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America's Fiscal Situation

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In January the American economy faced the "fiscal cliff," whereby previously legislated tax increases and cuts in expenditures would together have led to a hit to the US economy equivalent to 4.5 percent of GDP. This almost certainly would have produced a recession in the first half of 2013, since the strength of the American economic recovery was not great enough to overcome it. The full fiscal cliff was avoided by last-minute bargaining between Congress and President Barak Obama on taxes. The significant tax reductions of 2001 and 2003, set to expire in 2012, were made permanent for all but the wealthiest Americans, whose maximum income tax rate was raised from 35 to 39.6 percent for incomes above $450,000 for a married couple ($400,000 for a single individual). Unemployment compensation was extended again (beyond the normal 26 weeks), thus preventing 2 million workers from losing such compensation in January. And the "sequester," whereby Federal government spending was to be cut by about 9 percent across the board (except for pensions and medical care) was postponed by two months.

This last-minute deal was an apparent victory for President Obama, who in November had been re-elected for a second four-year term on a pledge to reduce the budget deficit in part by higher taxes on rich Americans. Not altered in the deal was a rise in payroll taxes (which falls on all working people) by two percentage points, which is used to finance public pensions and was reduced two years earlier as an anti-recession measure.

It was widely assumed that the new Congress (which after the November elections came into being in January) would use the two-month reprieve to eliminate or at least greatly alter the "sequester," since by wide acknowledgement that was a poor way to cut government spending; and that Republicans in particular would balk at the reductions required in military spending, since in recent decades the Republican Party has been strongly supportive both of defense spending on its merits and of the private business firms that sell goods to the Defense Department. This assumption proved to be incorrect. Despite efforts by President Obama to achieve a more rational balance between revenue increases and reductions in expenditures, Republican congressmen refused to budge on legislating further increases in revenues, arguing that the tax deal struck in early January settled the tax issue. Thus on March 1 the sequester went into effect. It formally affects the authorization of government agencies to spend money, so the impact on actual expenditures would be somewhat delayed, estimated to be a $35 billion reduction (0.8 percent of quarterly GDP) by June 30, but if not undone would rise during the remainder of the year, providing a drag on the economy. One leading forecaster suggested that in the first quarter of 2013 the US economy would grow by 2.3 percent at an annual rate, but that this would drop to 0.7 percent in the April-June quarter as a result of the cuts in government spending.

At the end of March – half way through the fiscal year – Congress finally acted on the budget for the fiscal year ending in September. It decreed with few exceptions that agencies could spend at the levels of fiscal year 2012, less the sequester that began on March 1. But importantly, Congress dropped the conditions that the sequester had to apply to each "program, project, and activity." It gave agencies some discretion to impose priorities on the cuts, reallocating funds from one program to another within each agency.

What of the future? The projected budget deficit for 2012 is 5.3 percent of GDP, down significantly from 10 percent in 2009 and 7 percent in 2012, but still too high for the long run. President Obama has proposed some further cuts in government expenditures over the next decade, along with some increased taxation on corporations. The maximum Federal tax rate on corporate profits is now 35 percent, one of the highest in the world. In fact corporations on average pay less than half of that, thanks to many legal deductions from profits, tax credits, and actions within the law to evade taxes, such as retaining profits earned on foreign investments abroad for long periods of time (they are taxable under existing law only when repatriated to the United States). The proposal involves closing many of these "loopholes," reducing the top tax rate, but using some of the proceeds to reduce the budget deficit further. Obama's objective is to have a deficit less than 3 percent of GDP by 2022, which with growth in nominal GDP in excess of 3 percent will gradually reduce the ratio of public debt to GDP, also a long-term objective.

So far the position taken by most Congressional Republicans is that there should be no further increase in taxes, even by closing loopholes, and that all further reductions in the budget deficit should come through reductions in government expenditures. Thus political agreement between the President and the Congressional House of Representatives (where the Republicans hold a majority) will not be possible in the near future. But my guess is that the Republican position will not hold, particularly as the elections of 2014 (for membership in the House, not the Presidency) come nearer and the Republicans will have to specify the particular government programs that they want to cut. Thus a political compromise on these issues should be possible before the end of next year. Another potential source of revenue is to reduce some of the deductions that households are able to make before calculating taxes on their incomes. These will be politically more difficult to eliminate, and again there will be disagreement on how much of any such changes should be devoted to reducing the budget deficit.

In the meantime, the current outlook for the US economy is for continued slow growth, perhaps 2 percent in 2013, picking up to 3 percent in 2014. The government budget on current path will exert some contractionary impact, but monetary policy remains easy and interest rates low. Private expenditure, especially home construction, is reviving, providing some impetus to the economy even in the face of fiscal contraction.