Republican proposal would eliminate about 40% with the one-year AMT patch, and 45% with the two-year AMT patch. Because more of the tax cuts in H.R. 8 and S. 3413 are directed at higher-income taxpayers, where effects are more likely to be captured when returns are filed, the revenue losses in the Republican plan are 37% larger than the Democratic plan in FY2013, but 61% higher during the budget window of FY2013-FY2022.

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<sup>13</sup> The House has passed H.R. 5652, the Sequester Reconciliation Replacement Act of 2012, relating to the sequester, which would have small effects on the budget deficit (estimated at an additional deficit reduction of \$7 billion, according to Mindy Levit, analyst in Public Finance, Congressional Research Service).

<sup>14</sup> See CRS Report R42622, *An Overview and Comparison of Proposals to Extend the "Bush Tax Cuts": S. 3412, S. 3413, H.R. 8*, by Margot L. Crandall-Hollick for additional details.

<sup>15</sup> Note that, had the Democrats' plan patched the AMT for 2013, the cost would have been somewhat less because of the interaction with higher tax rates.

**Table 3. Revenue Losses—Democratic Tax Proposal, S. 3412**  
(\$ billions)

Provision	FY2013	FY2014	FY2013-FY2022
2001-2003 Extensions	\$62	\$66	\$130
10% bracket	31	13	44
25%/28% and Part of 33% Rates	13	65	19
Pep and Pease/Limited	a	a	1
Child Credit	4	32	36
Marriage Penalty	5	5	9
Other	1	2	3
Capital gains	3	(2)	2
Dividends	5	10	15
2009 Extensions	3	25	27
Section 179 Expensing	4	3	1
AMT Patch (1 Year)	99	(7)	92
Total	167	87	250

**Source:** Joint Committee on Taxation, JCS-65-12, "Estimated Revenue Effects Of S. 3412, The Middle Class Tax Cut," July 27, 2012, at <https://www.jct.gov/publications.html?func=startdown&id=4477>.

**Note:** Parentheses indicate that the provision raises revenue. Numbers may not add due to rounding. Some revenue effects occur after FY2014.

a. Less than \$500 million.

**Table 4. Revenue Losses—Republican Tax Proposal, H.R. 8 and S. 3413  
(Two-Year AMT Patch), and Effect of One-Year AMT Patch**  
(\$ billions)

Provision	FY2013	FY2014	FY2013-FY2022
2001-2003 Extensions	105	90	210
10% bracket	31	13	44
25%/28% rates	13	5	18
33% and 35% rates	22	10	32
Pep and Pease	6	5	11
Child Credit	6	32	36
Marriage Penalty	4	5	9
Other	1	2	3
Capital gains	14	(17)	10
Dividends	5	10	16
Estate Tax	4	23	31
Section 179 Expensing	2	2	1

Provision	FY2013	FY2014	FY2013-FY2022
AMT Patch (1 Year)	99	(7)	92
AMT Patch (2 Years)	122	78	193
Total (1 Year AMT Patch)	205	80	302
Total (2 Year AMT Patch)	228	169	403

**Source:** Joint Committee on Taxation, JCS-64-12, "Estimated Revenue Effects Of H.R. 8, The 'Job Protection And Recession Prevention Act Of 2012,'" July 24, 2012, at <https://www.jct.gov/publications.html?func=startdown&id=4476>. The one year AMT estimate is from a Joint Committee on Taxation Memorandum to Mark Prater, Jim Lyons, Tony Coughlan, Curt Beaulieu, July 18, 2012, providing revenue estimates for a modified version of Senator Hatch's S. Smdt. 2491 to S. 2237.

**Notes:** Parentheses indicate that the provision raises revenue. Numbers may not add due to rounding. Some revenue effects occur after FY2014.

The Senate Finance Committee has approved a bill (S. 3521) that would combine a two-year AMT patch, extension of Section 179 expensing (which allows equipment investments to be deducted immediately with a higher cap), and the "extenders." Provisions would expire at the end of 2013. **Table 5** shows the revenue effects of these provisions. There are 50 extenders but most of them—40—are for businesses and energy rather than for individuals. Two business provisions (the research credit and deferral of foreign-source financing income) account for two-thirds of the business total, and the renewable energy production tax credit accounts for two-thirds of the energy extenders. Continuing the extenders, which is not included in the other bills discussed above, would eliminate about 7% of the policy-related fiscal cliff.

