After the presidential election, US political attention turns to addressing the challenge of the country’s long-term public debt. Ethan Ilzetzki and Jonathan Pinder explain the most prominent proposals for reform – and the economics of the so-called ‘fiscal cliff’.

**America’s fiscal cliff**

There is cross-party consensus in the United States that public debt levels are a serious problem, at least in the medium term. Debt levels rose significantly in the Great Recession (see Figure 1), but much of the increase can be explained by the automatic responses of public spending and taxes to the state of the business cycle.

The more worrying fact is that the long-run debt trend is clearly upwards. Public spending has risen secularly over the past decades, due to increases in public healthcare (Medicare for the elderly and Medicaid for the poor) and social security (pensions), up from 3% of GDP in the 1950s to almost 12% today and projected to rise to 16% by 2037. Since tax revenues have not kept up with these spending trends, public debt has been marching upwards. In contrast, public consumption as a share of income has not increased since the 1950s and public investment has actually declined (see Figure 2).

In December 2010, the bi-partisan National Commission on Fiscal Responsibility and Reform (known as ‘Simpson-Bowles’ after the two co-chairs) released a majority report proposing a mixture of cuts in entitlement spending and tax reform, backloaded to avoid exacerbating the recession (see Table 1).

The commission recommended eliminating most tax deductions, increasing revenue by about $1.1 trillion. Part of this higher revenue would be used to reduce tax rates and overall tax revenues would be targeted as less than 20% of GDP in the long run. The remainder would be allocated to debt reduction.

Social security would be brought into balance through broadening payroll tax bases and increasing the retirement age. Simpson-Bowles recommended setting targets to contain Medicare’s growth beyond 2020 (unfortunately without much detail) and containing discretionary spending growth to half the rate of inflation.

Although the Commission’s proposals are broadly seen as the starting point for any serious reform, President Obama has not fully embraced them and Paul Ryan, a commission member and the defeated...
include tax increases. With no ‘grand bargain’ on resolving longer-term debt problems, agreement was reached to raise the debt ceiling temporarily and to find a compromise on longer-term challenges over the coming year.

To give incentives to both sides to arrive at a long-term compromise, the vice-presidential candidate in November’s election, explicitly voted against the majority report. Simpson-Bowles did not obtain the super-majority required to bring forward legislation.

Political conflict peaked in the summer of 2011 over the ‘debt ceiling’. Due to (outdated) rules from the early twentieth century, Congress is required not only to approve tax and expenditure laws in its budget but also, in separate legislation, to set a limit on total government debt. As US federal debt approached this limit in July 2011, Congress was unable to reach an agreement on a change to the debt ceiling.

Democrats insisted that the debt ceiling be increased unconditionally or for the agreement to include tax increases. With no ‘grand bargain’ on resolving longer-term debt problems, agreement was reached to raise the debt ceiling temporarily and to find a compromise on longer-term challenges over the coming year.

To give incentives to both sides to arrive at a long-term compromise, the

The tax rises and spending cuts of the fiscal cliff would almost certainly plunge the US economy into recession.

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**Figure 1:**
Debt of US federal government (percentage of GDP)

**Figure 2:**
Expenditure breakdown of US federal government (percentage of GDP)
legislation required automatic public spending cuts – the Budget Control Act – to be triggered in 2013 if no agreement is reached by then. The spending cuts were designed to target the essential priorities of both parties to force the two sides to an agreement.

With the presidential election approaching, no attempt was made to find an alternative to the ‘sequester’ schedule in the Budget Control Act. With no change in legislation now that the election has passed, the sequester will be triggered in January 2013. In addition to the spending cuts in the Budget Control Act, tax cuts introduced by the Bush administration in 2001 will expire at the end of 2012.

The combination of these two factors is known as the ‘fiscal cliff’ (see Table 2), which will mean that taxes rise by about 2.7% of GDP and spending falls by almost 1%. This fiscal contraction of close to 3.7% in 2013 relative to current plans would almost certainly plunge the US into recession, even on the most optimistic estimates.

To make things worse, the law does not address the root causes of the US debt problem – healthcare and pensions. If the economy falls over the fiscal cliff, it will cut only discretionary spending, which is not the main cause of the long-run debt problem.

The fiscal cliff does not address the root causes of the US debt problem – healthcare and pensions

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