fiscal shock

America's Economic Crisis
Executive Summary

The U.S. economy is bracing to take an immediate $500 billion hit on January 1, 2013. The "double whammy" of across-the-board cuts in spending and federal tax increases will be large and sudden.

Fiscal Shock: America's Economic Crisis reveals the devastating economic consequences of not addressing the fiscal cliff before it happens. The NAM's report concludes the following:

- Absent legislative action, large spending cuts and large tax increases will hit the economy at the same time, causing a total fiscal contraction of $500 billion, or about 3.2 percent of GDP.
- Washington's failure to address the pending fiscal cliff is already having an impact, cutting 0.6 percentage points from GDP growth for 2012.
- The worst could be ahead. If the fiscal contraction happens, the economy will almost certainly experience a recession in 2013 and significantly slower growth through 2014.
- From 2012 to 2015, the economy will lose 12.8 percent of the average annual real GDP it could have attained with moderate growth, sapping critical resources from all economic sectors.
- Job losses will be dramatic. By 2014, the fiscal contraction will result in almost 6 million jobs lost, and the unemployment rate could reach more than 11 percent.
- Households will take a big hit. Real personal disposable income will drop almost 10 percent by 2015.
- Manufacturers of consumer goods and defense contractors likely will see large and durable contractions in their industries.
- It will take most of the decade for economic activity and employment levels to recover from the fiscal shock. Another recession could deal a substantial blow to long-term economic potential, permanently reducing living standards in the United States.

Fiscal Shock: America's Economic Crisis

Manufacturers and other businesses are worried about slowing global growth. Many of our top trading partners are seeing their economies move in the wrong direction. Europe is in a recession, and its sovereign debt crisis remains an economic and political challenge. Parts of Asia (including China) and South America are also experiencing slow or contracting levels of manufacturing activity, as new sales remain weak. Meanwhile, North America (including the United States, Canada and Mexico) is doing better than the rest of the world in the global marketplace right now, with modest gains in real GDP and slow, but positive growth in employment and incomes. As a result, the United States has become a "safe haven" for companies looking to invest and locate businesses. While the U.S. economy has been fragile, this safe haven has helped keep America growing and out of another recession. But that is now all at risk in historic proportions as the U.S. economy is set to take an immediate $500 billion hit with federal tax increases and spending cuts come January 1, 2013.

The National Association of Manufacturers (NAM) has pulled back the veil to reveal the true impact the fiscal cliff would have on the economy in its report, *Fiscal Shock: America's Economic Crisis.*[1] As key drivers of our economy, manufacturers are already reacting negatively to the tax and spending changes set for January 1 by holding back on hiring and investing in their businesses due to the fiscal uncertainty they face. Consumers have also followed suit. The report shows that Washington's failure thus far to address the pending fiscal cliff is having an immediate impact on our economy by cutting 0.6 percentage points from our annual GDP growth for 2012.

> "...the United States has become a 'safe haven' for companies looking to invest and locate businesses."

It is clear from the report that a fiscal shock of this magnitude is unprecedented for the United States and will be similar in impact to some of the "big bang" fiscal adjustments experienced by developing nations and the austerity programs in several euro-area economies.

[1] Inforum, University of Maryland, September 2012.

Moreover, the worst could be ahead of us. If the fiscal contraction does happen, the economy will almost certainly experience a recession in 2013 and significantly arrested growth through 2014. Most alarming, another severe recession could trigger long-run durable losses to GDP, productivity and real income—losses that would prove incredibly difficult for the United States to recover from.