**Table 5. Revenue Losses—Family and Business Certainty Act of 2012 (S. 3521)**  
(\$ billions)

Provision	FY2013	FY2014	FY2013-2022
2-Year AMT Patch	\$104.1	\$37.4	\$132.2
Extenders	31.1	14.6	63.9
Individual	6.1	6.5	13.5
Business	20.2	5.9	38.9
Energy	4.7	2.1	18.1
Section 179 Expensing	8.1	4.0	2.4
Total	143.3	56.0	205.1

**Source:** Joint Committee on Taxation, JCX-71-12., "Estimated Revenue Effects Of The Revenue Provisions Contains in the 'Family And Business Tax Cut Certainty Act Of 2012,'" August 29, 2012, at <https://www.jct.gov/publications.html?func=startdown&id=4484>.

**Note:** Numbers may not add due to rounding. Some revenue effects occur after FY2014.

At this point, treatment of the remaining provisions in the fiscal cliff has not been addressed. If the past is a guide, the doc fix will likely be continued; it is also part of CBO's alternative baseline. The outlook for the payroll tax reductions and unemployment benefits is unclear.

In his latest budget, President Obama proposed extending some but not all of the tax cuts (as in S. 3412) and reducing spending cuts, along with other proposals.

## Aggregate Short-Run Effects of the Fiscal Cliff

The contraction in aggregate demand resulting from the fiscal cliff, according to standard economic analysis, would reduce output and employment in the economy.<sup>16</sup> A number of estimates and comments suggest that the fiscal cliff, which CBO expects to reduce the deficit by 5.1% of output in calendar year 2013, will also reduce aggregate demand and have a large negative effect on the economy in the short run. Chairman of the Federal Reserve Ben Bernanke indicated in testimony before Congress that, while there is a need for long-run debt sustainability, the tax increases and spending cuts occurring in 2013 could endanger the recovery.<sup>17</sup> The International Monetary Fund, an organization that often stresses the need for reducing debt levels, expressed concern that the fiscal cliff would damage the U.S. and worldwide economy and recommended that the deficit decrease by only 1% of GDP (output), about a fifth of the fiscal cliff.<sup>18</sup> The IMF also identified the fiscal cliff as the most important risk to global recovery:

In the short term, the main risk relates to the possibility of excessive fiscal tightening in the United States, given recent political gridlock. In the extreme, if policymakers fail to reach consensus on extending some temporary tax cuts and reversing deep automatic spending cuts, the U.S. structural fiscal deficit could decline by more than 4 percentage points of GDP in 2013. U.S. growth would then stall next year, with significant spillovers to the rest of the world.<sup>19</sup>

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<sup>16</sup> The discussion of economic effects in this section may be seen as a mainstream view as reflected in the analysis of the Congressional Budget Office, the International Monetary Fund, the Federal Reserve Board, other government forecasters, and private forecasters. There are prominent economists who disagree that fiscal stimulus is effective or that the fiscal cliff is an important issue for the demand side and unemployment. See, for example, Robert J. Barro, "Keynesian Economics vs. Regular Economics," *Wall Street Journal*, August 24, 2011, and John B. Taylor, "An Empirical Analysis of the Revision of Fiscal Activism in the 2000s," *Journal of Economic Literature*, vol. 49, September 2011, pp. 686-702. For a discussion of the various models that have been developed that reject fiscal stimulus (primarily by academic economists) as well as modifications that have affected some modeling of a fiscal stimulus, see N. Gregory Mankiw, "The Macroeconomist as Scientist and Engineer," *The Journal of Economic Perspectives*, vol. 20, fall 2006, pp. 29-46. There are also arguments that countries have grown after deficit reductions (sometimes referred to as fiscal consolidations), although the examples cited generally began at full employment, rather than the circumstances facing the United States. For a discussion of the intertemporal models referenced by Barro, see CRS Report RL31949, *Issues in Dynamic Revenue Estimating*, by Jane G. Gravelle. For a review of the evidence on fiscal consolidation, see CRS Report R41849, *Can Contractionary Fiscal Policy Be Expansionary?*, by Jane G. Gravelle and Thomas L. Hungerford. Note that recently a number of countries taking the path of fiscal consolidation, either by choice or after outside pressure, have seen growth suffer. See, for example, the discussion of Great Britain, "Economy to Shrink in 2012 as Quick Austerity Hurts – NIESR," *Reuters*, August 3, 2012, at <http://www.reuters.com/article/2012/08/02/britain-economy-niesr-idUSL6E8J2JWK20120802>. In general, the constraints of the European Union, the contractionary policies now being undertaken, and the fragility of debt in some countries have exacerbated the problems of the world, including the United States. See Mark Zandi, *U.S. Macro Outlook: Policymakers Must Get It Right*, Moody's Analytics, at [http://www.economy.com/dismal/article\\_free.asp?cid=232471&src=mark-zandi](http://www.economy.com/dismal/article_free.asp?cid=232471&src=mark-zandi).

