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Restoring Fiscal Equilibrium in the United States

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Halfway through this presidential election year, there is great uncertainty about how, when, and even whether the United States will restore fiscal sustainability. As shown by the near-default because of the impasse over the debt ceiling in July 2011, the two parties have been in sharp opposition on this issue. The Republicans have insisted that adjustment be accomplished by spending cuts rather than tax increases. Two hundred and thirty eight Republican congressmen and 41 Republican senators have signed the Grover Norquist pledge to oppose any attempt to raise marginal tax rates or reduce deductions without implementing offsetting tax reductions.[1] In contrast, Democratic lawmakers have tended to emphasize the maintenance of social and entitlement programs and expressed a willingness to restore higher tax rates if necessary.

1. See the Americans for Tax Reform website, www.atr.org/taxpayer-protection-pledge.

THE FISCAL CLIFF

The United States faces a "fiscal cliff" at the end of calendar year 2012, when the two major tax cuts from the Bush era[2] and some other tax provisions will expire and in the absence of action scheduled reductions in spending will begin. The subsequent increase in taxes and reduction in spending would dramatically tighten the federal budget deficit at a time when unemployment remains high.

Together, the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) had cut revenue by about 2.6 percentage points of GDP (Cline 2005, 114). However, in order to obtain passage of this legislation, Congress at the time included a phase-out date in the expectation that the cuts would eventually be made permanent. A large permanent tax cut may have looked feasible a decade ago after the budget surpluses of the late 1990s, but it looks far less feasible today, after three years of fiscal deficits close to 10 percent of GDP and a surge in debt held by the public from about 40 to about 70 percent of GDP.

The fiscal cliff also includes four other components. First, the temporary payroll tax cut will expire. This tax cut has temporarily eliminated 2 percentage points out of the employee's 6.2 percent Social Security tax on the first $110,000 of salary. Second, the compromise Budget Control Act of 2011, which avoided default in July 2011, provided that if a super committee could not agree on fiscal cuts, an automatic mechanism beginning in 2013 would cut spending by $109 billion annually, divided evenly between defense and nondefense nonentitlement spending (Kogan 2012). Third, the emergency unemployment benefits will expire. Fourth, in the absence of action there will be a surge in collections

2. The original expiration date was end-2010, but in December 2010 the cuts were extended for two years, accounting for about half of an $858 billion stimulus bill that also temporarily cut payroll taxes, extended unemployment benefits, and reinstated the estate tax at moderate rates. The legislation was the second large stimulus package under the Obama administration in response to the Great Recession, following the $831 billion American Recovery and Reinvestment Act of 2009. See http://stimulus.org.

Table 1 The fiscal cliff: Revenue and spending changes on track in 2013 in the absence of new legislation (billions of dollars)

Category	FY2013	CY2013e
Revenue increases		
Expiration of certain provisions in income tax, estate tax, and AMT indexation at end-2012	221	294
Expiration of employee's payroll tax reduction	95	126
Other expiring provisions	65	86
Taxes in the Affordable Care Act	18	24
Subtotal	399	531
Spending reductions		
Automatic cuts, Budget Control Act	65	86
Expiration of emergency unemployment benefits	26	35
Reduction in Medicare payment rates for physicians	11	15
Subtotal	103	137
Other revenue and spending changes	105	140
Total reduction in deficit: Direct (percent of GDP in parentheses)	607 (3.7)	807 (4.9)
Effect of economic feedback	–47	–62
Total change (percent of GDP in parentheses)	560 (3.4)	745 (4.5)

AMT = alternative minimum tax; FY = fiscal year; CY = calendar year; e = estimate

Source: CBO (2012d).

of the alternative minimum tax (AMT) and enforced cuts in payments to doctors under Medicare, two components of the budget that in recent years have repeatedly been dealt with through annual "fixes."

