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The Fiscal Cliff Crisis and the Real Economic Crisis in the United States

The United States is still far from recovering from the effects of the 2008-2009 recession. The Congressional Budget Office (CBO) estimates that actual GDP is six percent below its potential. Using a projection from the start of 2008, before the CBO recognized the impact of the recession, the falloff is more than ten percent. The economy is still down more than nine million jobs from its trend path, and the unemployment rate is more than three full percentage points above its pre-recession level.

This situation would seem to suggest an urgent need to stimulate the economy. Unfortunately, almost no one in Washington policy circles is considering any proposals that would provide a substantial boost to growth. The debate over the budget has managed to displace nearly all other economic issues from public debate.

This debate is especially silly since there is little reason for the United States to be concerned about its debt or interest burden any time in the foreseeable future. While deficits have been large in recent years, this is entirely due to the plunge in the economy associated with the collapse of the housing bubble. The deficit was just 1.2 percent of GDP in 2007, a level consistent with a declining debt-to-GDP ratio. Deficits were projected to remain near this level throughout the current decade, even if the tax cuts put in place under President George W. Bush were left in place.

There have been no major permanent increases in spending since 2007, with the exception of President Obama's health care reform, which is fully funded with higher taxes and offsetting spending cuts. The increase in the deficit from its low 2007 level to more than ten percent of GDP in 2009 and 2010 was the direct effect of the downturn and the stimulus measures put in place to counteract it. Even with these large deficits and the resulting increase in the national debt, interest rates remain near post-World War II lows, and the ratio of interest payments to GDP also remains near a post-war low at just 1.5 percent of GDP. The ratio of interest payments to GDP is actually less than one percent if the interest rebated from the Federal Reserve Board is deducted. In effect, the markets are telling the United States as clearly as they possible can that current deficits are not a problem.

However the Washington debate is worlds removed from the underlying economic reality. Both President Obama and the Republicans in Congress have embraced the idea that the deficit is a horrible problem that must be addressed as soon as possible. The main difference is that the Republicans paint a picture of a deficit driven by out-of-control spending, whereas the Democrats speak of the need to use a "balanced" approached to reduce the deficit with a mixture of tax increases and spending cuts. There is no one in any position of prominence who is making the obvious point that deficits are not really a problem and that it would actually be desirable to run larger deficits until the economy recovers.

This background is essential to understanding the fiscal cliff debate. President Obama and Congress had agreed to a series of fiscal measures that were set to take effect starting January 1, 2013. The largest of these measures was the ending of the Bush tax cuts. The cuts were originally scheduled to expire at the end of 2010, but President Obama had agreed to extend them two years in recognition of the weakness of the economy. A temporary two percentage point reduction in the payroll tax that funds Social Security was also set to expire at the end of the year. In addition, $110 billion in spending cuts

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(split evenly between military and domestic spending) were supposed to begin on January 1, 2013.

The “fiscal cliff” referred to these three measures, along with several others occurring simultaneously. According to the CBO, the combined effect of all the tax increases and spending cuts would have knocked more than three percentage points from the annual growth rate, pushing the economy back into recession. President Obama and Congress rushed to meet this January 1 deadline in order to avoid the dire consequences predicted if they missed it.

In reality, the consequences of missing the deadline (which they did by two days) were close to zero. No one would see a tax increase until they had the money deducted from their paycheck at some point in January. Even if a deal was delayed past this point, any extra money deducted would be repaid in subsequent checks and would therefore have little effect on consumption. On the spending side, if a deal seemed imminent, there would have been no reason for President Obama to reduce the pace of spending below the level that he expected in the deal.

For these reasons, the idea of a fiscal “cliff” with a crucial January 1 deadline did not make any sense. Nonetheless, the media coverage played up the deadline, with some news outlets actually maintaining a countdown clock.

As it turned out, President Obama was able to get a deal largely on his terms, with the Republicans consenting to most of his demands on taxes. The Bush tax cuts for people earning more than $400,000 a year were allowed to expire, restoring the Clinton-era tax rates. (President Obama had set a cutoff of $250,000 during the presidential campaign.)

While this deal got the government through the immediate problem, there are still three other major budget disputes that will have to be resolved in the first quarter of the year. Congress will have to agree to raise the debt ceiling, as the government will have to borrow in excess of the current level before the end of February. It now appears that the Republicans will yield on this issue for the next three months, but this only temporarily postpones the showdown over the debt ceiling. Congress will also have to decide on the $110 billion package of spending cuts (half for the military and half for domestic spending) that is now scheduled to kick in on March 1. And it will be necessary to come up with an annual funding bill that will keep large sections of the government funded past March 1.

The main demand of the Republicans in these budget discussions is that President Obama agree to cuts to Social Security and Medicare, the health insurance system for retired and disabled workers. This is a politically difficult position for them to push, since the overwhelming majority of the public, including an overwhelming majority of Republican voters, strongly supports these programs. This means that the Republicans do not want to be too visible in pushing their own agenda. Effectively, they want President Obama to propose cuts to Social Security and Medicare that they will consent to as part of a larger budget agreement.

At this point, it is difficult to assess the likelihood to any sort of “grand bargain” that will set in place the outlines of a budget for the rest of President Obama’s presidency. It is entirely possible that we will see a series of major and minor confrontations over the next two and possibly four years, with Congress and the president setting new deadlines every three or six months. The one thing that seems virtually certain at this point is that no one is going to push through any major measures to boost economic growth. As a result, the employment and overall economic situation is likely to be not much better at the end of President Obama’s second term than it was at the beginning.