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

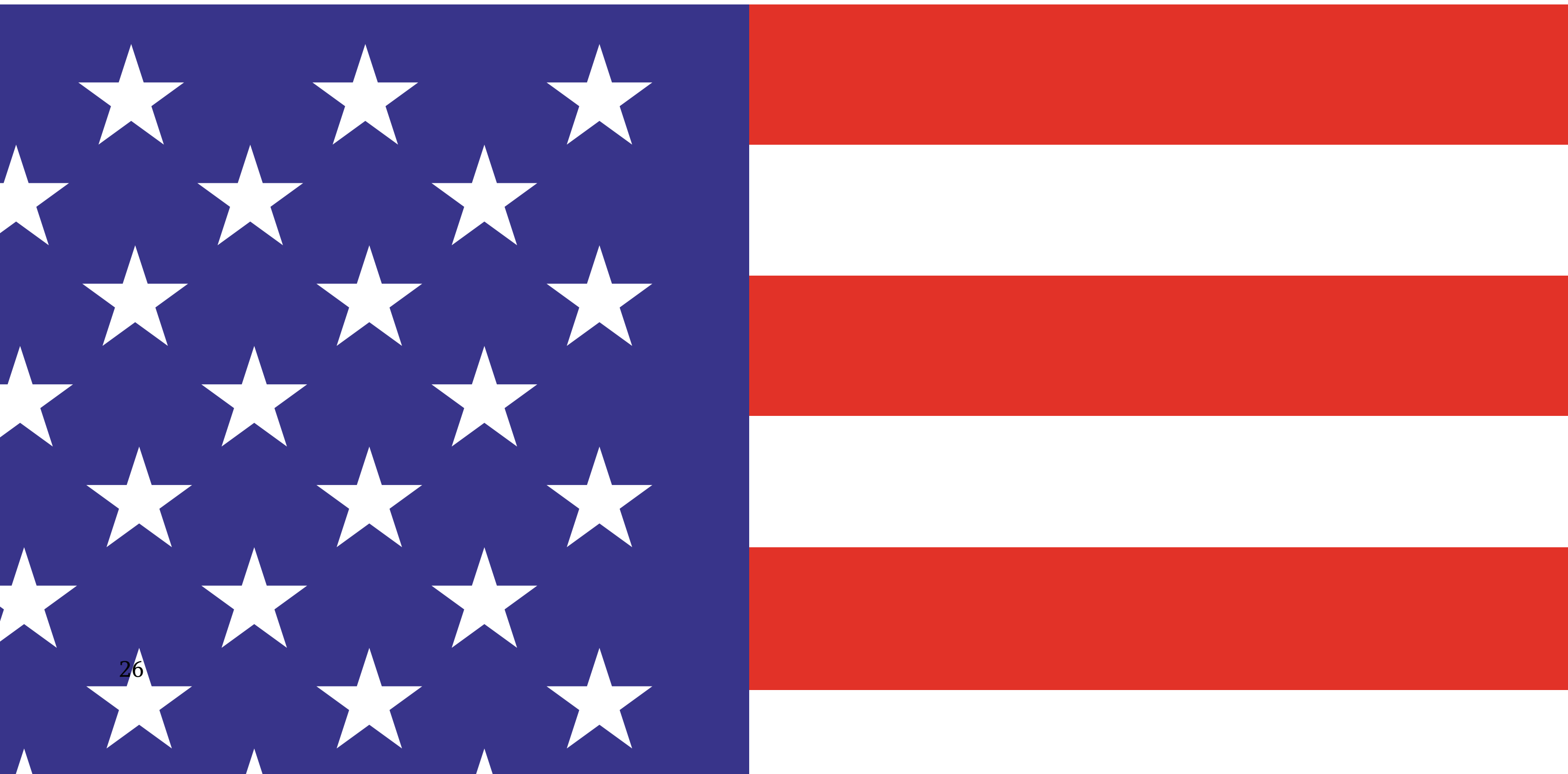