Table 1 summarizes the components of the fiscal cliff. The first column reports the impact of the fiscal cliff for the portion of FY2013 after December 2012, a nine-month period. The final column annualizes these amounts to obtain an approximation of the full effect for calendar year 2013. On an annual basis the total impact of the fiscal cliff amounts to a reduction in the federal budget deficit of about $800 billion on a direct basis (about 5 percent of GDP). After taking account of revenue losses and extra social spending resulting from induced slowdown in the economy, the Congressional Budget Office (CBO 2012d) places the net fiscal impact at $560 billion for the first nine months of 2013, implying $745 billion or 4.5 percent of GDP for calendar year 2013. The CBO calculates that allowing the full fiscal cliff effects to take place will cut growth in the first half of 2013 to –1.3 percent at an annual rate (a recession by the usual definition of two negative quarters). Growth would rebound to 2.3 percent in the second half, leaving growth for the full year barely positive at 0.5 percent (CBO 2012d, 6).

The CBO estimates imply that even running the economy headlong over the fiscal cliff would not be fatal. The same study estimates that in an "alternative scenario" in which the expiring tax provisions are extended (except for the temporary payroll tax cut), the AMT is indexed for inflation after 2011, Medicare payments to doctors are held constant rather than reduced, and the automatic spending cuts of the Budget Control Act do not occur (but caps on discretionary spending in that law are retained), US growth in 2013 would be 2.1 percent instead of 0.5 percent (CBO 2012b, 2012d). However, by 2022 debt held by the public would reach 93 percent of GDP. In broad terms, for the price of 1.6 percent of one year's GDP, or $260 billion, the United States could aggressively fix its long-term fiscal problem, because the "current law" fiscal cliff scenario would cut deficits to an average of 1.4 percent of GDP in 2013–22 and bring debt held by the public back down to 61 percent of GDP by 2022 (CBO 2012b). The eventual output loss from the correction would be somewhat smaller because longer-term growth would tend to be higher with more resources available for capital formation rather than being required to service public debt.[3]

3. Even so, this effect seems to be small. In January 2012, the CBO (2012a) estimated that the level of real GDP in the fourth quarter of 2013 would be 0.5 to 3.7 percent higher under the "alternative" policy scenario than in the baseline current law ("fiscal cliff") case, whereas by 2022 the alternative real GDP path would be in a range 2.1 percent below to 0.2 percent above the baseline. The estimate midpoint of 1 percent loss in real output level by 2022 from pursuing the alternative scenario seems small, however, and does not include any "expected value" of a future debt crisis as a consequence of raising the debt level in the alternative scenario.

THE NEED FOR FISCAL ADJUSTMENT

The loss of 1.6 percent of GDP in the near term from failing to act and submitting passively to the fiscal cliff is driven by the fact that with still high unemployment, the reduction in demand would mean a sacrifice in potential output rather than a redeployment of resources from use in government purposes to use in private purposes. If instead there were no excess capacity and unemployment were at, say, 4 to 5 percent, a case could be made to simply allow the fiscal cliff effects to happen. After all, recent deficits have been extremely high, spending extremely high, and revenue extremely low. As shown in figure 1, for fiscal years 1990–2007 federal revenue was an average of 18.3 percent of GDP, federal outlays an average of 20.1 percent, and the deficit an average of only 1.8 percent of GDP. In contrast, during fiscal years 2008–11, revenue fell to an average of only 15.8 percent of GDP, whereas outlays rose to an average of 23.5 percent of GDP, placing the average deficit at 7.8 percent of GDP and increasing the debt held by the public from 36.3 percent of GDP in 2007 to 67.7 percent at the end of FY2011 (figure 2).[4] Outlays had already risen by 2 percent of GDP from 2000–01 to 2005–07, in part because defense spending had rebounded from a post–Cold War low of 3 percent to about 4 percent of GDP, spurred by the Iraq and Afghanistan wars. By 2010 defense spending was up to 4.8 percent of GDP, nearly at its 5.1 percent average in 1991–92 (CBO 2012a, appendix F).

There should be little doubt that over the medium to longer term revenue should at least return to its earlier average of about 18 percent of GDP, and spending should ease back toward the earlier average as well (as automatic stabilizer spending and fiscal stimulus phase out). The deficit needs to fall to no more than about 3 percent of GDP and would preferably return to about 2 percent or less as in 1990–2007.

