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AND NOW FOR THE FISCAL CLIFF

By ADAM CREIGHTON - 11/9/2012

The looming US economic reckoning presents opportunities as well as dangers

WHOEVER won the US presidential election was always going to face a daunting challenge: how to steer the nation clear of fiscal catastrophe without crushing an economy floundering in the wake of the worst slump since the 1930s Depression.

Four years after the global financial crisis dramatically unfurled itself, what Americans call the great recession is still not over. More than 12.3 million people are still unemployed and American wages are growing at their slowest pace since 1986.

``The United States economy's post-GFC healing process remains unusually hesitant,'' says Westpac analyst Russell Jones.

President Barack Obama's decisive victory against Republican challenger Mitt Romney has done nothing to alter the congressional gridlock that has repeatedly thwarted attempts to avert the looming fiscal cliff that is forecast to plunge the US into recession and drag the world down with it.

``If anything, Obama's re-election increases the chance the United States will fall over the fiscal cliff, at least for a few months,'' says Adam Lockyer, a lecturer in US politics at the University of Sydney's US Studies Centre.

``He's more likely to take negotiations to the eleventh hour and engage in political brinkmanship to elicit a long-term solution, but this carries the risk of no solution at all,'' he says.

While the Democrats control the White House and the Senate, Republicans still hold a sizeable majority in the House of Representatives.

By a quirk of history the US faces a sudden, automatic fiscal reckoning on January 1. Without congress lifting a pen, a slew of spending cuts and taxes totalling $US668 billion kick in.

Perhaps the largest fiscal reversal in history, it will almost certainly derail the US's tepid track back to economic normality unless politicians cobble together some alternative.

Nathan Sheets, Citi's global head of international economics, said during a visit to Sydney last month that unless the cliff could be averted, the US economy would stumble into recession next year, potentially sapping the growth rate of the world's biggest economy to minus 2 per cent.

``I'm hard-pressed to think of a single country that won't be damaged economically,'' he said, emphasising the ripple effect of a US slowdown on China, and hence on Australian exports.

Following the terrorist attacks in the US in September 2001, then president George W. Bush negotiated a range of stimulatory tax cuts: the top rate of income tax fell from 39.6 per cent to 35 per cent, capital gains tax dropped from 20 per cent to 15 per cent; payroll tax fell from 6.2 per cent by almost a third; and taxes on dividends tumbled. About 90 per cent of American workers will face a real tax increase one way or another as these measures are reversed, increasing the government's tax haul by $US532bn.

Meanwhile, January 1 triggers the doomsday clause, which curbs annual spending on defence, unemployment and medical benefits by $US136bn.

Congress could only agree to increase the US debt limit to $US16.3 trillion last year by insisting that, if the bipartisan super committee created to come up with spending cuts failed to reach agreement, then a doomsday clause would ensure cuts occurred anyway.

The committee couldn't agree. ``The measures in the clause were meant to hurt Democrat and Republican constituents roughly equally,'' says Lockyer, pointing to broadly equal cuts to defence and social security programs.

Sheets says ``doing too much too fast is a sure-fire recipe for a recession'', pointing to a similar cliff in the late 60s that pushed the economy into recession.

Most economists and commentators believe the fiscal medicine is worse than the disease. But toppling over the cliff would dramatically improve the US's parlous fiscal position, which is lurching ultimately toward bankruptcy.

This year the gap between the federal government's revenues and expenses was $US1.1 trillion, only a little lower than Australia's entire national income.

It was the fourth successive year the budget deficit exceeded $US1 trillion. For every $US1 the government is spending, it borrows almost US32c. The government's gross debt has ballooned to $US16.2 trillion, just shy of the legislated debt ceiling.

President Obama's decision in 2009 to rescue American banks and insurers and enact the world's second-largest stimulus plan -- behind South Korea's and ahead of Australia's -- has proved extremely costly. Before then, US net borrowings were equivalent to 36 per cent of national income; now they are 73 per cent, the highest level since 1950.

Yet the fiscal cliff might be more akin to a dislocated shoulder that needs painfully to be shoved back into place. The Congressional Budget Office reckons that without dramatic changes to America's spending and taxation patterns, the federal government's debt-to-gross domestic product ratio will explode to about 200 per cent by 2037 as a result of surging health and social security costs, putting Greece's fiscal woes in the shade.