<sup>17</sup> Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve, Testimony before the Senate Committee on Banking, Housing and Urban Affairs, July 17, 2012, at <http://www.federalreserve.gov/newsevents/testimony/bernanke20120717a1.pdf>.

<sup>18</sup> International Monetary Fund Fiscal Monitor, *Nurturing Credibility While Managing Risks to Growth*, July 16, 2012, at <http://www.imf.org/external/pubs/ft/fm/2012/update/02/pdf/0712.pdf>.

<sup>19</sup> International Monetary Fund World Economic Outlook Update, *New Setbacks, Further Policy Action Needed*, July 16, 2012, p. 5, at <http://www.imf.org/external/pubs/ft/weo/2012/update/02/pdf/0712.pdf>.

In its May 2012 report, CBO considered a range of estimates.<sup>20</sup> The midpoint of those estimates indicates that, if the fiscal cliff occurs, GDP will actually contract by 1.3% in the first half of calendar year 2013, with growth of 2.3% in the second half, for an overall growth over the year of 0.5%. With elimination of the fiscal cliff, their midpoint estimate indicates that growth will be 4.4% (5.3% in the first half and 3.4% in the second half). Thus, the fiscal cliff would be projected to lead to a reduction in output of 3.9%. CBO projects that not eliminating the fiscal cliff will increase unemployment by 2 million. CBO's analysis notes some uncertainty about these effects. Although the midpoint estimate is a reduction of 3.9% of output, the range of potential effects of the fiscal cliff in the CBO analysis is set at 0.9% to 6.8% of output. Thus, the effects might be considerably smaller, but they also could be much larger.<sup>21</sup> CBO does not explicitly analyze the fiscal cliff in its August 2012 budget update, but it does project a larger initial contraction of 2.9% in the first half of 2013 under current law, followed by a 1.9% increase, with unemployment reaching 9.1% by the last quarter. This contraction would qualify as a recession.<sup>22</sup>

Other forecasters project similar effects, although they vary somewhat in what they include in the fiscal cliff. Mark Zandi of Moody's Analytics estimates a fiscal cliff deficit reduction at 4.6% of output, producing a contraction of 3.6% of output.<sup>23</sup> Morgan Stanley reports a deficit effect of 5% of output, for a contraction of 5% of output, and Goldman Sachs reports a deficit effect of 4% of output, for a contraction of 4% of output.<sup>24</sup> IHS Global Insight assumes that the fiscal cliff would be avoided in its forecasts but indicates that going over the fiscal cliff will lead to recession.<sup>25</sup>

## Differential Effects of the Components of the Fiscal Cliff

The principal reason the fiscal cliff has such a potential to slow and even contract the economy in the short run is its size. At a deficit reduction of 5% of GDP, the changes in policies constitute a large contractionary effect. However, the effect of the fiscal cliff on the economy also depends on the mix of policies. The differential contractionary effects of different elements of the fiscal cliff could potentially play a role in balancing short-term and long-run objectives.

The contractionary effect of spending cuts and tax increases occurs because these changes reduce spending and contract demand. Reductions in direct spending directly reduce demand, and increases in taxes or decreases in transfers may partly cause a reduction in savings and partly a reduction in private spending. This decreased demand causes fewer workers to be hired and less

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<sup>20</sup> Congressional Budget Office, *Economic Effects of Reducing the Fiscal Restraint That Is Scheduled to Occur in 2013*, May 2012, at [http://www.cbo.gov/sites/default/files/cbofiles/attachments/FiscalRestraint\\_0.pdf](http://www.cbo.gov/sites/default/files/cbofiles/attachments/FiscalRestraint_0.pdf).

<sup>21</sup> CBO's ranges reflect the range of estimated effects from a variety of sources. For a further discussion of sources, see Felix Reichling and Charles Whalen, *Assessing the Short-Term Effects on Output of Changes in Federal Fiscal Policies*, CBO Working Paper 2012-08, May 2012, at [http://www.cbo.gov/sites/default/files/cbofiles/attachments/WorkingPaper2012-08-Effects\\_of\\_Fiscal\\_Policies.pdf](http://www.cbo.gov/sites/default/files/cbofiles/attachments/WorkingPaper2012-08-Effects_of_Fiscal_Policies.pdf).

<sup>22</sup> Congressional Budget Office, *An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022*, August 2012, at [http://www.cbo.gov/sites/default/files/cbofiles/attachments/08-22-2012-Update\\_to\\_Outlook.pdf](http://www.cbo.gov/sites/default/files/cbofiles/attachments/08-22-2012-Update_to_Outlook.pdf).

