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CIGS Seminar : "Post-Election Fiscal Drama in the United States: A Real Cliffhanger"

by Professor Jay Rosengard

< Speech of Professor Jay Rosengard >

Good morning, ladies and gentlemen. I appreciate all of you coming this morning despite the frightening whether forecast today.

Before I talk about the current fiscal crisis in the United States I would like to quickly review my previous presentations. This is my fourth presentation at the Canon Institute for Global Studies (CIGS). I have one slide for each of my previous presentations as a recap. All materials have been published on the CIGS website. Today's presentation along with the summary of the Q&A will also be posted.

(Slide 2) The first time I was asked to come to the CIGS in 2010, I talked about the background and causes of the global economic crisis, i.e. what were the underlying structural problems that led to the crisis. Then, we discussed what the immediate trigger for the crisis was. The acid bubble was growing for many years. So the question was what specific events triggered the crisis at that time and why did it happen then? We talked about how it got worse, i.e. how did a relatively normal financial crisis become a full-blown economic crisis getting from the financial sector into the real sector? We also discussed how big the crisis was and how much bigger it might get.

We talked about what were the responses to the crisis. We discussed liquidity, solvency and recapitalization, and to rebuild trust in the government and the regulatory system. We also touched upon some of the solutions and the means to prevent another financial crisis of this nature.

(Slide 3) In 2011, we had the big debate between the Keynesians and Hoover which is still going on today. In the Keynesian approach, when there is a crisis and the private sector is contracting, the government sector should expand both fiscal and monetary policies to recover the economy, and then when the private sector recovers, the government cuts back on public spending. That is opposite to the austerity approach. I used the name of Herbert Hoover who was the President at the beginning of the American Great Depression. He adopted the austerity measures, which did not work very well and made the situations much worse.

We talked about fiscal policy: Do you want to have a temporary increase in spending leading to temporary deficits or should we balance the budget right now to restore confidence? On the monetary policy: Should it be expansionary like the FED has done for several years now or should it be contractionary to complement cutting in spending? If you look at Keynesian policy that has been the US policy - although it is a kind of what I would call Keynesian-like because there has been resistance from Republicans especially the Tea Party - there has been a stimulus but probably not big enough. The FED has probably done everything they can on the monetary side.

The other view has been the UK which is a good example of having adopted the austerity approach. It has not worked very well.

Then, the question was: Is the US today like the world after the Great Depression which means the Keynesian approach would be the right approach, or is it more like Japan's lost decades where a temporary stimulus becomes a chronic stimulus which loses impact and becomes unsustainable. In fact, in Japan it has been counterproductive in the sense that every time there is a new stimulus package, Japanese people get even more worried and spend less, and then you get a deflationary spiral, meaning that people believe that the best thing is to wait until crisis slows down.

(Slide 4) Last year the US election was approaching. The idea was: Did you see the United States starting to recover or was it going to a double-dip recession? (We saw the results today.) Did the monetary stimulus work? All the data I presented at the time support the fact that the fiscal stimulus worked, FED intervened aggressively and creatively and the situation would have been much worse without both the monitory and fiscal stimulus.

Does austerity foster growth? I presented some study results around the world including IMF's study dealing with almost 200 different cases, and concluded that, with a few exceptions, austerity increases contraction when the economy is contracting.

We looked at the road ahead. How do we balance the long-term concerns and the long-term need for fiscal consolidation? We clearly have a deficit problem which leads to a debt problem whereas the economy is vulnerable if you cut too much too soon. Everybody agrees that in the long run you need to reduce the deficits and the debt. The question is really the timing.

What did this mean for the upcoming presidential election? The question was whether the US was on the path of a slow and painful recovery, which I call rehabilitation, or whether we are going back into a recession. That is where we stopped last year.

(Slide 5) What I would like to do today is to continue the discussion. We have now had another year. We have had a presidential election and have had the same president. We have had the same problem in the Congress where the Republicans control the House of Representatives while the Democrats still control the Senate and the White House. We have the same political configuration, but a very strong mandate for President Obama to be more aggressive this term. In that context, I would like to check up again the US economy: How are we doing today versus 2008? I will give you some numbers to indicate where we are going. Generally, it looks like we are on the slow and painful path of recovery. The numbers look good, but the economy is still very vulnerable.