Specific findings include the following:[2]

- Absent legislative action, large spending cuts combined with large tax increases will hit the economy at the same time, for a total fiscal contraction of $500 billion, or about 3.2 percent of GDP.
- Because of the uncertainty surrounding fiscal policy, consumers and businesses already have reduced spending significantly, cutting 0.6 percentage points of annualized GDP growth for 2012.
- The economy will suffer significantly. The level of GDP will be at least 3 percent lower in 2013 and almost 5 percent lower in 2014, compared to a moderate growth baseline. From 2012 to 2015, the economy will lose a cumulative 12.8 percent of the average annual real GDP it could have attained with moderate growth, sapping critical resources from all economic sectors.
- Job losses will be dramatic. By 2014, the fiscal contraction will result in the loss of almost 6 million jobs compared to the baseline, and the unemployment rate could reach more than 11 percent.
- Households will take a big hit. Real personal disposable income will drop almost 10 percent compared to the baseline by 2015.
- Manufacturers of consumer goods and defense contractors likely will see large and durable contractions in their industries.
- It will take most of the decade for economic activity and employment levels to recover from the fiscal shock. In addition, there is a significant threat that another recession could deal a substantial blow to long-term economic potential, permanently reducing living standards in the United States.

[2] Summarized in Table 1.

The Upcoming Crisis

The pending changes in fiscal policy set for January 1 are both large and sudden. The Budget Control Act (BCA)[3] of 2011 calls for across-the-board cuts in defense and nondefense spending (sequestration) starting in the new calendar year, the same day a number of temporary tax relief provisions expire. Sequestration will reduce federal spending by $65 billion in 2013 alone. Combined with other federal spending cuts in unemployment benefits and Medicare payments to doctors, total federal spending will drop more than $100 billion in 2013.

Just as layoffs of federal employees and contractors begin, many U.S. taxpayers, including investors, employees and businesses, will see an immediate increase in their tax liability. For fiscal year (FY) 2013, these tax policy changes are expected to raise about $400 billion in new revenues compared to FY 2012. Businesses of all sizes will quickly feel the economic impact as consumer spending and investment fall off. The increased revenues will not be sustainable as more people become unemployed and the tax base shrinks considerably.

This will result in the "double whammy" effect, where large spending cuts combined with large tax increases will hit the economy at the same time, for a total fiscal contraction of $500 billion, or about 3.2 percent of GDP. A sudden and durable fiscal contraction of more than 3 percent of GDP is unprecedented for the United States and would be similar to some of the "big bang" fiscal adjustments experienced by developing nations beset by balance-of-payments crises or to the austerity programs recently experienced by several euro-area economies.

"A sudden and durable fiscal contraction of more than 3 percent of GDP is unprecedented for the United States..."

[3] Pub. L. 112-25, S.365, 125 Stat. 239, enacted August 2, 2011.

Heading Down a Steep Slope

Economic theory and empirical evidence imply that forward-looking consumers, businesses and even government agencies will attempt to smooth expenditures over time. If they anticipate the possibility of significant reductions to income, they will reduce expenditures immediately. Given the specter of a sharp fiscal contraction starting in 2013, and notwithstanding the uncertainty over whether the contraction will actually occur, consumers and businesses could reduce, and likely have already reduced, consumption and investment expenditures across 2012.

In fact, an increasing number of manufacturers are canceling new investments and putting off new hires because of the fiscal stalemate.[4] Kellie Johnson, president of ACE Clearwater Enterprises, recently told *The New York Times* that ACE, an aerospace company that employs about 200 employees, is not filling vacant positions and has canceled a half-million-dollar machine order, preventing the company from growing and hiring.

This smoothing behavior implies that the sudden change in fiscal policy will not produce a dramatic contraction at the outset of 2013. Instead, the report estimates that the threat of fiscal contraction has already cut 0.6 percentage points off 2012 GDP growth. Rather than falling off a "cliff," the economy actually slides down a "steep slope" that started sometime in 2012. While the loss of activity and employment in 2013 might not be as large in the absence of smoothing behavior, the negative output and employment effects become more protracted and will grow well into 2014.

"...an increasing number of manufacturers are canceling new investments and putting off new hires..."

[4] Schwartz, N. (August 5, 2012). "Fearing an Impasse in Congress, Industry Cuts Spending." *The New York Times.*

Recession in 2013

Activity and job losses across 2013 and 2014 will be immense. Table 1 shows the percent difference in the level of various macroeconomic indicators in the fiscal contraction case relative to the baseline. In 2013, GDP is 3 percent lower than the baseline, a level that implies a recession with two to three quarters of negative growth. The short-term trauma peaks in 2014, when GDP reaches a low of 4.8 percent below the baseline scenario. From 2012 to 2015, the economy loses a cumulative 12.8 percent of average annual real GDP, compared to the baseline scenario.

