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Experts Forecast the Cost of Failure to Compromise

By NELSON D. SCHWARTZ

Even if President Obama and Republicans in Congress can reach a last-minute compromise that averts some tax increases before Monday's midnight deadline, experts still foresee a significant drag on the economy in the first half of 2013 from the fiscal impasse in Washington.

While negotiators in the capital focus on keeping Bush-era tax rates in place for all but the wealthiest Americans, other tax increases are expected to go into effect regardless of what happens in the coming days. For example, a two percentage point jump in payroll taxes for Social Security is all but certain after Jan. 1, a change that will equal an additional $2,000 from the paycheck of a worker earning $100,000 a year.

Many observers initially expected the lower payroll-tax deduction rate of 4.2 percent to be preserved. But in recent weeks, as it became clear that political leaders were prepared to let that rate rise to 6.2 percent, economists reduced their predictions for growth in the first quarter accordingly.

Largely because of this jump in payroll taxes, Nigel Gault, chief United States economist at IHS Global Insight, is halving his prediction for economic growth in the first quarter to 1 percent from an earlier estimate of just over 2 percent. That represents a significant slowdown in economic growth from the third quarter of 2012, when the economy expanded at an annual rate of 3.1 percent.

Mr. Obama has pushed to preserve Bush-era tax rates on income below $250,000 a year but Republicans have held out for a higher threshold, perhaps in the neighborhood of $400,000 a year. Republicans also favor deeper spending cuts to curb long-term budget deficits — a move many Democrats oppose.

While hopes dimmed Sunday afternoon that a deal could be reached before Jan. 1, most observers said they did not expect the full impact from more than $600 billion in potential tax increases and spending cuts to swamp the economy right away. Indeed, a compromise could be struck in the coming weeks that heads off the worst of the fallout.

In the event no compromise is found, however, the Congressional Budget Office and many private economists warn that the sudden pullback in spending and the rise in taxes would push the economy into recession in the first half of the year. Under this outcome, Mr. Gault said, the economy could shrink by 0.5 percent over all of 2013.

With the clock ticking, some observers bolstered their criticism of Washington. “If we have a recession, it’s unforgivable,” said **Bernard Baumohl, chief global economist at the Economic Outlook Group.** “For the first time in modern history, we will have a self-inflicted recession in the U.S.”

Despite Washington’s history of delaying fiscal compromises to the last possible minute — as in the fight over raising the debt ceiling in the summer of 2011 — investors had assumed until very recently that a deal would be completed before year-end.

But last week, stocks sold off as hopes for a quick compromise faded. More pressure on shares is expected beginning on Monday, especially if the fight does indeed slip into 2013. If anything forces politicians to act, Mr. **Baumohl** said, it could be a sell-off on Wall Street. “The politicians need to be pressed by markets to be forced to the table,” he said.

Payroll managers at many companies are also watching the negotiations closely but have already prepared systems for the two percentage point change in payroll taxes, said Scott A. Schapiro, a principal at KPMG.

“We’re primarily closed down from Christmas to New Year’s,” he said, “but our payroll folks are working. Payroll has to be around.”

“This is one of the most obvious effects of the fiscal cliff,” Mr. Schapiro added, “because it will affect all taxpayers.” The Social Security payroll tax applies to the first $113,700 of annual income, he said. It was first cut by Congress in late 2010 to help give the economy a jolt, and was extended again last year to cover 2012.

Another big question mark is whether unemployment benefits for more than two million jobless Americans will be extended beyond Jan. 1. While there is still the possibility these payouts for the long-term unemployed will be preserved as the negotiations go down to the wire, failure to extend them would deliver another sizable blow to a still-fragile economy, experts said.

“This is not just an inside-the-Beltway-game,” said Vincent Reinhart, chief United States economist at Morgan Stanley. “Both the payroll tax increase and the change in unemployment benefits would hit hand-to-mouth consumers hard. This has consequences for the whole economy.”

Consumer spending is especially critical right now, because many businesses have pulled back already, citing the fiscal impasse in Washington as a prime concern. Until recently, consumers have been more optimistic about the economy, although sentiment has eroded in recent weeks as anxiety increased about just what policy makers would do in terms of taxes and spending.

If it were not for the uncertainty in Washington and the fallout from the fiscal impasse, Mr. Reinhart said, the economy would be growing at an annual rate of 2 percent to 2.5 percent. Instead, he estimated growth in the fourth quarter of 2012 at just under 1 percent, and said he expected it to edge up only slightly to around 1 percent in the first half of 2013. Unemployment, now at 7.7 percent, is about 0.3 percentage point higher than it otherwise would be, he added.

To be sure, the impact from some other scheduled changes will not be felt right away — and could still be reversed if a deal is completed in the coming weeks. For example, automatic spending cuts set to hit the Pentagon budget as well as nonmilitary programs are spread out between now and the end of the 2013 fiscal year in September, giving legislators time to change course and head off any major impact.

But the longer the standoff continues, the deeper the economic damage, experts said. “Because the politicians couldn’t get out of the way,” Mr. Reinhart said, “growth in the last quarter of 2012 and the first two quarters of 2013 will be below trend. There is a real cost of not coming to the table.”

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