

## **Forecast Update: November 30, 2012**

### **A Preliminary Snapshot of the Fiscal Cliff Impact in Indiana**

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The Budget Control Act of 2011 was passed to permit the Federal Government to borrow in excess of its existing borrowing caps. As part of that agreement, decisions regarding tax and spending policy were deferred until after the 2012 election. However, as part of the agreement to extend Federal borrowing, a ‘sequestration’ or mandatory tax increases and spending cuts were scheduled for January 2013. Without further congressional action, this ‘Fiscal Cliff’ will occur in one month. To better evaluate the impact of the Fiscal Cliff, this research update analyzes the impact of the Federal tax increase and spending reductions on Indiana’s economy through 2018. To do so we briefly review the tax increases, the spending cuts and then provide a preliminary economic analysis of the impact on the Indiana economy. We end with a brief summary.

#### **Taxes Spending and the Fiscal Cliff**

The sequestration outlined in the Budget Control Act of 2011 has been labeled the Fiscal Cliff because it contains significant tax increases, and spending cuts which will occur at a time of very tepid economic growth in the United States. This combination of tax increases and spending cuts will be employed to reduce the current deficit, and so might be viewed as paying for government services provided in earlier periods. As a consequence, there will be lower spending by consumers resulting from the tax increases, and fewer goods and services provided by the Federal government resulting from the spending cuts.

The changes to tax policy envisioned in the Fiscal Cliff include a number of taxing instruments. However, two major changes dominate the revenue effect. These are the

elimination of the Bush Tax Cuts (*Economic Growth and Tax Relief Reconciliation Act of 2001* and later changes) and the expiration of FICA payroll tax cuts enacted under two different stimulus bills passed since 2009 (a 2% reduction in the tax rate for payrolls under \$110,300). Child deductions will also be discontinued. Together, the U.S. Office of Management and Budget expects these tax changes to be roughly \$221 billion and \$95 billion, respectively. Indiana’s share of this tax increase would be roughly \$5.5 billion. The Tax Foundation estimates Indiana will see a Federal tax increase of 5.27 percent or roughly \$3,653 per household.<sup>1</sup>

Spending cuts associated with the Fiscal Cliff include unidentified Defense and non-defense discretionary spending (not Medicaid, Medicare or Social Security) of roughly \$55 billion in each category. The Indiana share of these cuts is far less certain than that of the tax increase. Cuts to Federal programs may be proportionately larger or smaller than the nation as a whole due to lumpiness in likely programmatic cuts. For example, defense cuts may occur at individual locations, leaving Indiana largely unscathed or suffering very deep and disproportionate cuts.

### Some Preliminary Impacts

To provide a preliminary estimate of potential impacts of the Fiscal Cliff on Indiana, we model two types of tax increases (FICA and elimination of the Bush Tax Cuts) and Indiana’s proportion of defense and non-defense related expenditures, using a well-known regional economic model.<sup>2</sup> The impacts are estimated from 2013 through 2018, though the sequestration continues in force through 2022. Selected impacts to private employment, Gross Domestic Product (overall economy) and Personal Income are reported in Table 1. These estimates assume proportional impacts of spending cuts in Indiana, due to lack of details on the nature of spending cuts.

**Table 1: Selected Indiana Impacts of the Fiscal Cliff**

Category	2013	2014	2015	2016	2017	2018
<b>Private Non-Farm Employment</b>	-36,500	-37,600	-37,600	-36,921	-35,800	-34,600
<b>Gross Domestic Product*</b> (\$ Billions)	-2.196	-2.325	-2.385	-2.395	-2.384	-2.369
<b>Personal Income</b> (\$billions)	-3.148	-3.469	-3.709	-3.892	-4.039	-4.17

*\*the dollar value of final goods and services produced within the state.*

## Summary and Discussion

The short-run economic impacts of the Fiscal Cliff are significant. January 2013 will see significant tax increases on household ranging from roughly \$1,800 for a household earning \$40,000 per year to roughly \$6,500 for a household earning \$200,000.<sup>3</sup> The aggregate economy in Indiana will also see a significant impact. Overall employment will be 1.2 percent lower than it would otherwise be for each of the years for which we provide estimates. The overall size of the economy (Gross Domestic Product) will decline by 0.9 percent and personal income will shrink by roughly 1.3 percent.

However, within the context of any deficit reduction legislation, these should not be surprising numbers. The aggregate U.S. deficit is sufficiently large, that a complete repayment of the current debt (principal only) will require a lengthy period. For example, the Hoosier share of repaying the debt (based on population share) over the next quarter century is more than \$13.2 billion per year, an amount roughly equal to the state's annual budget. Thus, any effort to repay this debt, even under optimistic economic growth assumptions will be expensive.

## Further Reading

Entin, Stephan J. "*Diving of the Fiscal Cliff: An Economy on the Rocks*" Tax Foundation, November 27, 2012

Gale, William G., and Peter R. Orszag. "Bush Administration Tax Policy: Starving the Beast?." Tax Notes 105, no. 8 (2004): 999-1002.

Faulk, Dagny, Nalitra Thaiprasert, Michael Hicks, *The Economic Effects of Replacing the Property Tax with a Sales or Income Tax: A Computable General Equilibrium Approach*. No. 201008. 2010.

Hicks, Michal Srikant Devaraj, and Hikoyat Salimova (2011) "*A Technical Analysis of the Economic Impact of U.S. Department of Defense Contracts in Indiana*" Center for Business and Economic Research, Ball State University.

Office of Management and Budget "*Economic Effects of Reducing the Fiscal Restraint That Is Scheduled to Occur in 2013*" November 2012.

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<sup>1</sup> See Kasprak,, Nick "How Would the Fiscal Cliff Affect Typical Families in Each State? Tax Foundation, November 12, 2012.

<sup>2</sup> Regional Economic Models, Inc., model for 23 sectors in Indiana.

<sup>3</sup> See Congressional Budget Office, Choices for Deficit Reduction, November 2012.