The damage to consumers is even greater. Because of lower real personal income and higher federal taxes, the fall in real personal disposable income exceeds the fall in GDP by a large margin, peaking at almost 10 percent in 2015. Across four years, the cumulative loss in real disposable income is almost 26 percent of an average year's income. After 11 years, the cumulative loss is a whopping 48.5 percent.

The employment loss is also dramatic. Compared to the baseline, the economy loses 3.6 million jobs by 2013. In 2014, the peak year of loss, employment is 5.7 million jobs lower relative to the baseline. The unemployment rate rises sharply at the beginning of the shock and reaches almost 12 percent in 2014. The unemployment situation remains dire throughout 2015, as job loss remains above 5 million compared to the baseline.

"Activity and job losses across 2013 and 2014 will be immense."

The Aftermath

By 2016, the situation improves as economic recovery takes hold. Eventually, however, deficit reduction will likely lead to lower capital and labor costs, a lower fiscal burden and lower interest rates. Businesses will respond by unlocking funds reserved for deleveraging. In addition, businesses should become more competitive in international trade, especially in export activity. Consumers will also feel more confident about the future, promoting higher spending on goods, services and housing. While GDP is negative 4.8 percent in 2014, it is only 1.3 percent below the baseline by 2020. The unemployment rate falls from 11.4 percent in 2013 to 5.7 percent in 2022, only 0.3 points above the baseline rate of 5.4 percent.

Still, 10 years after the original fiscal contraction, economic performance remains significantly lower than the baseline. The outcome for real disposable income is even more severe. Even after a decade of adaptation, real household income remains 5 percent below its baseline level in 2022. These results suggest that long-run losses to GDP, productivity and real income could be a durable consequence of a large and sudden short-term fiscal contraction in 2013. A fiscal shock of this nature would, in essence, wipe away a generation's worth of labor and growth, turning back the clock on our economy.

Moreover, there's a chance that the long-term economic damage could be much larger if the recession has a greater negative impact on the labor participation or productivity of the potential worker pool. The report assumes that labor participation does not react to the fiscal policy changes; this may not be the case as long periods of unemployment historically have reduced both the long-term employability and productivity of workers. Another long-running jobs recession coming on the heels of the Great Recession, with high rates of long-term unemployment, has the potential to produce additional lasting damage to economic output.

> "A fiscal shock of this nature would, in essence, wipe away a generation's worth of labor and growth..."

In addition, the recession could cause lower investment levels than expected, especially for infrastructure and human capital. Under the sequestration mandated by the BCA, government spending is reduced across the board. A more rational fiscal retrenchment would likely tread more gradually and lightly on education, infrastructure, defense and other government programs that are vital to the productivity and human capital of the nation.

Finally, further economic recovery depends on positive resurgences in private business activity and exports. However, realization of the worst-case fiscal contraction scenario in January 2013 could be associated with a highly visible paralysis in federal policymaking. Additional problems in Europe would also weigh on confidence. Government failures of such consequence could land another large and lasting blow to consumer and business demand, reducing economic performance and employment by significantly more than indicated in this analysis.

It has been four years since the financial crisis induced a steep recession followed by an anemic recovery. The extent of long-run economic damage from this episode is still unknown. A second deep recession following so closely on the first would compound the effect on potential growth.

Conclusion

The inaction and stalemate in Washington will continue to weigh heavily on consumer and business confidence as the year winds down. Even if the Administration and Congress resolve the uncertainty before the end of the year, economic growth already has sustained significant damage. The short-term fiscal contraction set for 2013 will trigger long-run durable losses to GDP, productivity and real income.

Even under the best-case scenario, it will take almost a decade for economic activity and employment to reach the levels they would have reached without a fiscal shock. While the spending cuts and tax increases reduce the federal deficit and debt, the substantial negative consequences of not addressing the end-of-year fiscal crisis before it happens will be devastating.

