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Averting the Fiscal Cliff: Necessary But Not Sufficient

By Frank Schell

The so-called fiscal cliff that may arrive at midnight on December 31st is a combination of tax increases and spending cuts directed by the Budget Control Act of 2011. It is a financial Sword of Damocles mandated by a Congress in August of that year that needed to avert a sovereign default (by increasing the debt ceiling 15% to $16.4 trillion)—and a Congress that has been unable to achieve agreement on the means to a balanced budget for several years. Indeed, after four months of deliberation, a "super committee" of twelve members of Congress was unable to agree on $1.2 trillion of spending cuts over a ten year period, to be evenly applied to defense and non-defense spending.

In the absence of a congressional deal embraced by the White House before year-end, the fiscal cliff would cause tax increases for 2013 of $532 billion and spending cuts of $136 billion. The degree of a potential recession is a known unknown. Fed chairman Ben Bernanke has warned of a recession. Goldman Sachs is predicting a 1.4% annual decline, and JP Morgan a 0.5% decline in the first quarter, narrowing in the second. In early November, the Congressional Budget Office predicted a 0.5% decline in GDP were the fiscal cliff to be reached, with some restoration of modest growth during the second half of 2013. Most recently in an interview with CNN, Christine Lagarde, the managing director of the IMF predicted zero growth if a major agreement is not reached, noting "a lack of confidence…the stock markets really taking a hit."

The fiscal cliff comprises many taxation related variables—for example, the end of the Bush tax cuts, a 2% payroll tax, and bonus depreciation for businesses; an increased estate tax and capital gains tax; extension of the Alternative Minimum Tax (AMT) to more taxpayers; and a number of tax benefits known as "extenders." Predictions about GDP decline may range from congressional impasse to selective agreement.

The U.S. does not have a revenue problem; it has a spending problem. Even if President Obama gets his wish and taxes on incomes over $250,000 are raised, the effect is only $82 billion per year on average for the next ten years, according to the Joint Tax Committee of Congress. This is a 7.5% reduction, versus the $1.1 trillion deficit. [1]

[1] "The President's Tax Bludgeon," *Wall Street Journal*, Updated November 11, 2012.

The fundamental issue is the level of confidence in government and whether a pluralistic democracy can achieve the extensive sacrifices necessary for fiscal prudence, modifying entitlements such as Social Security, Medicare, and Medicaid. As goes the United States which can issue a reserve currency, so could go the euro zone now in a recession, reporting four successive quarters of zero growth or slight contraction—the only exception being Germany, a country nevertheless slowing to 0.2% in the third quarter.[2] A contagion brought about by a U.S. impasse cannot bode well for Europe, already the subject of a Bundesbank admonition about the peril of low interest rates,[3] and the European Central Bank predicting slow growth in 2013.[4] Japan, moreover, is now in recession, according to the latest government statistics.

With the recent memory of Congress going on vacation in August 2011, passing the buck to the super committee following a U.S. debt downgrade by Standard and Poor's, it is difficult to have faith in the ability of our elected officials to compromise and act in the national interest. It is fundamentally the same Congress, and of course the same president.

However, even assuming a "grand bargain" can be achieved that represents compromise and the goring of many oxen to avert the fiscal cliff, the U.S. economy would still be imperiled. The continuing merchandise trade deficit, which increased 14% to $737 billion in 2011, is driven by oil and goods imports from China.

While the hydraulic fracturing process known as "fracking" to extract oil and gas from shale sands is strategically promising, its potential will not be realized for a decade at best. Further, China is not about to allow its currency to float upward quickly, as that movement causes a transfer of wealth from the export sector to relatively affluent consumers of the emerging middle class, with no benefit to hundreds of millions of the rural population—a destabilizing force indeed, for a country with a history of peasant rebellions. While China is a convenient source to blame, several years ago over a three year period, the Yuan appreciated about 16%, yet the U.S. trade position with China worsened during that period. And as far as unemployment at or near 8% is concerned, there has been little official effort to identify the effects of the internet, which eliminates intermediaries not adding sufficient value, and the consequences of information technology that enables wider spans of control in industry and fewer middle managers.

As trade deficits continue, and with foreign governments holding vast stocks of U.S. Treasury securities, interest rates will remain freakishly low over any planning horizon. The effect of this is to punish savers and seniors in particular, cause some investors to incur higher risk to maintain yield, and continue to perpetrate what is known as a moral hazard—encouraging the use of debt, sometimes recklessly.