In addition, we would like to discuss what exactly the fiscal cliff means. I will explain people's worst fears when we talk about the fiscal cliff. Now, some of those fears have been reduced because of the actions taken by the Congress over the last few weeks. I drafted my presentation in early December, and have updated it last week. So you will get the latest information based on the very last actions of the Congress. You will also see the key outstanding issues as of today.

Then, we would like to discuss three options for the fiscal cliff: (i) To do nothing. If the Congress had done nothing, what would be the impact? Luckily, this first scenario will not happen because the Congress did something which may not be enough but something. (ii) The grand compromise. Will there be a long-term strategic plan for fiscal consolidation? Can the Democrats and the Republicans actually agree on some strategy? (iii) To kick the can down the road. Will they continue crisis by crisis or issue by issue? Right now we are on the third path with my projection of a glimmer of hope that we might actually get to the second path that is something more than month to month or budget to budget.

2012 Economic Health Checkup versus 2008

(Slide 6) How are we doing today versus 2008? These figures are based on the information from a variety of sources including the US Department of Labor, the Congress, National Association of Realtors, a private sector institution that is called Realty Trac, Moody's Analytics, and Freddie Mac.

The first indicator is an average unemployment rate. In 2008 it was almost 6%. It actually peaked at 10% in 2009. As of the end of September last year it was 8.2%. Today, it is 7.9%. The issue is that if you look at the next number, we have been creating 150,000 to 200,000 jobs every month mostly in the private sector, but it is not enough to drive the unemployment rate down because the way we count unemployment is the number of people who are looking for jobs versus those who have jobs. As the economy recovers, people who gave up and stopped looking, start looking again. The denominator keeps growing even as we are creating jobs. The good news is that we have gone from a high unemployment rate of 10% to just below 8%. The bad news is that the job creation is still not enough to get it lower.

Economic growth rate in 2008 was minus 0.3%. It actually was the worst in the second half of 2008. If you annualize GDP growth for the last half of 2008, it was minus 6.3%. It was 1.7% through September 2012. The updated number for 2012 is 2.2%. We went from an annualized contraction of minus 6.3% in the second half of 2008 to a year-end figure for last year of 2.2%. That includes a slight contraction of about 1% in December maybe because the Defense Department dramatically cut spending ever since 1950. Private sector continues to do very well.

Inflation rate was almost zero in 2008. It is still quite modest at around 2%. Average household income has not quite recovered but it is close at around $50,000. Seasonally-adjusted annual rate of home sales recovers but is not a boom. Median home price is slowly coming back. Average mortgage rate is at an all-time low. Foreclosure filings were 2.2 million in 2008. The worst was 2010 where it hit around almost 3 million, from which we came back to about 1.8 million last year.

Again, I would say that the numbers look pretty good but markets are still skittish and investors are still nervous because the fiscal cliff issues have not all been resolved. Corporations in the US have lots of cash. They are sitting on piles of cash waiting to see what happens with the politics, but not investing or hiring many people. Households are saving a lot more, which is what we want them to do in the long run, but unfortunately when they save, the short-term consumption goes down.

The Fiscal Cliff

(Slide 7) What do we mean by the fiscal cliff? The perfect storm was when everything listed here happens at once. This was the worst fear of people before some of the actions were taken by the Congress last month.

The worst fear would be an expiration of all of the George W. Bush tax cuts which includes an income, investment and inheritance taxes and an increased coverage of the AMT (Alternative Minimum Tax). In the US, every rich people should pay a minimum tax as well as an additional tax on higher income than a certain threshold. As it was not indexed to inflation, it has got into lower tax brackets and it started to affect many people in a middle class. This is a big issue in taxation.

When we talk about an expiration of the Bush era tax cuts, we are talking about reduction in tax rates for earned and unearned income. Earned income is wages and salaries while unearned income is interests, dividends and capital gains. People are worried that if nothing is done, the tax rates will go back to higher ones before the Bush era. It also involves payroll tax adjustments for married couples, families with children and reduction of inherited taxes. If nothing is done about the AMT, it would affect additional middle-class taxpayers of 26 million and the average tax increase would be about $3,700. That is a political bomb. This is the first fear.