<sup>23</sup> Mark Zandi, *U.S. Macro Outlook: Policymakers Must Get It Right*, Moody's Analytics, July 16, 2012, at [http://www.economy.com/dismal/article\\_free.asp?cid=232471&src=mark-zandi](http://www.economy.com/dismal/article_free.asp?cid=232471&src=mark-zandi).

<sup>24</sup> As reported in Committee for a Responsible Federal Budget, *Between a Mountain of Debt and a Fiscal Cliff*, updated July 16, 2012, at [http://crfb.org/sites/default/files/Between\\_a\\_Mountain\\_of\\_Debt\\_and\\_a\\_Fiscal\\_Cliff.pdf](http://crfb.org/sites/default/files/Between_a_Mountain_of_Debt_and_a_Fiscal_Cliff.pdf).

<sup>25</sup> IHS Global Insight, *U.S. Economic Outlook*, July 2012, p. 3.

output to be produced; some of the resulting reduced income also reduces spending, with another round of contraction. The outcome of these successive rounds of reduced spending are called multipliers. There are forces in the economy that limit the effects. For example, with a relatively small contraction for an economy at full employment, the multiplier could be close to zero because the contraction may lower interest rates or prices or both without any real output effects. Even with an underemployed economy, there are aspects that dampen the effects on the economy. For example, part of each round of decreased income reduces savings rather than spending, or some part of the contraction in demand decreases imports rather than domestic production, or some of the contraction drives down interest rates and increases private investment. (During this recession and recovery, there has been little evidence of fiscal policies altering interest rates.)

The CBO projections indicate an aggregate multiplier for the fiscal cliff of 0.76 (a 3.9% contraction in output divided by a 5.1% decrease in the deficit relative to output). Zandi's multiplier is about the same at 0.78 (3.6% divided 4.6%), whereas the other two forecasters indicate multipliers of one.

A crucial feature that causes different policies to have different effects is the size and speed of the first round of spending cuts. If the federal government decreases direct purchases of goods and services, spending is reduced by 100% of that amount. However, if the government increases taxes, individuals would reduce spending by only a fraction of that tax increase (with savings falling as well). If only half of a tax increase decreases spending, a tax multiplier is half as large as a spending multiplier. Reduced transfers and tax increases for low-income individuals are likely to reduce spending because these individuals are usually liquidity constrained (unable to borrow to meet their spending objectives). Higher-income individuals are more likely to reduce spending by a smaller share of a tax increase, and businesses are also unlikely to change their spending very much. Reductions in transfers to state and local governments may also partially reduce savings, although these governments are now generally financially constrained and may be more likely to reduce spending.

There are also issues of timing. If spending increases are authorized but cannot take place quickly, their effect would be delayed. This concern was a significant one in considering spending increases in 2009, particularly with respect to infrastructure, where a planning period might have been needed. Of course, that timing issue would be different because the policy in this case involves not a spending increase, which could take some time but avoiding a spending cut. Presumably, cuts could be made more quickly than increases. (Note that in measuring the fiscal cliff, CBO projects spending changes under the BCA, not changes in budget authority.)

The general patterns of differentials can be seen in CBO's analysis of the effects of the 2009 stimulus (tax cuts and spending increases to expand the economy) as shown in **Table 6**. Considering the midpoint of multipliers in the last column, changes in federal spending have a higher multiplier than a low-to-middle-income tax change. Tax changes for higher-income individuals and businesses have the smallest multipliers. Transfers to individuals (such as unemployment benefits) have a somewhat smaller multiplier effect than spending changes but considerably higher effects than tax cuts.

**Table 6. Multipliers for Components of the American Recovery and Reinvestment Act of 2009 (ARRA; P.L. 111-5) for the First Quarter of 2012**

Policy	Low Multiplier	High Multiplier	Midpoint
Federal Purchases	0.5	2.5	1.5
State/Local Infrastructure Transfers	0.4	2.2	1.3
State/Local Other Transfers	0.4	1.8	1.1
Transfers to Individuals	0.4	2.1	1.25
Payment to Retirees	0.2	1.0	0.6
Low/Middle Income Individuals' Tax Cut	0.3	1.5	0.9
High-Income Individuals' Tax Cut	0.1	0.6	0.35
First-Time Homebuyers' Credit	0.2	0.8	0.5
Corporate Taxes (Affecting Cash Flow)	0.0	0.4	0.2

**Source:** Congressional Budget Office, Estimated Impact of the American Recovery and Reinvestment Act on Employment and Economic Output from January 2012 Through March 2012, May 2012, at [http://www.cbo.gov/sites/default/files/cbofiles/attachments/ARRA\\_One-Col.pdf](http://www.cbo.gov/sites/default/files/cbofiles/attachments/ARRA_One-Col.pdf).

