CENTRE *for* ECONOMIC PERFORMANCE

US ELECTION ANALYSIS NO. 1

Recession and Recovery: The US Policy Debate on Taxes, Spending and Public Debt

- The Great Recession that struck in 2008 is the most severe economic downturn since the Second World War. The US unemployment rate rose from a low of 4.4% in late 2006 to 10% in late 2009. The rate currently stands at 7.8%.

- High unemployment appears to be mainly cyclical rather than structural. The 2009 fiscal stimulus and continuing monetary policy activism by the US Federal Reserve (the Fed) have sustained higher output and jobs.

- Government spending has been declining since the end of 2010. The so-called 'fiscal cliff' looms in January 2013, when automatic spending cuts and tax rises are planned in the order of 3.7% of GDP. This would almost certainly plunge the US into another major recession with negative repercussions for the world economy.

- The US has a long-term debt problem mainly driven by growth of health entitlements (Medicare for the elderly) and pensions (social security). The bi-partisan Simpson-Bowles Commission proposed raising tax revenues through eliminating deductions, increasing the retirement age and reducing entitlements. These are sensible reforms, which have been rejected by both US presidential candidates.

- Neither candidate has so far announced any detailed or convincing plan to tackle the public finances in the long term, particularly over social security entitlements.

- The Republicans' plan would tackle the deficit through cuts to entitlements and other spending. For example, vice-presidential candidate Paul Ryan proposes capping Medicare spending at 0.5% above the rate of GDP growth after 2023. President Obama's Affordable Care Act extends coverage but contains cost control measures such as reducing Medicare reimbursement rates for hospital services.

- Under a Romney administration, tax revenues from the elimination of (unspecified) tax loopholes would be used to extend the 2001 tax cuts made under President Bush, reduce tax rates even further and reduce corporate taxes. This would leave no extra tax revenue to reduce public indebtedness; it may increase the debt.

- President Obama would extend the Bush tax cuts (except for households earning over $250,000) and limit tax deductions for high-income households. These would only raise about 1% of GDP, insufficient to deal with the long-term fiscal challenges.

LSE THE LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE

E·S·R·C ECONOMIC & SOCIAL RESEARCH COUNCIL