It can be argued that over a long-enough time frame the benchmark for both spending and revenue should be somewhat higher than in 1990–2007 to take account of the increased public responsibilities associated with an aging population (mainly Social Security and health costs). In the proposed 2013 budget of the Obama administration, for example, the average for revenue in 2013–20 is 19.4 percent of GDP, or 1.1 percent of GDP higher than the 1990–2007 average; the average for outlays is 22.5 percent of GDP, an increase of 2.4 percent of GDP above the 1990–2007 average (CBO 2012c). The resulting average deficit of 3.2 percent of GDP would be 1.5 percent of GDP higher than the average deficit in 1990–2007 and would be consistent with the debt held by the public plateauing at a steady 76 percent of GDP by 2020 (OMB 2012).

A Republican alternative would presumably involve lower spending and lower revenue. Thus, candidate Mitt Romney has proposed that federal spending be capped at 20 percent of GDP. He has also proposed elimination of taxes on capital gains, dividends, and interest for families earning less than $200,000, as well as eliminating estate taxes and reducing corporate taxes. A central estimate of the consequences of his plan places the resulting debt held by the public at 86 percent of GDP in 2021 (CRFB 2012), although Mr. Romney would presumably project a more favorable outcome.

TARGETS AND TIMING

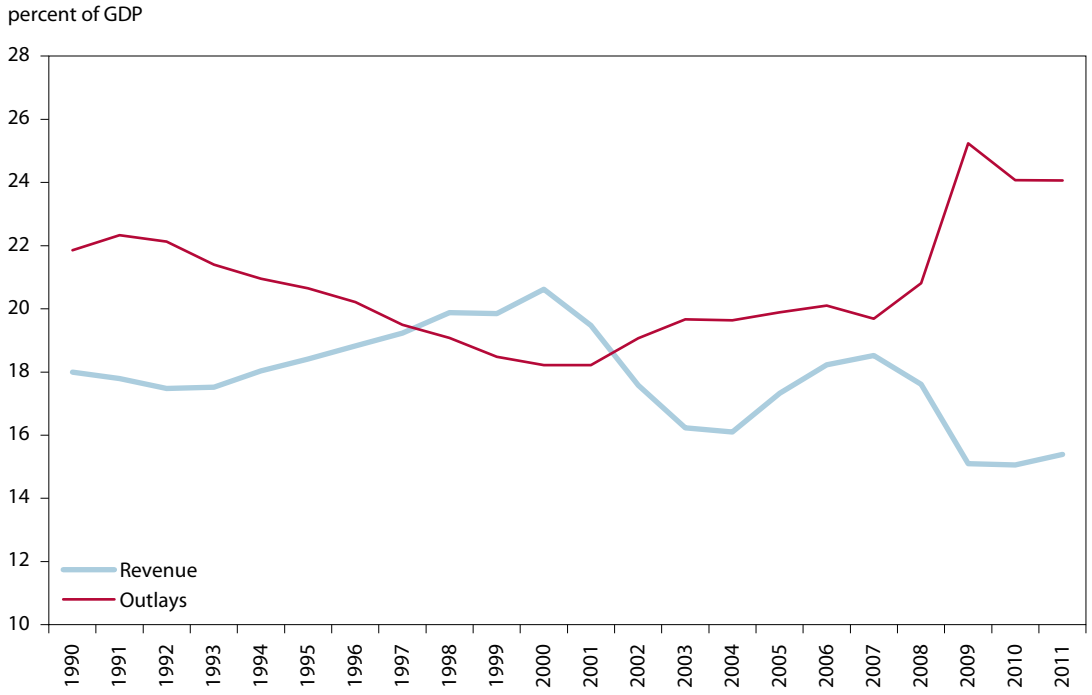
Overall, in the medium term federal spending needs to be held down to a range of 20 to 22 percent of GDP and federal revenue needs to recover to a range of 18 to 19 percent of GDP. Republicans will likely favor the lower end for each range, and Democrats, the higher end. For FY2012 the CBO (2012a) projects spending at 23.5 percent of GDP and revenue at 16.3 percent of GDP, yielding a deficit of 7.2 percent of GDP. So the medium-term target would be to raise revenue by 1.7 to 2.7 percent of GDP and cut spending by 1.5 to 3.5 percent of GDP against FY2012 levels. Suppose for simplicity one were to adopt the averages of these ranges as the targets, placing the spending cut at 2.5 percent of GDP (to 21 percent of GDP) and the revenue increase at 2.2 percent of GDP (to 18.5 percent of GDP). The medium-term deficit would then be 2.5 percent of GDP. This magnitude would be consistent with long-term sustainability.[5] The operational questions would then be the following: First, how much of this adjustment could be expected to occur automatically as the economy returns to full employment? Second, of the remaining amount needed from specific changes in fiscal policy, what should be the timing in order to minimize the loss of output as a consequence of Keynesian demand contraction?

