Box 1

RECENT DEVELOPMENTS IN US FISCAL POLICY AND THEIR LIKELY IMPACT ON ECONOMIC ACTIVITY

A number of fiscal policy developments have taken place in the United States since the start of 2013. The measures implemented imply considerable fiscal policy restraint in 2013. Nevertheless, an even larger amount of fiscal tightening that the US economy had faced at the start of the year according to previous legislation (commonly referred to as the "fiscal cliff") has been avoided and recent decisions have reduced uncertainty.[1] This box summarises these developments and provides model-based estimates of their impact on US economic activity. It concludes by discussing the outstanding fiscal risks surrounding the outlook for the US economy.

1 A more detailed explanation of the fiscal cliff and a previous assessment can be found in the box entitled "Economic implications of the fiscal restraint in the United States in 2013", *Monthly Bulletin*, ECB, September 2012.

The American Taxpayer Relief Act of 2012 and the "sequester"

On 2 January 2013 the American Taxpayer Relief Act (ATRA) of 2012 – a fiscal agreement that avoided some of the fiscal tightening that had previously been legislated to occur at the start of 2013 – was signed into law. Its main elements are the following: (i) a permanent extension of the Bush-era income tax cuts for low and middle-income households, and the expiration of those for high-income earners; (ii) a permanent indexation of the Alternative Minimum Tax (AMT) to inflation; (iii) the expiration of the 2 percentage point payroll tax reduction; (iv) the extension for a further year of most corporate tax credits and deductions; (v) a one-year extension of emergency unemployment benefits as well as a one-year delay in the scheduled reduction of payment rates for physicians; and (vi) a postponement of the automatic spending cuts under the Budget Control Act of 2011 (the so-called "sequester") for two months and, at the same time, a reduction in those cuts by USD 24 billion, to be offset by a combination of alternative spending cuts and tax increases.

The Budget Control Act had imposed cuts of USD 1.2 trillion on both defence and non-defence spending over ten years by means of sequestration to take effect on 1 January 2013. While the postponement of the sequester for two months under ATRA was aimed at giving policy-makers more time to avert the across-the-board government spending cuts by working out an alternative deficit-reduction package, failure by the US Congress to reach an agreement eventually led the sequester to take effect on 1 March 2013.

Overall, the combined fiscal restraint measures under ATRA and the sequester amount to around 1.7% of GDP for the calendar year 2013, less than half of what was scheduled to occur under previous legislation; the full fiscal cliff represented roughly 4.0% of GDP (see Table A).

Table A US fiscal restraint in the calendar year 2013 (ATRA and the sequester versus the fiscal cliff)

(USD billions; percentages of GDP)

	ATRA and the sequester		Fiscal cliff	
	USD billions	% of GDP	USD billions	% of GDP
Tax policies				
Expiration of Bush-era tax cuts 1)	59	0.4	295	1.8
Expiration of the payroll tax cut	121	0.7	121	0.7
Other expiring provisions 2)	One-year extension		87	0.5
Some tax provisions of the Affordable Care Act 3)	24	0.1	24	0.1
Expenditure policies				
Provisions of the Budget Control Act – sequester covered by ATRA 4)	16	0.1	87	0.5
Provisions of the Budget Control Act – remaining sequester	64	0.4		
Expiration of the emergency unemployment benefits	One-year extension		30	0.2
Reduction in Medicare's payment rates for physicians	One-year extension		11	0.1
TOTAL	**284**	**1.7**	**655**	**4.0**

Sources: Congressional Budget Office, Joint Committee on Taxation and ECB calculations.
Notes: The estimate of the fiscal cliff has been revised compared with earlier estimates, according to which the full fiscal cliff amounted to 4.1% of GDP.
1) Includes the expiration of certain income tax provisions originally enacted in 2001, 2003 and 2009 and indexing of the AMT to inflation. Under the fiscal cliff, this applies to all income brackets, while under ATRA it applies only to high-income earners, defined as those earning more than USD 400,000 for individuals and USD 450,000 for couples.
2) Relates largely to the partial expensing of investment property.
3) Includes increased tax rates on earnings and investment income for high-income taxpayers.
4) With ATRA, it was agreed to delay the sequester for two months and to finance this with offsetting measures amounting to USD 24 billion, of which USD 16 billion in 2013.

Table B Estimated impact of ATRA and the sequester on US GDP growth

(percentage point differences from the baseline)

	2013	2014	2015
ATRA	-0.4	-0.1	-0.1
Sequester – abrupt implementation	-0.4	-0.1	0.1
Sequester – gradual implementation	-0.1	-0.2	-0.2
Total impact (abrupt)	**-0.8**	**-0.2**	**0.0**
Total impact (gradual)	**-0.5**	**-0.3**	**-0.3**

Sources: ECB calculations and CBO.
Note: The gradual implementation scenario assumes that cuts in public spending are phased in gradually over a three-year period (2013-15).