Similar patterns are found in some of the alternatives reported in earlier testimony shown in **Table 7**. The smaller effect of infrastructure may reflect expectations that the spending will occur slowly (whereas in **Table 6** that spending is already in place). Both of these tables show multipliers from stimulus (which produces output increases) but the concept is the same as a contraction, just reversed.

**Table 7. Multiplier Effect of Selected Stimulus Policies, 2012-2013**

Policy	Low Multiplier	High Multiplier	Midpoint
Unemployment Insurance	0.4	1.9	1.15
Refundable Tax Credits	0.2	1.2	0.7
Payroll Tax Reductions	0.1	1.8	0.9
AMT Patch	0.2	1.1	0.65
Expensing Investment	0.1	1.1	0.6
Business Tax Cuts	0.0	0.3	0.15
State/Local Aid Infrastructure	0.2	1.0	0.6
Spending on Infrastructure	0.1	0.7	0.4

**Source:** Testimony of Douglas W. Elmendorf, Director, Congressional Budget Office, "Policies for Increasing Economic Growth and Employment in 2012 and 2013," before the Committee on the Budget, United States Senate, November 15, 2011, at [http://www.cbo.gov/sites/default/files/cbofiles/attachments/11-15-Outlook\\_Stimulus\\_Testimony.pdf](http://www.cbo.gov/sites/default/files/cbofiles/attachments/11-15-Outlook_Stimulus_Testimony.pdf).

**Note:** Not all options are shown. In particular, the testimony includes extending expiring tax cuts, but at the time of the testimony, they would have taken effect with more delay relative to the period output is measured than other policies, so their multiplier effects would not be comparable to those of other policies.

CBO's report on the fiscal cliff also contains additional estimates that allow separate multipliers for different components of the fiscal cliff. CBO indicates that the fiscal cliff with a deficit decrease at 5.1% of GDP comparing calendar 2012 and 2013 will result in a decrease in output of



3.9%. CBO also estimates that the decreases in the deficit under the alternative baseline compared with current law, which accounts for 3% of GDP, would lead to an offsetting gain of 1.6% of output, with the remainder of the fiscal cliff (including non-policy-related amounts) leading to a 2.3% reduction. These estimates imply that these largely tax changes have a multiplier of 0.5 (1.6% divided by 3%) and the other provisions a multiplier of 1.1 (2.3% divided by 2.1%). In its August report, CBO estimates a similar reduction comparing the current law baseline and the alternative scenario (-0.5% versus 1.7% for a net increase of 2.2%).<sup>26</sup> Apparently, CBO's August update compared to the May analysis indicates a gloomier outlook in general.

**Table 8** shows the estimates of the individual components of the fiscal cliff by private forecaster Mark Zandi. Multipliers are calculated by dividing the contractionary effect by the deficit decrease. The data in **Table 8** indicate that the largest multiplier is for cutting unemployment insurance, followed by the automatic spending cuts, both with multipliers above one. The components of the tax extenders plus the doc fix have a weighted multiplier of about 0.6, whereas the remaining components of the fiscal cliff have a multiplier averaging about one. These results are similar to the CBO calculations for the extenders.

**Table 8. Zandi's Estimates of the First-Year Effect of Elements of the Fiscal Cliff**

Provision	Deficit Decrease (\$billions)	Contractionary Economic Effect (\$billions)	Implied Multiplier (Col. 3 divided by Col. 2)
Bush Tax Cuts (Below \$250,000)	198	174	0.9
AMT Patch	120	59	0.5
Payroll Tax Holiday	115	100	0.9
Automatic Spending Cuts	100	105	1.1
Bush Tax Cuts (Above \$250,000)	83	40	0.5
Emergency Unemployment Insurance	40	58	1.5
Affordable Care Act	20	9	0.5
Medicare Doc Fix	20	9	0.5
Tax Extenders	20	4	0.2
Bonus Depreciation	12	2	0.2
Total	728	560	0.8

**Source:** Mark Zandi, *U.S. Economic Outlook: Policymakers Must Get It Right*, Moody's Analytics, at [http://www.economy.com/dismal/article\\_free.asp?cid=232471&src=mark-zandi](http://www.economy.com/dismal/article_free.asp?cid=232471&src=mark-zandi); CRS calculations of multiplier.