One guide to the first question is the difference between the cyclically adjusted and actual fiscal accounts. The International Monetary Fund (IMF 2012) estimates that the difference between the actual general government deficit and the structural general government deficit removing cyclical

4. The high fiscal deficits in 2008–11 were due in part to automatic stabilizers, which contributed an average of 1.9 percent of GDP in deficits in this period and will account for an average of 2.6 percent of GDP in FY2012–14 (CBO 2012a, 117). The estimate appears on the low side, however. It should include revenue losses from a weaker economy but is considerably smaller than the 3.5 percent of GDP reduction in revenue from 2007 to 2010.

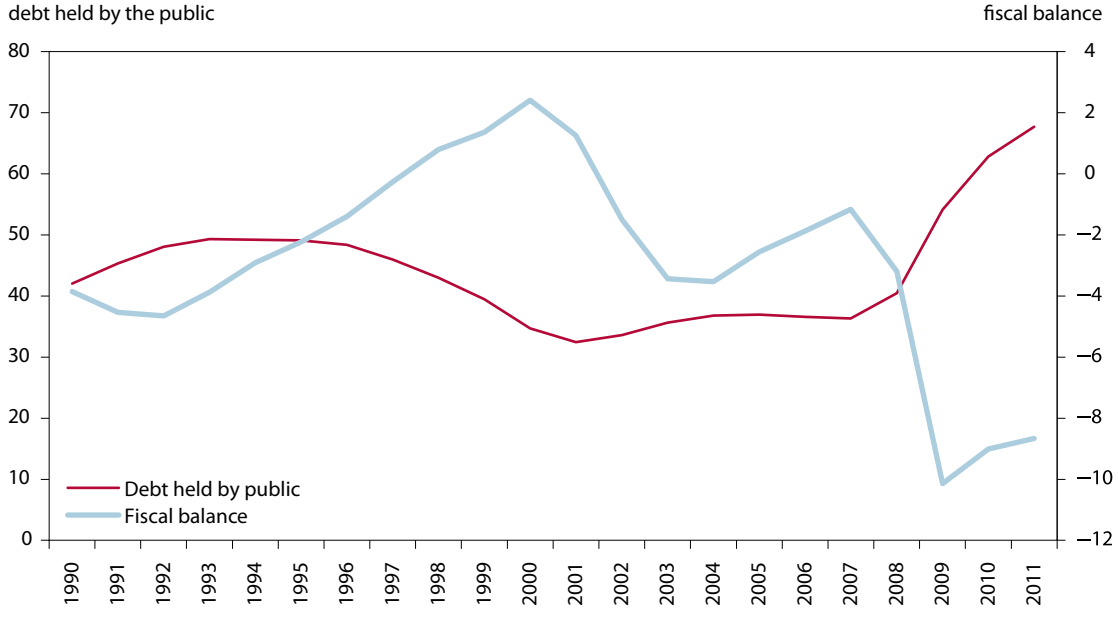
5. With nominal growth at say 4.5 percent (2.5 percent real, 2 percent inflation), a deficit of 2.5 percent of GDP would cause the very-long-term debt/GDP ratio to converge to 55.5 percent, close to the 60 percent limit typically considered reasonable for industrial countries.