The second is an expiration of the Obama payroll tax cut. There was a 2% cut on the employee contribution to social security. That would affect all employees from the first dollar they earned. That again has dramatic impact especially for the voting base of the Democrats. Every year the Congress has passed the legislation to extend temporary tax cuts, so they become almost permanent.

Expiration of tax extenders affects all businesses and individuals as it concerns tax credits for R&D, some modifications of individual income tax calculations, etc.

Then, we have something called sequestration which you may have heard many times. It is automatic expenditure cuts based on the Budget Control Act of 2011. If the Congress does not find any sustainable ways, there will be automatic budget cuts of $1.1 trillion over 10 years split evenly between discretionary domestic programs and defense under the Budget Control Act, meaning roughly $110 billion cut every year split evenly between domestic and defense programs. The problem is that it is indiscriminate. It does not consider whether it is a good program, a bad program, a high priority or low priority regardless of value, productivity, or impact. Every department gets cut.

Next one is an expiration of benefits for the long-term unemployed. Again, some of the most vulnerable people would be hard hit if these benefits are not extended. One of the problems with this recession is that people have been out of work much longer than normal. So these benefits are their lifeline. If they are cut, it could devastate the households.

Cut in Medicare reimbursements: There was a proposal for a sharp cut in reimbursements for doctors who participate in Medicare. Medicare is health insurance for the retired people. It is not Medicaid which is health coverage for the very poor. That is an entitlement as part of the social safety net. Medicare is for all people who retired and paid into it. It is an insurance program, but not social aid. If doctors are paid much less, they will not participate in Medicare. It means that the retired people have a shortage in the supply of medical services. This is politically sensitive.

According to the estimates of the CBO (the Congressional Budget Office), the total deficit reduction for this year will be about $700 billion if all of these (tax cuts expire, automatic budget cuts, etc.) happened. You may remember that the Obama stimulus package was about 787 million. So in the worst case a reduction in spending would be about equal to the stimulus package. Most economists said that it could kick the US back into recession. It is exactly the wrong thing to do now. These are the revenue side and the spending side.

Then we have got a bonus. It has not yet over when you talk about the perfect storm. A bonus challenge means that the Congress must increase the government's borrowing cap or the debt limit. Current debt limit is $16.4 trillion. The debt limit does not authorize the president to spend any more money on new activities. It simply allows him to finance everything that the Congress has already approved. This has been a very contentious issue. The Republicans said that in order to increase the debt limit the administration had to cut expenditure dollar for dollar. They tried to do this right before the election. In the end, it did not work. President Obama said that he would not negotiate for the payments for what the Congress already approved. Obama said that the Republicans can fight about future spending and that is the normal fight for budget.

But he said that the treasury can finance the current commitments, current legislation and current budget approved by the Congress.

When this happened last time, it was the first time the US credit rating was downgraded. That became very unpopular among the voters and they blamed mainly the Congress and mainly the Republicans.

When we talk about the fiscal cliff, these are exactly what people are talking about: Increase in taxes, increase in budget cuts and no authorization to pay for anything above $16.4 trillion.

(Slide 8) I would like to highlight the long-term concerns about our deficit and our debt. There is a need for fiscal consolidation. The question is when and how you do it.

In 2001 we generated a budget surplus and gross federal debt as a share of GDP was actually half of its current level (this was the legacy of President Clinton). Can you imagine the United States actually had a budget surplus not so long ago? The person who was head of OMB (Office of Management and Budget) at that time was Jacob Lew who has now been nominated as the new Secretary of the Treasury. President Obama clearly sees that the highest priority treasury issue is the budget. So he has a budget expert now to replace Tim Geithner. It is an interesting move.

Since 2007, even though GDP is growing, the budget deficit as a share of GDP has increased seven-fold. It is now about 8.5%. The gross federal debt as a share of GDP went up from just over 60%. It is now over 100%. You may not be so concerned because Japan has more than double of this number. But 104% is really bad. For the US the number we usually try to hit is about 60%, above which we cannot go normal as the deficit leads to accumulated debt.