A final set of multipliers derived from models is shown in **Table 9**. As with **Table 6** and **Table 7**, these are the result of a stimulus, which is the reverse of a contraction but yields a multiplier that could be applied to a contractionary policy. These estimates are averages from several different structural models that would roughly be considered "New Keynesian." These models are also referred to as dynamic stochastic general equilibrium (DSGE) models, which involve optimization over time. These models embed the standard macroeconomic models (which might

<sup>26</sup> Congressional Budget Office, *An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022*, August 2012, at [http://www.cbo.gov/sites/default/files/cbofiles/attachments/08-22-2012-Update\\_to\\_Outlook.pdf](http://www.cbo.gov/sites/default/files/cbofiles/attachments/08-22-2012-Update_to_Outlook.pdf).

be loosely referred to as IS-LM models) in a dynamic intertemporal model.<sup>27</sup> The ranking of multipliers in those estimates are similar to those in the tables above, with the largest multipliers for spending, followed by transfers to lower income individuals. All of the tax cut multipliers (and general transfers) are smaller than those in earlier tables although, as indicated in **Table 9**, spending multipliers and multipliers for transfers to lower-income individuals are similar to those in earlier tables.

**Table 9. Multipliers in Structural Dynamic Models**

Policy	Multiplier
Government Spending (Consumption)	1.55
Government Spending (Investment)	1.59
Targeted Transfers (Lower Income)	1.30
Consumption Taxes	0.61
General Transfers	0.42
Corporate Income Taxes	0.24
Labor Income Taxes	0.23

**Source:** Gunter Coenen et al., "Effects of Fiscal Stimulus in Structural Models," *American Economic Journal, Macroeconomics*, vol. 4, January 2012, pp. 22-68.

**Notes:** This study simulates estimates on seven structural dynamic models, including those of the Federal Reserve Board, the European Central Bank, the International Monetary Fund, the European Commission, the Organisation for Economic Co-operation and Development (OECD), the Bank of Canada, and two models developed by academic economists. Not all models are used in every estimate. All changes last for two years.

To some extent, the larger discrepancy between tax cuts and spending is because only a fraction of consumers change their spending when income increases temporarily, a result of the optimization element of DSGE models. Most consumption is by individuals who optimize over an infinite time period (or a very long one) and a single year or two of reduced income has no effect. Some fraction of consumers are liquidity constrained (varying from 0% to 27%) and respond. Targeted transfers are directed at these lower-income individuals and thus have a larger stimulus effect than other transfers. The numbers in **Table 9** assume that the monetary authorities accommodate the fiscal stimulus by keeping nominal interest rates fixed; without this monetary accommodation, the multipliers (except for labor income taxes) drop significantly.<sup>28</sup>

<sup>27</sup> It is useful to distinguish between three types of models. The standard macroeconomic model used for forecasting is frequently referred to as an IS-LM model, which is a model that is built on a Keynesian model, but with many types of enhancements, including multiple sectors, actions of the monetary authorities, and expectations. At the opposite end of the spectrum is the real business cycle model (discussed in footnote 16). In this model, there is no involuntary unemployment and business cycles occur because workers respond to shocks, in part, by voluntarily shifting their labor supply across time. In these models, agents have infinite horizons and perfect foresight and optimize their consumption and leisure over time. These models are also referred to as DSGE models. A third type of model embeds the modified Keynesian model in a DSGE model by allowing for sticky prices and liquidity constraints that prevent agents from optimization and cause them to spend more of a short-term income change. These latter models are reflected in **Table 9** and are sometimes called New Keynesian models or structural models. Multipliers are also studied in reduced form econometric estimates (vector autoregressions).

<sup>28</sup> For a labor tax cut, labor supply in these models increases, which drives the wage rate and prices down, causing real interest rates to rise and offsetting some of the demand side stimulus. In fact, it is possible to derive a contractionary effect for these models for a labor tax cut when interest rates are constrained at zero and all consumers are unconstrained. See Gauti B. Eggertsson, "What Fiscal Policy Is Effective at Zero Interest Rates?" Federal Reserve (continued...)

In general, these models are more popular with academics and tend to not be as influential among policymakers and private forecasters. Some researchers raise questions about whether the spending behavior in these models is consistent with direct evidence.<sup>29</sup>

Multipliers are also directly estimated using multiple time series regressions (statistical studies that examine changes in deficits and output over time), but often these studies focus on government spending (where the policies are more uniform and the first round can be presumed to be spent) or do not distinguish among the types of policies (although theory suggests that tax cut multipliers should be smaller).<sup>30</sup> An important issue that has been raised about these studies (and about estimates of multipliers in general) is that multipliers should be estimated in a way that allows different multipliers in booms and recessions. One recent study indicated that the government spending multiplier was between 0 and 0.5 during expansions and between 1 and 1.5 in recessions.<sup>31</sup>

## Implications for Policy Choices

The policies that have received significant legislative attention that would change the size of the fiscal cliff—extending the expiring tax cuts—are a majority of the fiscal cliff but a minority of the economic effects, although the economic effects are still notable. According to the implications of the CBO estimates of the effects of the alternative fiscal scenario (which largely extends the expiring tax cuts), the provisions in the alternative scenario are responsible for 60% of the fiscal cliff but 40% of the contraction. Hence extending the expiring tax cuts eliminates less than half of the projected contraction in the economy due to the fiscal cliff.