Figure 1 Federal revenue and outlays as percent of GDP, 1990–2011



Source: CBO (2012a, appendix F).

Figure 2 Debt held by the public and fiscal balance as percent of GDP, 1990–2011



Source: CBO (2012a, appendix F).

influences amounts to 2.2 percent of GDP in 2012, declining to 0.5 percent of GDP by 2016. A conservative estimate, then, would be that a 1.7 percent of GDP reduction in the fiscal deficit can be expected to occur automatically as the adverse fiscal effects in the aftermath of the Great Recession run their cyclical course.

The fiscal cliff occurs too early and amounts to overkill, but well more than half of it is necessary and should not be delayed indefinitely.

Against the FY2012 deficit of 7.2 percent of GDP, then, the component representing a medium-term structural deficit would amount to 5.5 percent of GDP. As suggested above, a reasonable target for the medium- and long-term deficit is 2.5 percent of GDP. The size of the required adjustment in the structural adjustment, by implication, amounts to 3 percent of GDP, or 60 percent of the fiscal cliff total of about 5 percent of GDP (table 1).[6]

My working hypothesis, then, is that *the structural fiscal adjustment task for the United States amounts to 3 percent of GDP*. The fiscal cliff occurs too early and amounts to overkill, but well more than half of it is necessary and should not be delayed indefinitely. The corollary question is then when to carry out the needed 3 percent of GDP adjustment. One way to think about timing is to consider the implications of setting the target for full adjustment by 2016. That time frame would have the advantage of committing the new president to an obligation to deliver by the end of his term a fiscal balance that is in a sustainable "equilibrium," defined as a 2.5 percent of GDP deficit from the above. The commitment of the president to what he would seek during the new term would help provide credibility to the strategy of seeking fiscal adjustment over time but delaying its full force because of concern for cyclical demand effects. The target of completing structural fiscal adjustment by 2016 would amount to returning to normal fiscal prudence fully eight years after the financial crisis of 2008, a period that one would think should be sufficient even following a financial crisis. Importantly, the output gap should be largely eliminated by 2016.[7]

Suppose the adjustment is phased evenly over four years. Under present conditions, the real multiplier is probably close to unity: 1 percent of GDP real fiscal adjustment reduces output by 1 percent, in part because the zero-interest constraint on monetary policy limits the scope for offsetting stimulus by the Federal Reserve (though another round of quantitative easing, QE3, might help fill that role). At full employment the real multiplier should be zero by definition, because there are no excess resources to mobilize through deficit spending. Suppose in practice the excess capacity is also assumed to disappear over the next four years. Simplifying by linear extrapolation, the implied output loss from the phase-in of 3 percent of GDP structural fiscal adjustment would then amount to about 1.9 percent of one year's GDP.[8] The same calculation for the full 2013 fiscal cliff would yield an output loss of 4.9 percent of GDP (multiplier of 1 times fiscal cut). So the real cost of the need to move ahead on fiscal adjustment despite incomplete recovery from the recession would be cut by more than half through the more gradual phase-in, as well as the pursuit of 3 percent of GDP adjustment in the structural deficit rather than 5 percent. Both estimates exceed the CBO's output cost of the sudden fiscal cliff and so are likely to be overstated but nonetheless may provide a sense of the merits of more gradual phase-in of a less-severe adjustment.

POLITICAL CONTEXT

In sum, the macroeconomics of the adjustment are as follows. The United States needs to cut 3 percent of GDP out of its noncyclical fiscal deficit; it would be reasonable to do so about half on the tax side and half on the spending side, restoring fiscal revenue to 18.5 percent of GDP and cutting spending to 21 percent of GDP; and that it would be reasonable to do so over the next four years but not all at once in 2013. But what about the politics? It seems unlikely that Congress will act before the presidential election. There are thus two scenarios for events following the election, one for a victory by President Obama and the other for a victory by Mr. Romney.