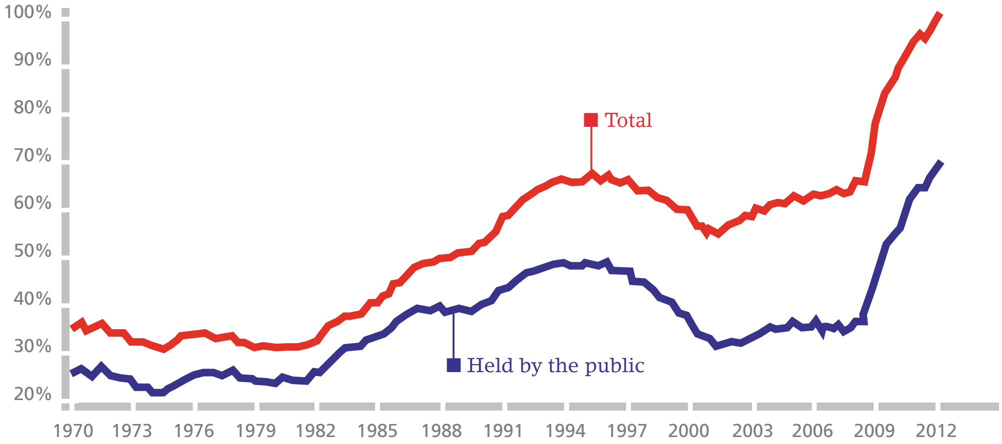
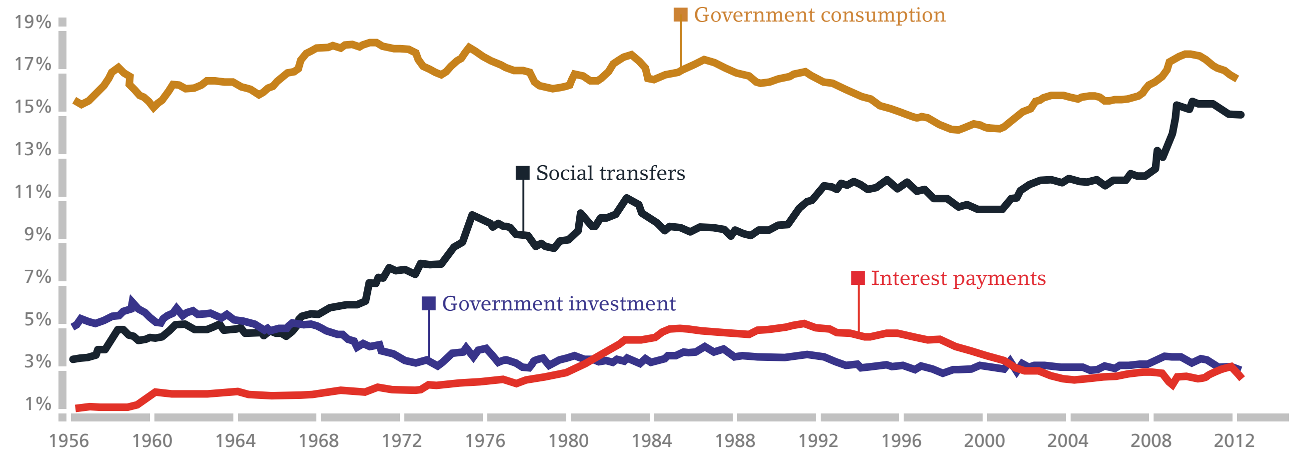