Then, we have service on the debt which has a budget impact. People are worried that the interest on the federal debt as a share of GDP will also increase to about 3% in about 5 years or over a half trillion dollars or 12.5% of the total federal budget. If you have over 12% of your budget just to pay for interest on the debt, you have the problem when interest rates come back to a normal level.

Again, if I look at Japan where almost half of new budget is new debt or new bonds, I feel okay for the US. But if I look at other high income countries I am very worried. This is not sustainable. There is a clear need for fiscal consolidation which combines an increase in revenue with a cut in expenditures. I think that all credible economists would agree that that has to be done.

If you look at the income side, normally federal income as a share of GDP is between 18% and 20% and subnational income is about 10%. Total revenue of national and subnational to GDP in the US is normally around 30%. If you look at 2009, federal income as a share of GDP was only 15%, which is the lowest since 1950. Last year it was only close to 16%. So, it is still 2% to 4% below what it should be. Part of the reason for that is of course that the economy has not been doing well. So tax basis are not growing. Other reason is that people are paying lower taxes because of a long series of tax cuts. There has to be some increase in taxes to come up to a normal level, which is sustainable.

On the expenditure side, if your revenue is 18% to 20% normally, you would want your expenditure to be around 18% to 20%. In 2009, the US expenditure as a share of GDP was 25%, increasing almost 30% since 2007. It was the highest since 1945 when we fought the WWII. Last year it has dropped to 24%. Again, there has to be some cut in expenditures. I think that everybody would agree that we need it.

(Slide 9) If you want to have a significant increase in revenue and a significant decrease in expenditures, what do you have to do? Problem is that we are sometimes politically hampered. I always like to combine politics and economics. When you put politics and economics together, we understand that we have some misunderstandings about the US debt. This graph shows the US federal debt presented by means of the total debt as a share of GDP, which is going up and down. I have put some political markers in the graph.

Before President Reagan took office, our total debt was $1 trillion, which was about a quarter of GDP. Twelve years later (after two administrations of Reagan and one administration of George H. W. Bush (Bush senior)), the debt nominally quadrupled at the end of the Bush senior administration although the Republicans call themselves fiscal conservatives or austerity hawks. Debt-to-GDP ratio went up to about 60%.

Prior to George W. Bush (Bush junior), we had President Clinton for two terms. During his period, the debt nominally went up, but because the economy was booming and GDP was growing so quickly, the debt as a share of GDP actually dropped from around 60% to 50%. This was done under the Democrat leadership which is called tax-oriented and austerity-leaning. We had a budget surplus and the debt as a share of GDP went down.

Then, we had Bush II. After the two terms of Bush junior, we can see that in nominal terms the debt doubled again. During Reagan and Bush I, it quadrupled. During Bush II it doubled again and debt as a share of GDP went up to over 75% because the economy was not doing well. You might recall Obama inherited pretty sick economy. Right now we are at about 16.4 trillion, a lot of that is because revenue is down and we have the stimulus packages. That is the debt increase in the political context.

Three scenarios for the Fiscal Cliff

(Slide 10) I said that there were three scenarios for the fiscal cliff. The first scenario was to do nothing. What would have been the cost of inaction? If the Congress did nothing about the tax cuts, the expenditure cuts and the debt ceiling, then the fear was that the combination of everything together could have resulted in budget cut of $700 billion for this year. The austerity budget would be nearly equal to the Obama stimulus package. Most economists feared that it would lead to a double-dip recession and a virtuous climb out of the recession would be back down into the vicious cycle of deepening the recession. That was why everybody was so nervous about doing nothing.

If there was no increase in borrowing limit or the debt limit, people were afraid that the credit rating would be downgraded again. That would certainly increase borrowing cost not just for the government but for the private sector whose borrowing cost is usually tied to the government cost of fund. This is why you heard so much talk right before the election about the fiscal cliff. The idea that all of the pain over the last several years under Obama administration would be wasted as you just go back into recession. As you know in Japan, it is much more difficult to climb out of the recession if you get into the second or third recession rather than the first one. That did not happen, but puts it in context.

