Post-Election Fiscal Drama in the United States: A Real Cliffhanger

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The Global Economic Crisis: Mitigating the Impact and Preventing a Recurrence

- Accumulation of fuel for the fire: Underlying causes of the crisis
- Lighting the fire: Short-term triggers for the crisis
- Pouring fuel on the fire: Accelerants for the crisis
- Scorched earth and unburned terrain: Current and potential magnitude of the crisis
- Responses to the crisis: Liquidity, solvency, and trust
- A new global financial architecture: A post-Bretton Woods world order
Hottest Issues at Present

• Fiscal Policy:

  Deficit (Keynes) or Balanced Budget (Hoover)

• Monetary Policy:

  Expansionary (Keynes) or Contractionary (Hoover)

→ Like U.S. after Great Depression or Japan today?
The Ailing U.S. Economy in 2012: Rehab or Relapse?

• Results to Date:
  Did the monetary stimulus work?
  Did the fiscal stimulus work?
  Does austerity foster growth?

• The Road Ahead:
  Balancing long-term concerns with short-term needs?
  Context of the upcoming presidential election?

→ Is the U.S. on the path of a slow and painful recovery (rehab) or will the U.S. end up back in the ICU with a double-dip recession (relapse)?
2013 Canon Institute Presentation
Post-Election Fiscal Drama in the U.S.: A Real Cliffhanger

• Results of 2012 Economic Health Check-Up:
  Is the U.S. better off than it was four years ago?

• The Fiscal Cliff:
  The Perfect Storm?

• Alternative scenarios:
  Cost of inaction?
  The grand compromise?
  Kick the can down the road?
## Results of 2012 Economic Health Check-Up: Is the U.S. better off than it was four years ago?

<table>
<thead>
<tr>
<th>Indicator</th>
<th>2008</th>
<th>2012 (through Sept.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average unemployment rate</td>
<td>5.8%</td>
<td>8.2%</td>
</tr>
<tr>
<td>Average monthly job growth</td>
<td>-300,000</td>
<td>155,000</td>
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<tr>
<td>Economic growth rate</td>
<td>-0.3%</td>
<td>1.7%</td>
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<tr>
<td>Inflation rate</td>
<td>0.1%</td>
<td>2.0%</td>
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<tr>
<td>Average household income</td>
<td>$52,546</td>
<td>$49,680</td>
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<tr>
<td>Home sales (Sept., seasonally adj. annual rate)</td>
<td>4.3 million</td>
<td>4.8 million</td>
</tr>
<tr>
<td>Median home price (Sept.)</td>
<td>$191,000</td>
<td>$183,900</td>
</tr>
<tr>
<td>Average mortgage rate</td>
<td>6.03%</td>
<td>3.75%</td>
</tr>
<tr>
<td>Foreclosure filings</td>
<td>2.2 million (approx.)</td>
<td>1.8 million (proj.)</td>
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</tbody>
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Sources: Labor Dept., Commerce Dept., National Association of Realtors, Realty Trac, Moody’s Analytics, Freddie Mac.
# The Fiscal Cliff: The Perfect Storm?

<table>
<thead>
<tr>
<th>Item</th>
<th>Potential Impact in 2013</th>
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<tbody>
<tr>
<td>Expiration of Bush income/investment/inheritance tax cuts + increased coverage of AMT</td>
<td>$330 billion (through 9/13)</td>
</tr>
<tr>
<td>Expiration of Obama payroll tax cut</td>
<td>$95 billion</td>
</tr>
<tr>
<td>Expiration of tax extenders</td>
<td>$65 billion</td>
</tr>
<tr>
<td>Mandatory cuts in domestic programs</td>
<td>$55 billion</td>
</tr>
<tr>
<td>Mandatory cuts in defense programs</td>
<td>$55 billion</td>
</tr>
<tr>
<td>Expiration of benefits for long-term unemployed</td>
<td>$26 billion</td>
</tr>
<tr>
<td>Cut in Medicare reimbursements</td>
<td>$11 billion</td>
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<tr>
<td>Total deficit reduction through September 2013</td>
<td>$500 billion (CBO estimate)</td>
</tr>
<tr>
<td>Total deficit reduction through December 2013</td>
<td>$700 billion (CBO estimate)</td>
</tr>
</tbody>
</table>

Bonus Challenge: Congress must increase the government’s borrowing cap (“debt limit”)
Long-Term Concerns: Deficit and Debt

• In 2001, generated a budget surplus and gross federal debt as a share of GDP was half of its current level
• Since 2007, 7-fold increase in federal budget deficit as share of GDP (now 8.5%) and 62.2% increase in gross federal debt as a share of GDP (now 104.8%)
• Interest in the federal debt as a share of GDP will also increase (projected to reach 2.8% in 2017, or $565 b and 12.5% of total federal expenditures)
• Need for fiscal consolidation combining increased revenue and decreased expenditures
  – 2009 fed receipts 15.1% of GDP, lowest since 1950; usually 18-20% since WW II, still only 15.8% in 2012 (est.)
  – 2009 fed outlays 25.2% of GDP, highest since 1945; increased 27.9% since 2007, still 24.3% in 2012 (est.)
Prior to Reagan: $1 tr.
End of GHW Bush: Prior to $4.4 tr. GW Bush: $5.8 tr.
After GW Bush: $11.9 tr.
Today: $16.4 tr.