Estimated impact on US economic activity

The economic impact of the fiscal restraint is assessed here using the National institute Global Economic Model (NiGEM).[2] Since there is considerable uncertainty surrounding the degree of flexibility that public agencies have in implementing the sequester, two scenarios are used, based on different speeds of implementation of the spending cuts. The first scenario assumes the spending cuts to take place immediately, while the second assumes they will be phased in gradually over three years. According to the US Congressional Budget Office (CBO), the sequester would lead to a reduction in "budget authority" of USD 85 billion in the fiscal year 2013[3], rising to USD 109 billion in subsequent years. The level of actual spending would, however, be reduced by less in the initial years (USD 42 billion in the fiscal year 2013 and USD 89 billion in the fiscal year 2014) given that it takes time for cuts in budget authority to result in a reduction in outlays.

The estimated impact of the fiscal restraint is reported in Table B. In 2013 the fiscal restraint of 1.7% of GDP is estimated to lower US GDP growth by 0.8 percentage point under the abrupt scenario for the sequester, with a further impact of -0.2 percentage point in 2014. Under the gradual implementation scenario, the impact is more muted in the first year (-0.5 percentage point), but more persistent over time (-0.3 percentage point in both 2014 and 2015). Focusing on the impact of the sequester alone, the estimate of -0.4 percentage point for the abrupt scenario is slightly below externally available estimates, such as that given by the CBO, which calculates that output growth in this scenario would be 0.6 percentage point lower in 2013. Overall, the simulations suggest that the impact on GDP growth in 2013 is smaller than the size of the fiscal tightening. This stems from the fact that a large part of the tightening under ATRA relates to income tax increases, which carry lower multipliers than government spending cuts.

Additional fiscal agreements

Two additional, recently concluded fiscal agreements have further reduced near-term fiscal policy risks. First, after the debt ceiling of USD 16.4 trillion was reached in late December 2012, the US Congress decided to temporarily suspend the debt ceiling until 19 May 2013, which has contributed to lowering uncertainty. Even if this level of debt is exceeded, the Treasury can turn

2 A model maintained by the UK-based National Institute of Economic and Social Research; for details see the dedicated website (http://nimodel.niesr.ac.uk/).
3 The fiscal year 2013 runs from October 2012 to September 2013.

to “extraordinary measures” to keep the government operating for a few additional months. But the debt ceiling may once again become binding in the summer of 2013, necessitating further budget negotiations. Thus there is the risk of the debt ceiling not being raised in time if political gridlock remains. In this case, the Treasury would only be able to make payments based on the inflow of available cash. Second, the continuing resolution that ensures current government funding, set to expire on 27 March 2013, was extended by Congress on 21 March. Funding is thus ensured until the end of the fiscal year 2013 and a government shutdown has been avoided. Furthermore, even though the approved funding bill leaves the sequester fully in place, it includes provisions designed to help several public agencies administer the cuts with more flexibility in terms of the programmes and areas to which they will apply.

Conclusion and risks

Recent US fiscal policy decisions are likely to result in a drag on US GDP growth of around 0.5-0.8 percentage point in 2013. While this is significant, the full fiscal cliff that could have led to a much greater drag on growth has been avoided, and fiscal policy uncertainty has declined. In the light of this, while the aforementioned fiscal developments are likely to imply a downward revision to US GDP growth forecasts in the near term, risks to economic activity emanating from fiscal policy uncertainty appear to be lower than before. This could help to increase business and consumer confidence and therefore promote investment and consumption in the United States.

As regards long-term fiscal imbalances, the CBO projects the budget deficit to decline from 7.0% of GDP in 2012 to 5.3% in 2013, and to reach 2.4% of GDP in 2015. Nevertheless, the budget deficit and public debt ratio are expected to start rising again in the latter part of the decade, as the main drivers of long-term fiscal imbalances in the United States remain unaddressed. This stems from the fact that fiscal consolidation in the near term will come mainly from the revenue side; the spending reductions resulting from the sequester as of 1 March 2013 do not tackle major entitlement programmes, consisting mostly of health care and social security spending. According to the CBO, health care programmes will rise from 5.3% of GDP in 2012 to 7.1% in 2023, while spending on social security will rise from 4.9% of GDP in 2012 to 5.5% in 2023.

All in all, despite the significant fiscal consolidation taking place in the near term in the United States, fiscal projections point to the need to put forward a medium-term fiscal consolidation plan that tackles the sources of long-term fiscal imbalances so as to ensure that debt dynamics remain sustainable in the medium to longer term.