(Slide 11) The scenario two: there still is hope of a grand compromise. On the left hand side of this slide, you see the Obama administration plan. On the right you have the plan of Congressional Republicans. If you look at the second half, you find that both of them agree. As I said, according to the Budget Control Act, you have to cut a trillion dollars over 10 years if you do nothing. If current foreign policy continues, under which the ground troops will be out of Iraq and there is withdrawal from Afghanistan, as a result of these we will have to borrow less. That would happen under both plans.

The difference is that, under the Obama plan, new savings will be obtained mostly from taxing wealthy families and from increased productivity and efficiency in healthcare under Obamacare.

Obamacare has been ruled constitutional by the Supreme Court. It will hopefully be implemented soon. It will greatly increase coverage for what we call the working poor amounting to 40 million families, partly by expanding Medicaid for the poor and partly by having all sorts of different plans for those who are working. But employers cannot afford to provide healthcare benefits. The board will be established for looking at cost and an automation of certain parts of the information system for healthcare, etc. This is where they hopefully have the savings.

On the Republican side, reducing tax breaks means closing loopholes which concern special treatment, exclusions, deductions and so on. Romney talked about this a lot, but he never identified which ones he would close and which ones he would cut. This is one of the problems with this. Then, they want to partly privatize the social safety net, which lead to entitlement cuts. They basically want to stop implementation of Obamacare, and instead, they proposed mandatory spending cuts and discretionary cuts. On the Republican side there basically are no new taxes but a lot of cuts.

The Obama administration and the Republicans are not far apart if they actually sit down and try to talk about it. There have been several bipartisan groups that have come up with plans. They split the difference. The plan they have come up with involve some cutting of entitlement benefits, some mandatory discretionary cutting and some structural adjustments. In fact, this is possible. It is not rocket science. Many plans have been put on the table, but politically it has been impossible to actually reach agreement. That is the grand compromise which would provide certainty, stability and a clear path to long-term fiscal viability. There is still a glimmer of hope for such compromise.

(Slide 12) In this slide, you will see some of the basic principles of how to raise money and revenue more efficiently and equitably. You cannot actually increase revenue with lower tax rates by expanding the tax bases which means cutting tax expenditures or closing tax loopholes. It is very easy to do conceptually until you start talking about favorable treatment to specific constituencies. In fact, people are paying less tax. If you look at inflation-adjusted income, people in general are paying a lower amount of taxes than they did in 1980. I think that it is important for both parties to recognize that there is some scope for increasing the tax burden a little more.

If you want to cut expenditures you see the two areas on the top. Mandatory spending is now two-third of all expenditures in our budget. Mandatory spending is social security, Medicare, Medicaid, free entitlement, insurance and social protection. If you want to have some impact on the budget, you have to somehow cut those. There are proposals, for example, for social security, such as raise of retirement age, compulsory testing on benefits, an exclusion of the ceiling on contribution, etc. You do not have to privatize it, nor do you have to change it radically. Some modest changes would give you another 75 years. Plans have been put forward, and the calculations have been done. It is now the question of politics.

There is an organization in the United States called AARP, American Association of Retired Persons, which is really a strong lobby group. They do not want to cut anything related to Medicare or social security. But, if you do not do anything on them, you really do not have a major dent in the budget.

On the defense, again it is not sustainable. The US spends more than 40% of the worldwide spending on defense. If you take the next 14 countries after the US and you combine them, the US spends more. That is not sustainable.

These are the two areas on the spending side that you have to address if you really want to look at the structural problems in our budget. Those are the challenges.

(Slide 13) Scenario three is that we wait for a new congress. As I said, I prepared this presentation right after the election in November but before the new Congress took office in January. Now the interim bad agreements have just reached, which is still better than having no agreements. A question is whether that is really a fiscal cliff or a fiscal slope. At a fiscal cliff you fall off and on a fiscal slope you tumble down. In fact, I think that it is more like a fiscal slope because the changes are made in year-by-year. So it is not cutting a trillion dollars now, but cutting 100 billion each year. The pain accumulates over time. At the beginning you can maneuver, but over time you find nothing more you can cut.