Figure 1:
Debt of US federal government (percentage of GDP)



Source: Bureau of Economic Analysis

Figure 2:
Expenditure breakdown of US federal government (percentage of GDP)



Source: Bureau of Economic Analysis

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.

Republicans demanded that increases in the debt ceiling be linked to legislation on spending restraint. 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

Table 1:
The Simpson-Bowles proposals

TAX POLICY

Income taxes

Eliminate most 'income tax expenditures', that is, all deductions from income taxes. Current income tax expenditures are estimated at $1.1 trillion annually. Use part of the savings to lower tax rates, limiting the top income tax rate to 29% and maintaining or increasing the progressivity of the tax code.

Payroll taxes

Broaden the base of social security taxes to apply to 90% of personal income by 2050.

Corporate taxes

Lower the corporate tax rate to no higher than 29%. Eliminate all 'tax expenditures' for businesses. Move to a territorial tax system.

Revenues

Revenues to increase gradually, stabilising at just under 20% in the long run.

EXPENDITURE POLICY

Discretionary

Hold spending in 2012 equal to or lower than spending in 2011 and return spending to 2008 levels in real terms in 2013. Limit future spending growth to half the projected inflation rate through 2020. Require equal cuts from both security and non-security spending.

Medicare and social security

The commission only proposes small fixes to Medicare in the short run, while setting targets to contain the programme's rate of growth after 2020. Increase the social security retirement age to 67 by 2027 and index the retirement age to average life expectancy thereafter. Index social security benefits to chain-indexed CPI. The plan is projected to close the social security shortfall over a 75-year horizon.

DEFICIT

Reduce the deficit gradually to 2.3% by 2015, with most deficit reductions scheduled to coincide with economic recovery. Put in place a credible plan to stabilise the debt over time, with debt (held by the public) stabilising at around 65% of GDP in 2020, after peaking at 72% in 2013.

Table 2:
The fiscal cliff: changes in tax and expenditures policy scheduled in current law

TAX POLICY

Revenues

Total revenue as a share of GDP projected to rise from 15.7% of GDP (2012) to 18.4% (2013) and 20.3% (2015). Personal income tax take to increase by 1.8% of GDP, social security taxes by 0.5% of GDP and corporate income taxes by 0.4% of GDP.

Income taxes

Scheduled to rise automatically from 2013,reversing the 2001 tax cuts. Tax rates to rise from 10-15%, 25%, 28%, 33% and 35% to 15%, 28%, 31%, 36% and 39.6% respectively

Payroll taxes

Temporary payroll tax cut of 2 percentage points is set to lapse

Capital gains taxes

Scheduled to rise from 15% to a maximum rate of 20% for most taxpayers from 2013.

EXPENDITURE POLICY

Total

Total outlays projected to fall from 22.9% of GDP (2012) to 22.4% (2013) and 21.5% (2015). The Budget Control Act has defence and non-defence budgets falling by $55 billion each year from 2013 to 2022 (0.7% of GDP in 2013).

Defence

$55 billion of cuts, almost entirely discretionary spending, amounting to 10% of discretionary defence spending in 2013. These cuts are not restored in future years but, as the economy and the size of the defence budget grow, they fall to 8.5% of the planned discretionary defence budget in 2022.

Medicare, Medicaid and social security

Medicare is shielded from cuts: 90% of Medicare spending can only be cut by a maximum of 2%; a further 9% is exempt entirely. Medicare and social security are exempt from cuts. In January 2013, doctors' payments under Medicare are due to fall by 27%. These cuts have been reversed by Congress each year since 2003 (the 'doc fix'). Under current law, these cuts to payments would reduce expenditures by $10 billion.

Unemployment benefits

Extensions in emergency unemployment benefit are set to lapse. Total expenditure on unemployment benefit is set to fall by over a third from $94 billion to $60 billion in 2013, despite a baseline CBO scenario that has unemployment rising over the course of the next year.

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' scheduled 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

This article is an extract from a briefing published as part of CEP's series of US Election Analyses: 'Recession and Recovery: The US Policy Debate on Taxes, Spending and Public Debt' by Ethan Ilzetzki and Jonathan Pinder (http://cep.lse.ac.uk/pubs/download/cepusa001.pdf).

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