Fiscal Cliff-hanger: The US Economic Outlook, Part II

David J. Stockton explains why the dangers to the US economy of going over the fiscal cliff are far more serious than most analysts say.

Steve Weisman: This is Steve Weisman with David Stockton at the Peterson Institute for International Economics talking about the American economic outlook. In Part II of the interview, I want to ask more specifically about the fiscal cliff. Remind readers and listeners what the fiscal cliff is and why you think some, including the Congressional Budget Office, are underestimating the impact of going off the fiscal cliff?

David Stockton: There are a variety of policies that will expire at the end of this calendar year. Starting January 1st there will be a significant increase in marginal tax rates associated with the expiration of the Bush tax cuts from 2001-2003. There's going to be a considerable expansion of the coverage of the alternative minimum tax to incorporate many middle income families that had been previously exempted from that. There's going to be an end to the payroll tax holiday and an expiration of extended law term unemployment insurance. In addition, of course, there are going to be very substantial facts coming from [budget] sequestration that will hit both defense and nondefense spending rather considerably.

So there's a substantial amount of fiscal restraint that would follow if all of those actions take place at the turn of the year.

Steve Weisman: A lot of people are warning about the negative consequences, but you seem a little bit more bearish.

David Stockton: I am a little more pessimistic. I think the reasons are that in the current circumstances I think significant fiscal restraint is likely to have bigger effects on the economy than is more generally appreciated. Some of that comes about because interest rates are already at zero, so there's absolutely no ability for monetary policy makers—or I should say limited ability for monetary policy makers—to offset any of the economic effects that would follow from additional fiscal restraint.

In addition, there are many households, and small businesses in particular, that lack access to credit, [that] would allow them to smooth through reductions in income and cash flow that will be associated with much higher taxes and cutbacks in spending. And so I think those are certainly important things as well. But more broadly, I think there are two other areas that I would be concerned about that don't typically get swept up in most estimates of the fiscal multiplier.

One is [that] the financial system in the United States has still been in the process of repair. One could not really argue that we are back to a normally functioning credit system. I think those conditions will deteriorate significantly if we get a substantial increase in unemployment and reduction in income growth. I think you'd see an increase in loan delinquencies and defaults. I think that would feed back quite negatively on financial markets and financial institutions, further tightening credit conditions.

Finally, I think if we do go over the fiscal cliff, it really will be an indication of a lack of confidence in our policymakers to undertake some of the tough decisions that are going to be necessary. I think that those confidence effects will affect not just businesses, but households as well. All that sums up to, I think, probably greater restraint on the economy, should the full effects of the fiscal cliff come to pass.

Steve Weisman: But there's another scenario of a benign fiscal cliff that you spoke of. What would that look like?

David Stockton: A benign fiscal cliff would be at the end of this year. So much of the difficulty right now between the two parties, especially [is] what to do on the revenue side and whether to raise taxes or not. If at the end of the year, in fact tax rates revert to pre-Bush era levels, then that changes the terms of the debate rather significantly. Now we'll be talking about whose taxes to cut and by how much, rather than whose taxes to increase.

So if one thought that that would be a situation that would be more conducive to actually reaching agreement on a set plan for fiscal consolidation, that might be what I would call a more benign situation. Even that will entail some risks, as it will not be immediately clear, if we go over the fiscal cliff, whether that will lead both parties to deal both subsequently and urgently with the consequences of doing that and I think that could at least engender some uncertainty. But at least some folks feel that that would be a risk worth taking.

Steve Weisman: Do you think that it makes sense to phase in this consolidation and if so, which parts of it should be phased in, when, and over how long a period of time?

David Stockton: I think it will be absolutely essential to phase this in and phase it in slowly. The economy is continuing to struggle, as I noted earlier. I think we've had a rather slow recovery. I don't think at this point in time we should be putting in place significant near-term fiscal restraints. So I would think it will need to be phased in. I would imagine, to be credible, some degree of restraint would have to be registered in the next year or so. But I think policy makers should be putting in place mechanisms that phase over the next five years to avoid undue restraint in the near term, but still need to be credible enough to produce long term physical consolidation and get the GDP ratio on a much better trajectory than it is currently scheduled to be on.

Steve Weisman: We'll know between now and the end of the year which path is taken and I hope we'll have you back to evaluate it. Thank you, David.

David Stockton: Thank you, Steve.