If there is a Republican victory, then nothing is likely to happen in the lame-duck session. By mid-January 2013, when Mr. Romney would take office, the Bush tax cuts would already have expired. Technically all of the Republicans who

6. The appropriate comparison is against the "direct" impact of 4.9 percent of GDP (table 1).

7. The IMF (2012) projects that the US output gap will decline from 4.9 percent of GDP in 2012 to 1.1 percent by 2016 and zero by 2017. The CBO (2012a, 117) estimates the output gap at 5.4 percent in FY2012 and (under the current law baseline) an average of 5.3 percent in FY2013–14, 2.7 percent in FY2015, 1.0 percent in FY2016, and zero in FY2017. The CBO's corresponding estimate of the "unemployment gap" is 3.3 percent in FY2012, falling to 1 percent in FY2016. The relationship is thus currently a bit below the "Okun's law" parameter of 2 percent of GDP output gap for each additional 1 percent unemployment.

8. Referring for each year to the product of the multiplier for that year and the adjustment tranche yields: 1.0 x 0.75 + 0.75 x 0.75 + 0.5 x 0.75 + 0.25 x 0.75 = 1.875.

have signed a pledge not to increase taxes would be relieved from the necessity to do so because taxes would already have rebounded. For them, the nature of the debate would then turn to the question of how far back down taxes could be pushed toward the Bush era levels. It seems likely that a new Republican administration would be in a good position to push through new legislation that would restore the tax cuts. Although the need to get past the 60-vote filibuster-cloture

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hurdle in the Senate might place a limit on the extent of the rollback, in budget matters the "reconciliation" arrangement provides a mechanism to circumvent this Senate supermajority requirement. The ultimate obstacle to a budget law is the presidential veto, rather than a Senate supermajority. With the executive branch held by a Republican, the House controlled by Republicans, and some possibility that even the Senate would have a Republican majority, in principle it would seem relatively feasible for new legislation to be in place early in 2013 so that the fiscal cliff effects are moderated. In this scenario the challenge is to identify plausible spending cuts that permit the restoration of a major part, if not all, of the Bush tax cuts. The principal risk would be that a Republican-controlled process would generate a result of major or complete extension of the Bush tax cuts accompanied by vague promises of spending cuts that were deep on paper but incapable of being realized in the event, leaving an outcome of future deficits far in excess of the targets.

If instead President Obama is reelected for a second term, and the Senate retains a Democratic majority, then presumably he would push for new legislation by the end of December. Such legislation might have a chance because the Republican opposition otherwise would be facing the sure alternative of expiration of the Bush tax cuts by January 1. President Obama has spoken of the goal of keeping the Bush tax cuts for households earning less than $250,000. Although popular as a gesture favoring the middle class, this constraint is costly and would eliminate about one-half to three-fourths of the revenue potential from the expiration of the Bush tax cuts.[9] The administration's call for a "Buffett Rule" taxing incomes over $1 million at a minimum of 30 percent is more symbolic than substantive, as the tax would raise only $4.3 billion annually.[10]

Table 1 provides a basis for considering the outlines of a cooperative solution in a lame-duck session. As a goal for medium-term reform with the economy back close to full employment, two large entries in the table could be retained: revenue from expiration of the payroll tax cut ($126 billion) and savings from expiration of emergency unemployment benefits ($35 billion). The amount in the table for the revenue from the Affordable Care Act ($24 billion) is also appropriate to retain. So there is a starting amount of $185 billion in fiscal adjustment that would seem relatively unambiguous as the goal for full phase-in. The total goal for the adjustment, at 3 percent of GDP, amounts to about $480 billion. The question would then be where to find the difference of $295 billion.