Similar results are obtained using Zandi’s estimates of the policy-related provisions and their impact (shares related to the fiscal cliff and the contraction shown in **Table 10**), where the expiring tax provisions alone account for 60% of the effect on the deficit but half the contractionary effect. By comparison, the two major non-tax provisions—automatic spending cuts and unemployment insurance benefits—account for about 20% of the policy-related fiscal cliff but 30% of the contraction.

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(...continued)

Bank of New York, Staff Report No. 402, November 2009, at [http://www.newyorkfed.org/research/staff\\_reports/sr402.pdf](http://www.newyorkfed.org/research/staff_reports/sr402.pdf).

<sup>29</sup> See N. Gregory Mankiw, “The Macroeconomist as Scientist and Engineer,” *The Journal of Economic Perspectives*, vol. 20, fall 2006, pp. 29-46; Jonathan A. Parker, “On Measuring the Effects of Fiscal Policy in Recessions,” *Journal of Economic Literature*, vol. 49, January 2011, pp. 703-718; and Felix Reichling and Charles Whalen, *Assessing the Short-Term Effects on Output of Changes in Federal Fiscal Policies*, CBO Working Paper 2012-08, May 2012, at [http://www.cbo.gov/sites/default/files/cbofiles/attachments/WorkingPaper2012-08-Effects\\_of\\_Fiscal\\_Policies.pdf](http://www.cbo.gov/sites/default/files/cbofiles/attachments/WorkingPaper2012-08-Effects_of_Fiscal_Policies.pdf).

<sup>30</sup> These are often referred to as vector autoregressions or VAR techniques. There is a large literature of this type. For a review of estimates of spending multipliers, see Valerie A. Ramey, “Can Government Purchases Stimulate the Economy?” *Journal of Economic Literature*, vol. 49, September 2011, pp. 673-685. See also Felix Reichling and Charles Whalen, *Assessing the Short-Term Effects on Output of Changes in Federal Fiscal Policies*, CBO Working Paper 2012-08, May 2012, at [http://www.cbo.gov/sites/default/files/cbofiles/attachments/WorkingPaper2012-08-Effects\\_of\\_Fiscal\\_Policies.pdf](http://www.cbo.gov/sites/default/files/cbofiles/attachments/WorkingPaper2012-08-Effects_of_Fiscal_Policies.pdf).

<sup>31</sup> Alan Auerbach and Yuriy Gorodnichenko, “Measuring the Output Responses to Fiscal Policy,” June 2011, at <http://elsa.berkeley.edu/~auerbach/measuringtheoutput.pdf>.

The Bush tax cuts for higher-income taxpayers, which are a focus of disagreement in Congress about tax policy, account for 11% of the fiscal cliff but 7% of the contraction. The tax extensions are not as powerful in their contractionary effect, not only because of the expected smaller effect of tax cuts as compared spending, but also because the tax cuts are concentrated among higher-income individuals. According to the Tax Policy Center's analysis, 65% of the tax cuts in H.R. 8 and S. 3413 (which extends the Bush tax cuts and the AMT) are in the top quintile. For the Democratic bill, S. 3412, 34.8% is in the top quintile.<sup>32</sup> Some of the difference between the two bills is the two-year AMT patch in the Republican bill compared with the one-year patch in the Democratic bill, but aside from that difference, the Republican proposal would be more concentrated in higher incomes because it continues more of the Bush tax cuts for higher-income taxpayers.

**Table 10. Shares of Fiscal Cliff Versus Shares of Contraction, Zandi Estimates**  
(in percentages)

Policy	Share of Deficit Reduction	Share of Contraction
Bush Tax Cuts (Below \$250,000)	27%	31%
AMT Patch	16	11
Payroll Tax Holiday	16	18
Automatic Spending Cuts	14	19
Bush Tax Cuts (Above \$250,000)	11	7
Emergency Unemployment Insurance	5	10
Affordable Care Act	3	2
Medicare Doc Fix	3	2
Tax Extenders	3	1
Bonus Depreciation	2	0

**Source:** CRS calculations based on **Table 8** of this report, see above.

If the only issue were the trade-off between effects on the debt and the short-term contractionary effects, one option would be to allow the less robust tax provisions to expire and concentrate on (and perhaps even replace them with) more robust spending and transfer programs. The IMF suggests deficit reduction of about 1% of GDP would be an appropriate compromise between short-run and long-run needs,<sup>33</sup> and some portion of the tax cuts could be allowed to expire while retaining items such as the payroll tax cut, delaying the spending cuts, or extending unemployment insurance.