A 2001 recession, tax cuts, war costs and the economic crisis accelerated the debt’s growth.
Scenario One: The Cost of Inaction?

- Combination of tax increases and expenditure cuts ("austerity budget") ≈ Obama stimulus package → double-dip recession → virtuous to vicious cycle?

- No increase in government borrowing authority → credit rating downgrade → increased borrowing costs?
### Scenario Two: The Grand Compromise?

<table>
<thead>
<tr>
<th>Obama Administration</th>
<th>Congressional Republicans</th>
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<tbody>
<tr>
<td><strong>10-year savings:</strong> $4.4 trillion</td>
<td><strong>10-year savings:</strong> $4.6 trillion</td>
</tr>
<tr>
<td><strong>New savings:</strong> $2.0 trillion</td>
<td><strong>New savings:</strong> $2.2 trillion</td>
</tr>
<tr>
<td>– New tax revenue: $1.6 tr</td>
<td>– Reduced tax breaks: $800 b</td>
</tr>
<tr>
<td>– New spending: -$0.2 tr</td>
<td>– Entitlement cuts: $200 b</td>
</tr>
<tr>
<td>– Health spending cuts: $350 b</td>
<td>– Health spending cuts: $600 b</td>
</tr>
<tr>
<td>– Mandatory spending cuts: $250 b</td>
<td>– Mandatory spending cuts: $300 b</td>
</tr>
<tr>
<td><strong>Previously planned savings:</strong> $2.4 trillion</td>
<td><strong>Previously planned savings:</strong> $2.4 trillion</td>
</tr>
<tr>
<td>– 2011 Budget Control Act: $1.0 tr</td>
<td>– 2011 Budget Control Act: $1.0 tr</td>
</tr>
<tr>
<td>– War drawdown: $800 b</td>
<td>– War drawdown: $800 b</td>
</tr>
<tr>
<td>– Interest savings: $600 b</td>
<td>– Interest savings: $600 b</td>
</tr>
</tbody>
</table>
Contextual Observations for Scenario Two: The Grand Compromise?

• How to raise more revenue efficiency and equitably
  – Can both increase tax revenue and decrease tax rates by broadening the tax base (reduce tax expenditures)
  – Most paid less in taxes in 2010 than those with the same inflation-adjusted incomes paid in 1980 because of cuts in federal income taxes; offset at lower income levels by higher federal payroll taxes, state sales taxes, local property taxes

• Where to cut expenditures so that it really matters
  – Mandatory spending now comprises \( \frac{2}{3} \) of all expenditures
  – U.S. accounts for > 40% of money spend on defense worldwide, and as much as the next 14 countries combined
Scenario Three: Kick the Can Down the Road?

• Wait for new Congress?
• Bad agreement worse than no agreement?
• Fiscal cliff or fiscal slope?
Scenario Three, Step #1: Prevent Widespread Tax Increases

- Tax bill passed by Senate and House on 1 Jan 2013
  - Permanent extension of Bush income tax cuts on incomes to $400,000 for individuals and $450,000 for couples; earnings above these amounts taxed at 39.6%, up from 35.0%
  - Permanent increase in taxes on l-t capital gains & dividends (15%→20%), estates (35%→40%) for wealthy taxpayers
  - Permanent end of 2.0% cut in the social security payroll tax for all taxpayers, reverting to the previous 6.2% tax rate
  - Permanent inflation indexing of AMT
  - 5-year extension of expansions of the child tax credit, EITC, and college tuition tax credit
  - 1-year extension of selected business tax credits
  - 1-year extension of jobless benefits for l-t unemployed
  - >90% of tax increases fall on HHs with incomes ≥ $1 m
Scenario Three, Step #2: Prevent Default on National Debt

- Bill passed by House (23 Jan) and Senate (31 Jan) to temporarily suspend $16.4 tr debt ceiling until 18 May
- Formal debt ceiling reached on 31 December 2012
- Postpones actually likely default from Feb to Aug 2013
- Allows government to borrow necessary ≈ $450 b
- Political compromise
  - Democrats: Not contingent on matching budget cuts
  - Republicans: “No budget, no pay”; “re-sequencing”
Scenario Three, Step #3: Prevent Sequestration

- Sequestration delayed until 1 March 2013 as part of new tax law (see Step #1)
- Still requires across-the-board automatic spending cuts to military and domestic programs
- $110 b for 2013 reduced to $85 b by new tax law
- Medicare, Medicaid, and food stamps exempted

Key remaining challenge is formulating a budget that balances the need for long-term fiscal consolidation with the vulnerabilities of short-term economic fragility