The various entries for revenue from expiration of the Bush era tax cuts and AMT fix ($294 billion), "other expiring provisions" ($86 billion), and "other revenue and spending changes" ($140 billion, mainly on the revenue side) amount to a total of $520 billion. In contrast, the baseline contributions from automatic spending cuts ($86 billion) and elimination of the "doc-fix" ($15 billion) amount to only $101 billion. Ending the doc fix is not a realistic option. The implication seems to be that if a substantial effort is to be retained on the spending side beyond the cut in emergency unemployment benefits, the bulk of the automatic spending cuts from the Budget Control Act would need to be retained. If so, then of the $295 billion needed, $86 billion would come from those cuts. The remainder of $209 billion would need to come from the $520 billion potentially available from the various tax cut

9. Complete elimination of the tax cuts would raise revenue by $2.84 trillion over 10 years (CBO 2012a, 19). Eliminating the tax rate cuts only for households with incomes over $250,000 would shrink the 10-year revenue gains by $1.52 trillion ($754 billion for retaining the 10 percent rate, $636 billion for retaining the 25, 28, and part of the 33 percent rates, and $132 billion for retaining the 0/15 percent rates on capital gains and dividends [JCT 2012]). Including other elements of the Obama administration's proposal for extending the Bush-era tax cuts (notably the marriage penalty relief at $365 billion and the child tax credit at $268 billion [JCT 2012]) would bring the total revenue losses from the administration's proposal to $2.39 trillion over 10 years, according to the JCT (2012), or to $2.08 trillion over 10 years, according to the CBO (2012c, 8), or 73 to 84 percent loss of potential revenue from complete elimination of the cuts. Moreover, extending the cuts to an even higher household income level of $1 million would cut the 10-year revenue gains by another $366 billion (Marr and Huang 2012).

10. Kim Dixon and Patrick Temple-West, "Q+A: The 'Buffett Rule,' a Minimum Tax on the Rich," Reuters, April 16, 2012.

expirations (not including the payroll tax cut). Broadly, the remaining needed adjustment could be achieved by cutting the amount of the prospective tax cut rollbacks by 60 percent. Under a Democratic administration, it seems likely that there would be a greater retention of the tax cut rollbacks and a lesser target for the Budget Control Act spending cuts. Under a Republican administration presumably there would be an effort at greater retention of the tax cuts and additional spending cuts not yet identified in table 1.

Unfortunately, there is a considerable risk that the politics of intransigence will cause a repeat of the impasse of mid-2011. House Speaker John Boehner has already stated that the next time the public debt ceiling needs to be increased (which will happen at about the beginning of 2013), he will push for $1 spending reduction for every $1 increase in the debt ceiling.[11] Placing the debt ceiling legislation into the debate revives the gamble of jeopardizing the nation's credit rating with the threat of a default. The contemporaneous timing of the debt ceiling being hit and the year-end fiscal cliff poses a potential perfect storm and could provoke considerable market turmoil.

CONCLUSION

Despite the year-end risks, it is difficult to escape the conclusion that it is a good thing that the United States faces a fiscal cliff. The expiration of the Bush era tax cuts at the end of 2012 provides a unique opportunity to raise tax rates and/or eliminate tax deductions so that the United States can restore federal revenue to at least 18 percent of GDP and probably somewhat more in order to meet growing fiscal needs associated with an aging population. The political pain of the higher tax rates should concentrate political minds on the associated task of finding more ways of cutting spending and limiting increases in entitlement spending. It will nonetheless be important to phase in the fiscal adjustment gradually, for example, over the four years of the next presidential term, in order to moderate the output loss that would otherwise occur under current conditions of high unemployment combined with interest rates near zero. Moreover, the target for adjustment in the structural (noncyclical) fiscal balance should be 3 percent of GDP, and the component of overkill included in the fiscal cliff's 5 percent of GDP adjustment should be avoided.

11. The ceiling on gross government debt (including that held by public agencies) is currently $16.4 trillion (Betsey Stevenson and Justin Wolfers, "Debt-Ceiling Déjà Vu Could Sink Economy," Bloomberg, May 28, 2012). As of late May 2012, gross federal debt stood at $15.7 trillion (www.USDebtclock.org). With the deficit running at $98 billion per month (CBO 2012a), gross debt is on track to reach the ceiling in seven months, or by the end of 2012.

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