(Slide 14) We are now on scenario three which is kicking the can down the road. The first issue is the automatic tax increases. On January 1st, the Senate and the House had to pass the tax bill. They did it at the very last minute. So the good news is that on the tax side a lot of uncertainty had been removed for the moment. There is a permanent extension - not temporary - of the Bush income tax cuts on incomes up to

$400,000 for individuals and up to 450,000 for couples. Earnings above these amounts are taxed at 39.6% up from 35% of the Clinton tax rate. Obama wanted a level lower at 250,000 but basically he obtained what he wanted. There is a tax increase actually reverting back to the Clinton at the margin of tax rate for the very rich.

Permanent increase also applies to taxes on long-term capital gains and dividends for the the wealthy individuals and households from 15% to 20%, and estate tax up from 35% to 40%. Basically, earned income and unearned income from the very wealthy will have tax increases. That was Obama's position.

There is also a permanent end to the 2% cut in social security payroll taxes for all taxpayers. That is now going back to 6.2%. This is the only major tax increase for everybody. Now the employee contributes 6.2% and the employer contributes the same amount which had not been cut.

Permanent inflation indexing for the Alternative Minimum Tax takes away a lot of uncertainty. Five-year extensions of child tax credit, earned income tax credit and college tuition tax credit are what the Democrats strongly supported. One-year extension of selected business tax credits is the most important for accelerated depreciation. One-year extension of jobless benefits for the long-term unemployed is also important.

In all, over 90% of the tax increases fall on household incomes of $1 million or more. It is a tax increase on the wealthy except for the social security payroll tax. Obama obtained pretty much everything he wanted here in tax increases. That has resolved a lot of the issues on the tax side.

(Slide 15) Second issue was how to prevent default on the national debt. The House of Representatives passed a bill on 23th January, and the Senate on 31th January, to temporarily suspend the current debt ceiling at $16.4 trillion until May of this year. We formally hit our debt ceiling at the end of December last year. But, the treasury could buy time – a month or so – by the calculations. We could have been in default in February. They passed the bill just before. It was a month after we hit our debt ceiling and right before actual default. This is really not good for confidence in the markets.

Now they pushed it down until the end of May, or maybe end of July or early August with very creative accounting by treasury. We have bought some time to try to figure out what to do. It allows the government to borrow about $450 billion namely between now and May to pay their bills, but again not for new spending. It is just treasury management to pay the bills.

It was the interesting political compromise. The Democrats like it because there is no matching of this with budget cuts. Raising the debt ceiling is not contingent on cutting anything, which was the Obama's position. The Republicans like it because they say that they have not given up anything and have just been re-sequencing the discussion. They say that if the Congress does not have a long-term blueprint by May they cut off their salaries. They say, "no budget, no pay." It sounds pretty good but it is unconstitutional. The 27th amendment provides that if you cannot affect the Congressional salaries within one Congress it has to be in between two Congresses. It sounds really good. They say that they took a stand and they have not given up anything - but in fact they have. But if both sides feel that they have won, that is a good political compromise. They can sell it to their constituencies.

(Slide 16) The last issue is how you prevent the automatic budget cuts. This concerns expenditure side and is called sequestration, which is a new word for most Americans. What is done under the new tax law is to delay the automatic budget cuts till the 1st of March. It gives the Congressmen more time to try to figure out what to do. It gives some hope that they might actually get a strategy like the grand compromise we were talking about.

It still requires across-the-board automatic spending cuts to military and domestic programs beginning March 1st. However, the $110 billion cuts I gave you in Slide 7 would be reduced to $85 billion because of the new revenue under the new tax law. There are still automatic cuts, but it is slightly less because of some compromise on the tax side. As I said, Medicare (health insurance for the retired), Medicaid (health coverage for the very poor) and food stamps (coverage for the very poor) were exempted, which are very important for the Democrats as they are their constituency.

The key remaining challenge is formulating a budget that balances the need for long-term fiscal consolidation with the vulnerabilities of short-term economic fragility. Our economy is growing but weak. The economy is vulnerable, but we saw from the figures that in the long run we need to cut government spending. The FED has to cut its balance sheet and figure its exit strategy from the current policy. Revenue has to be increased somewhere. This is where we are as of February 6, 2013. With that we have about an hour for provocative and informative discussion. Thank you.