William Gale has made such a proposal, namely that the fiscal cliff be allowed to occur along with enacting some temporary measures to protect the economy in the short run.<sup>34</sup> He suggests payroll tax cuts, infrastructure investment, and aid to the states. He also suggests that the higher

<sup>32</sup> Brookings-Urban Tax Policy Center. Links to distributional tables at <http://taxpolicycenter.org/taxtopics/Senate-Tax-Cut-Extension-Bills.cfm>.

<sup>33</sup> International Monetary Fund Fiscal Monitor, *Nurturing Credibility While Managing Risks to Growth*, July 16, 2012, at <http://www.imf.org/external/pubs/ft/fm/2012/update/02/pdf/0712.pdf>.

<sup>34</sup> William G. Gale, "The Fiscal Cliff? Let's Pass Right Over It," July 25, 2012, at <http://www.taxpolicycenter.org/publications/url.cfm?ID=901519>.

baseline revenues would facilitate tax reform. Of course, it would also be possible to adopt part of Gale's proposal, by allowing some of the tax cuts to expire and offsetting the effect with temporary spending and transfer provisions.

This debt versus stimulus trade-off, however, is not the only policy consideration. There are disagreements that have yet to be settled about the role that revenue increases versus spending cuts (and what types of spending cuts) will play in the ultimate decisions about dealing with the long-term unsustainable debt.<sup>35</sup> Similarly, there are disagreements about how high marginal tax rates should be, given their distorting effects, which have led to proposals for tax reform that broadens the base and lowers the rates. Specifics of these proposals have not yet been determined and base broadening may be complex or difficult or both.<sup>36</sup> Some observers have expressed concern for the distributional effects of the Bush tax cuts, which favor higher-income individuals, given the growing inequality of income in the economy, whereas others believe that fair taxation should limit the share paid by wealthy individuals in taxes.<sup>37</sup>

Given these uncertainties, proponents maintain that there is a case for continuing most or all of the current tax cuts temporarily. Moreover, some tax cuts are generally agreed upon and not likely to be allowed to expire. The need for the AMT patch, for example, stems from not initially adopting a permanent solution to the fundamental AMT issue, namely that the exemption has not been indexed for inflation. Without continual adjustments, the value of the exemption would be much smaller. The AMT was intended to be a narrowly applicable provision to target wealthy individuals who were making excessive use of tax benefits. Allowing the increase in the exemption to lapse would expose large numbers of individuals in what might be considered to be the upper middle class to the tax. Without the AMT patch, the number of taxpayers affected would rise to 34 million from less than 4 million. The AMT has been continually patched, generally on a year-by-year basis, since the first temporary increase in the exemption was enacted in 2001.<sup>38</sup>

The analysis of differential multipliers suggests that more discussion might be directed at those aspects of the fiscal cliff that have not yet been the subject of legislative proposals, but which may have the more powerful short-term effects on the economy: spending cuts, extended unemployment insurance, and the payroll tax cut. Extending these policies, or replacing them with other temporary stimulus with larger multipliers, may have a more powerful effect on the economy than extending the tax cuts.

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<sup>35</sup> See CRS Report R41970, *Addressing the Long-Run Budget Deficit: A Comparison of Approaches*, by Jane G. Gravelle. The analysis in this study suggests it would be difficult to deal with the projected path of the debt without contributions from both raising revenues and cutting spending.

<sup>36</sup> See CRS Report RL34229, *Corporate Tax Reform: Issues for Congress*, by Jane G. Gravelle and Thomas L. Hungerford, and CRS Report R41743, *International Corporate Tax Rate Comparisons and Policy Implications*, by Jane G. Gravelle, for a discussion of corporate income base broadening; and CRS Report R42435, *The Challenge of Individual Income Tax Reform: An Economic Analysis of Tax Base Broadening*, by Jane G. Gravelle and Thomas L. Hungerford, for a discussion of the individual income tax base broadening.

<sup>37</sup> David Wessel, "The Numbers Inside a Hot-Button Issue Amid the Debate About Whether and How to Reform the Tax Code, a Look at How the Picture Has Changed," *Wall Street Journal*, August 6, 2012, at <http://online.wsj.com/article/SB10000872396390444246904577571042249868040.html>.

<sup>38</sup> See CRS Report RL30149, *The Alternative Minimum Tax for Individuals*, by Steven Maguire, for data on coverage and a history of the AMT.

## **Author Contact Information**

Jane G. Gravelle  
Senior Specialist in Economic Policy  
jgravelle@crs.loc.gov, 7-7829