The CBO, the country's pre-eminent budgetary adviser, presents the choice starkly. If the US puts off the tax hikes and spending cuts, budget deficits out to 2022 will average about 5 per cent of GDP every year (bigger even than Kevin Rudd's historic, whopping 4.2 per cent deficit in 2009) until 2022, and net debt will climb to 90 per cent of GDP, bigger than in any year since World War II.

``Ultimately (to avoid the cliff) would lead to a level of federal debt that would be unsustainable from both a budgetary and an economic perspective,'' it says, adding that ``the persistence of larger budget deficits and rapidly escalating federal debt would hinder national savings and investment, thus reducing GDP and income relative to the level that would occur with smaller deficits''.

To be sure, the economy is projected to shrink if America swallows the budgetary medicine, but only for a year, as economic activity is projected to begin growing again from late 2013 and the unemployment rate will fall to 5.7 per cent by 2017.

Europe's example shows what happens when debt levels begin to approach 100 per cent and levels of government spending absorb close to half of national income: financial crises and seemingly permanent economic stagnation.

Political pig-headedness may well push the US over the cliff

anyway.

Lockyer points to the increasingly acrimonious state of US politics, which has helped make the present congress the most unpopular since the Truman administration.

``Party discipline was typically far weaker in the United States than in Australia, and conservative Democrats and moderate Republicans would generally overlap in the congress and find agreement,'' he says.

The economic crisis appears to have sharpened the ideological divide.

The US came close to budgetary paralysis in August last year when the Republican-controlled congress refused, until the last minute, to raise the US debt ceiling to enable the Obama administration to pay its bills. Standard & Poor's later withdrew the US's AAA credit rating.

``The congress and President have been pushing this problem down the road for a long time, so it is hard to be optimistic they will find a solution'' says Stephen Oliner, a resident scholar at the American Enterprise Institute.

Oliner thinks it likely no agreement will be reached until about the middle of next year, although he anticipates the debt ceiling will be increased with less drama than last year.

``That was an extremely ugly situation that caused great damage to the country,'' he says, arguing everyone from President Obama down had learned a lesson.

But the US has more choices than between bad and worse.

``The set of tax increases and spending cuts does nothing to address spiralling spending on America's massive entitlement programs,'' says Sheets, pointing to Medicare and Social Security, the US's publicly funded retirement scheme.

Almost 80 per cent of the fiscal cliff entails tax increases, including hikes in marginal tax rates.

Obama and the congress would be wiser to focus on spending reductions rather than tax increases, given government in the US has grown far beyond the night-watchman state guarding individual liberty that its 18th-century founders envisaged.

Today, total public spending in the US weighs in at about 45 per cent of national income, even higher than Australia's 36 per cent, as successive Supreme Court decisions have eroded the constitutional limits to government spending and taxation.

It is clear to Daniel Mitchell, a senior fellow at the **Cato Institute** in Washington, DC, that the congress could agree to an alternative set of measures that restored sound public finance without such a big emphasis on tax increases.

``Letting marginal tax rates increase is the worst possible outcome,'' he says.

``The fact the government will take more money out of our pockets is of course not ideal, but that's not the main problem,'' Mitchell adds, arguing higher marginal tax rates undermine the incentive for businesspeople and individuals to save, invest and work, which is what underpins economic growth.

Whether commentators want the US to endure or avoid the approaching cliff depends on which economic principles they subscribe to.

``People in the White House are Keynesians,'' says Mitchell, arguing presidential advisers are too focused on the level of aggregate demand in the short run rather than the pernicious effects of increasing marginal tax rates.

In any case, he says, the fiscal cliff is really a slope, because businesses and households are rationally factoring in tax increases and spending cuts into their plans, implying the sudden economic crunch widely feared will not occur.

Indeed, the evidence on whether debt-fuelled government spending sustains economic growth, even in the short term, is highly contested.

Most people understand that all government spending must ultimately be paid for with taxes, out of either present or future income.

The far more popular St Augustinian approach to fiscal reform -- grant me chastity, but not yet -- simply foists tax on future generations without asking their permission.

It also ignores politicians' natural temptation to defer tough decisions. The fiscal cliff might in fact be a useful, even serendipitous, mechanism that forces fiscal prudence on US politicians.

``America's never been about what can be done for us,'' Obama said on Tuesday night in his rousing victory speech, echoing John F. Kennedy's immortal exhortation.

``It's about what can be done by us together, through the hard and frustrating but necessary work of self-government.

That's the principle we were founded on.''

If the President truly wants to encourage individual responsibility and greater citizen engagement with government, as he suggests, he must return the US to fiscal probity without eroding further Americans' capacity for individual enrichment with high taxes and misguided social interventions.