Box 2.1

The "fiscal cliff" facing the US economy

First coined by the Fed Chairman Ben Bernanke in late February 2012, the term "fiscal cliff" becomes popular as a general description of a wide range of tax increases and fiscal spending cuts due to take effect in the US under the current US law around this year-end. Adopting this huge fiscal consolidation within a short time as the baseline scenario, the nonpartisan Congressional Budget Office (CBO) estimated in August 2012 that fiscal deficit would narrow markedly by US$487 billion (about 3% of US's GDP) in fiscal year 2013 (FY2013) as compared to FY2012(1). The major changes in fiscal policies and their corresponding contributions to the deficit reduction as postulated by the CBO are listed below. It should be noted that other policy, economic and budgetary developments not listed below would also affect the estimated budget deficits in 2012 and 2013 by the CBO.

Major scheduled changes in tax policies under current law:

- Expiration of the provisions that limited the reach of the alternative minimum tax in December 2011 will increase tax revenues in 2013 as compared to 2012. Also, other provisions that extended the lower tax rates, expanded credits and deductions originally enacted in 2001, 2003 and 2009 are set to expire on 31 December, 2012. These changes will increase federal revenues by about US$225 billion in FY2013.
- Expiration of the two-percentage point cut in payroll tax rate initiated in January 2011 by the end of this year will raise revenues by about US$85 billion in FY2013.
- Various other provisions that expired at the end of 2011 or that are slated to expire by the end of 2012 will boost revenues by about US$65 billion in FY2013.
- Some tax provisions that are scheduled to take effect in January 2013, including an increase in the tax rates on earnings and investment income for high-income taxpayers, will raise revenues by about US$18 billion in FY2013.

Major scheduled changes in spending policies under current law:

- Commencement of automatic enforcement procedures designed to restrain discretionary and mandatory spending in January 2013 will lower outlays by US$54 billion in FY2013.
- Expiration of emergency unemployment compensation by the end of 2012 will reduce outlays by US$34 billion in FY2013.
- Reduction of Medicare's payment rates for physicians by 27% in January 2013 will lower spending by US$10 billion in FY2013.

If nothing is done by the US Congress after the election in November, the contractionary impact on the US economy arising from the "fiscal cliff" will be severe. According to the CBO (***baseline scenario in Table 1***), the US economy would shrink by 0.5% in the fourth quarter of 2013 from that of 2012, falling into a recession. The labour market would deteriorate again, with the unemployment rate surging from the latest 7.9% to more than 9% by the fourth quarter of 2013. In sum, the "fiscal cliff" represents a heavy punch to the already-slow-moving US economy, which grew only at an annualised rate of 2.0% in the third quarter of 2012.

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(1) "*An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022*", CBO, August 2012.

Box 2.1 (Cont'd)

The US Congress can avert the "fiscal cliff" if agreement can be reached on revising the current law by the end of this year. To illustrate how different decisions by the US Congress would affect the future growth path of the US economy, the CBO provided an alternative scenario, based on the following hypothetical policy changes:

- all expiring tax provisions (other than the payroll tax rate reduction), including those that expired at the end of 2011, are extended;
- the alternative minimum tax is indexed for inflation after 2011 (starting from the 2011 exemption amount);
- medicare's payment rates for physicians remain unchanged from the current amounts; and
- the automatic enforcement procedures designed to restrain spending do not take effect (although the original caps on discretionary appropriations in that law remain in place).

Relative to the baseline scenario, the near term economic outlook under the alternative scenario improves visibly (***Table 1***). However, the estimated fiscal deficit would stay high at 6.5% of GDP in 2013 in the alternative scenario, as compared to the deficit of 4.0% in the baseline scenario. Even then, the US economy is only projected to post a very modest growth in 2013 at 1.7%, and the unemployment rate to stay high at 8.0% by end-2013.

Table 1 : CBO's projections on key US economic indicators

	2012	2013	
		Baseline scenario	Alternative scenario
Real GDP*	2.1	-0.5	1.7
Unemployment rate (%)#	8.2	9.1	8.0

Notes : (*) Percentage change from the fourth quarter of the previous year to the fourth quarter of the year indicated.
(#) Fourth-quarter level.

From a broader perspective, the "fiscal cliff" also reveals the urgent need to strike an important and delicate balance between short-term economic growth and long-term fiscal sustainability of the US economy. On the one hand, the pace of recovery in the US economy from the 2008-09 recession has been modest. The abrupt premature tightening as prescribed in the current law could derail the fragile recovery process. On the other hand, the debt burden on the economy as a whole could escalate to unsustainable levels if the budget deficit is to narrow only slowly over time. Because both goals are of great importance, the IMF had, on multiple occasions, urged policymakers to avoid excessive fiscal consolidation while delivering credible medium-term fiscal plans for the US economy.

Indeed, the pressing need to avoid falling off the "fiscal cliff" has been recognised by most US politicians. Reportedly, there have been discussions among some members of the old Congress over the possibility of introducing some temporary solutions, with a view to buying time for the newly elected President and the new Congress to work on the issue next year. In any case, the challenge is immense for the US politicians and also increases notably the uncertainty facing the global economy. Should the US economy relapse into recession, the repercussions for world trade and global economic growth would be severe. How the US Congress is going to resolve such a dangerous issue needs to be monitored closely.