Table 1: The Macroeconomic Impact

Fiscal Policy Changes (Billions of Dollars)								
	2012	**2013**	**2014**	**2015**	**2016**	**2018**	**2020**	**2022**
Total Revenue Increases	0	399	449	456	471	516	573	653
Total Spending Decreases	8	103	115	122	126	132	137	142
Total Static Fiscal Contraction	**0**	**502**	**564**	**578**	**597**	**648**	**710**	**795**
Percent of GDP (CBO)	0.1	3.2	3.4	3.3	3.2	3.1	3.1	3.2

Economic Effects: Figures Are Percent Difference from Baseline Scenario, Except Where Noted								
	2012	**2013**	**2014**	**2015**	**2016**	**2018**	**2020**	**2022**
Gross Domestic Product	-0.6	-3.0	-4.8	-4.4	-3.2	-1.5	-1.3	-1.3
Cumulative Percentage Loss	-0.6	-3.6	-8.4	-12.8	-16.0	-17.5	-18.8	-20.0
Real Disposable Income (Bil. 2005$)	-0.6	-6.1	-9.4	-9.8	-8.1	-5.3	-4.5	-4.7
Cumulative Percentage Loss	-0.6	-6.8	-16.1	-25.9	-34.1	-39.3	-43.9	-48.5
Civilian Employment (% Difference)	-0.6	-2.5	-3.9	-3.6	-2.3	-0.6	-0.4	-0.4
Difference in Thousands	-839	-3,617	-5,759	-5,348	-3,532	-946	-611	-581
Cumulative Loss in Job Years	-839	-4,456	-10,215	-15,563	-19,095	-20,040	-20,651	-21,233
Manufacturing Employment	12,840	12,858	12,931	12,987	13,056	13,318	13,498	13,545
Difference in Thousands	-48	-227	-429	-411	-200	181	282	307
Fed Net Borrowing Reduction (Bil. $)	1	372	508	630	653	604	562	702
Baseline Deficit as % of GDP	-7.8	-6.0	-5.3	-4.5	-4.2	-3.5	-3.3	-3.2
Reduction in Percent of GDP	0.0	2.2	2.9	3.4	3.4	2.8	2.4	2.7

Table 2: Impact on Industries

	2012	2013	2014	2015	2016	2018	2020	2022
Agriculture, Forestry, Fisheries	-0.3	-1.9	-2.6	-1.9	-1.0	-0.2	0.0	-0.2
Mining	-0.3	-1.5	-2.4	-2.0	-1.2	0.1	1.0	2.0
Construction	-1.0	-3.1	-6.5	-6.3	-4.4	0.6	0.9	-0.5
Manufacturing								
Non-Durables	-0.5	-2.7	-4.1	-3.6	-2.4	-1.1	-0.7	-0.6
Durable Materials and Products	-0.6	-3.0	-4.6	-3.5	-1.4	1.4	1.6	1.3
Non-Electrical Machinery	-0.1	-1.4	-2.6	-2.0	0.6	5.2	5.6	6.1
Electrical Machinery	-0.4	-3.1	-4.9	-4.6	-2.3	2.2	4.2	5.0
Transportation Equipment	-0.8	-4.5	-6.0	-4.4	-1.7	1.4	1.8	2.2
Instruments and Miscellaneous	-0.3	-2.3	-3.4	-2.7	-0.9	1.8	2.4	3.2
Transportation Services	-0.6	-3.5	-5.2	-4.7	-3.1	-1.1	-0.6	-0.5
Utilities	-0.5	-2.7	-4.5	-4.8	-4.3	-2.5	-1.8	-2.0
Trade	-0.7	-4.0	-6.3	-5.6	-3.6	-1.6	-1.2	-1.2
Finance, Insurance and Real Estate	-0.7	-4.1	-6.5	-6.1	-4.6	-3.0	-2.8	-2.9
Other Services	-0.6	-3.3	-5.4	-5.1	-3.5	-1.7	-1.5	-1.0