Other forces are yet to be reckoned with. The Affordable Care Act of 2012, or "ObamaCare," has not been well-explained to the American people in qualitative or quantitative terms, but has some possible economic value. There may be potential benefits of scale due to increased access

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[2] "Euro zone economy sinks into recession," *International Herald Tribune*, November 16, 2012.

[3] "Bundesbank Warns on Risks of Low Rates," *Wall Street Journal*, November 16, 2012.

[4] *International Herald Tribune*, November 16, 2012.

and the enfranchising of millions of the estimated 40 million people who are uninsured, and due to less usage of high cost emergency rooms by the now uninsured. Further, pre-existing conditions are no basis for denying insurance, and this has much appeal as a point of morality.

However, offsetting these benefits is the increased cost of benefits to employers, which in theory can increase unemployment. In addition, decision making about medical treatments by government employees is quite controversial. As insurance companies raise their premiums in view of liability for pre-existing conditions, the cost of private insurance may rise, making a government insurance alternative attractive—perhaps evolving into a "single payer" system. A shortage of general practitioners should be expected, with lesser qualified practitioners needing to perform the role of physicians now. Indeed, various comparisons to other countries are offered, without due regard for access to medical technology, waiting periods, and the deficits needed to sustain those programs. The national dialogue about ObamaCare has thus far been principally about access, and not about cost or quality. Quite simply, ObamaCare is a blur of good and bad news, with impassioned speculation pro and con. The credibility of the argument that it will reduce federal deficits is not well-accepted. Its bottom line is another known unknown, and its sponsors have not encouraged clarity or dispassionate analysis by a disinterested third party.

Finally, confidence must be restored in the private enterprise system. Confidence is an intangible psychological force that drives long range planning, resource allocation, and the credit and equity markets. Without it, there is an aversion to taking strategic and operating risk. An effort to create a partnership between the private sector and the White House would have much psychological value and might convey that some of the divisiveness is over.

In May of this year in an interview with *Fortune* magazine, Admiral Mike Mullen, former Chairman of the Joint Chiefs of Staff, said that our national debt, which affects confidence in America, is the "single biggest threat to our national security." A country that cannot manage its finances effectively suffers debt downgrading, and cuts in its defense budget may be deemed a sign of weakness and something to be tested by its adversaries. The U.S. needs influence in the Middle East, and partnerships with ASEAN countries, at a time when China seeks to expand its influence in the Indian Ocean, South China Sea, and the Pacific at large. An economically weakened America is a provocative invitation.

It seems that recently the GOP is softening on the issue of raising tax rates for households with income over $250,000; capping itemized deductions would be another way to increase effective tax rates. Any compromise should substantially address the driver, which is entitlements. Raising the age of eligibility for Medicare and Social Security is another area for potential agreement.

A deal seen as a positive outcome by midnight of December 31st would be cause for celebration and recognition of a purposeful Congress at work. However, it is only the first step in series of fiscal and operating actions. Such outcome would be focused on one fiscal year and would not begin to address the unfunded liabilities of the federal government, mainly Social Security, Medicare, and federal employee pensions, estimated at $87 trillion. Writing for the *Wall Street Journal*, Chris Cox and Bill Archer indicate that $8 trillion in annual tax revenue is required to prevent incurring deeper indebtedness. Further, that amount is more than the sum of adjusted gross income for individuals filing returns earning more than $66,000 and corporate taxable income.[5] Their math is unfortunately suggestive of the remark, "You can't get there from here."

Failure to identify and embark upon a path toward fiscal responsibility could mean the loss of confidence in the United States as the keeper of some semblance of world order. Accompanying this could be a GDP choked by debt and unable to grow, rising unemployment, a continuing decline in sovereign debt ratings, and weak capital formation – or worse. It would confirm that for once, the prospects of one generation are not as good as those of its forebears. To restore confidence will require sacrifice and bipartisan purposefulness that we have not seen since the Cold War.

One certainly hopes that Alexis de Tocqueville was wrong in his published work of 1838, *Democracy in America*, when he wrote of the existence of democracies being inevitably imperiled by fiscal self-indulgence.

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[5] Chris Cox and Bill Archer, "Why $16 Trillion Only Hints at the True U.S. Debt," *Wall Street Journal*, November 27, 2012.