

US teeters on edge of fiscal cliff

By Simon Carswell – 12/14/12

It's been described as a fiscal cliff – the looming raft of spending cuts and tax hikes that will send the US economy back into recession if a deal is not done by the end of the year. But the wrangling among lawmakers makes this more of a political cliff-hanger.

Buoyed by victory in last month's election, President Barack Obama is pressing to include tax increases on the richest Americans in any deal in order to avoid the automatic introduction of \$607 billion (€460 billion) in spending cuts and tax hikes from the start of next year.

Obama's re-election for a second term has given momentum to his case for tax increases on US households earning more than \$250,000 a year.

The political capital banked from his second win gives him leverage over the Republicans at a time when the GOP undertakes painful soul-searching in the wake of Mitt Romney's presidential election defeat.

Republican factions aligned to the far-right Tea Party movement have been uncharacteristically quiet in the bickering, while businesses have shifted position and encouraged Republican politicians to abandon their no-tax-increase foxholes.

The latest economic crisis to face the US has enlivened what is usually a quiet political period between the presidential election and the inauguration.

The crisis stems from the decision by Congress and Obama in 2010 to extend George W Bush's tax cuts for a period and a deal last year to curb the ballooning deficit that kick-starts nine years of spending cuts totalling \$1.2 trillion next month.

The effect on the economy of failure to avoid the cliff next year is the equivalent of 3.5 per cent of GDP, the value of the spending cuts and tax hikes sucking \$607 billion out of the US economy.

Most of this comprises \$399 billion in tax increases, mostly from the expiry of the Bush-era tax cuts. The remainder is made up of \$103 billion in spending cuts and \$105 billion in other changes to state revenues and expenditure.

Some see the fiscal cliff negotiations as the latest skirmish in a long-running failure to address a rising debt mountain and runaway spending growth on defence and healthcare.

“I would argue that we have already gone off the cliff, given that the country is \$16 trillion in debt,” said Tad DeHaven, a budget analyst at the non-partisan Washington DC-based think tank, the Cato Institute.

“Neither party has any plan to deal with the fiscal imbalances, which are going to get worse and worse as the years go on,” said DeHaven, who has worked for two Republican senators and a governor.

As Obama and the Republican House of Representatives speaker, John Boehner, the party’s top man in Congress, slug it out on a deal while the clock ticks towards the deadline, polls show a high level of support for the President and for an agreement being reached.

Obama’s approval rating on his handling of the negotiations stood at 49 per cent this week compared with Boehner’s 25 per cent, according to a Washington Post/ABC poll.

Another poll by the Wall Street Journal and NBC News on Wednesday found that about two-thirds of Americans of all political hues would like Congress to strike a deal to reduce the federal budget deficit, even if it meant reducing Social Security and Medicare state healthcare payments, and increasing taxes.

This is hardly surprising given that middle-class families will be forced to pay an average of \$2,200 more in taxes next year in the absence of a deal.

The mood among Republican supporters has also moved sharply amid fears that the US economy will move from a position of recovery to recession.

More than three-quarters of Americans, including 61 per cent of Republicans, said they would accept higher taxes on the rich to avoid the cliff, this week’s WSJ/NBC poll found.

“There is a growing group of folks looking at this and realising that we don’t have a lot of cards as it relates to the tax issue before year end,” Republican senator Bob Corker told Fox News earlier this week.

Wall Street rowed into the debate this week when Jamie Dimon, the chief executive of US investment bank JP Morgan, said the US economy could be booming “in a couple of months” if a deal were reached.

The onset of the tax increases and spending cuts – and the accompanying squabbling between Congress and the White House to avoid it – is seen more as

a political cliff and a fiscal slope given that most changes will arrive gradually next year.

“This image of a cliff is sort of a misnomer; it is more of a political term than an economic term,” said US economist Steven Seelig, a former senior International Monetary Fund official and a board member of the National Asset Management Agency, Ireland’s “bad bank”.

“If the Republicans do nothing, there is going to be a big increase in tax rates and they will fall off the cliff, more than anyone else. There is an argument that Obama should hang tough as Republicans will lose out.”

Talks between the Democratic president and a Republican Congress are deadlocked and could drag on past Christmas as the GOP must also grapple with internal strife among congressional Republicans, a factor that is weakening Boehner’s hand.

Little has been conceded in public about any shift in opposing negotiating positions and the differences on the surface appear to be stark.

Boehner, an Ohio Republican, has said Obama’s latest proposal on the table for \$1.4 trillion in new tax revenues did not meet his promise for a balanced approach to tackling the federal deficit and that it had no chance of passing Congress.

“I remain the most optimistic person in this town, but we’ve got some serious differences,” he told reporters after meeting Republicans in Congress, and warned that negotiations could run right up to the end-of-year fiscal deadline.

“Keep your Christmas decorations up and make no plans” was the advice that Boehner gave Republicans in a private meeting, Republican Congressman John Shimkus from Illinois told the Washington press.

The White House is not backing down on Obama’s demand that Republicans cede to his proposal for new revenue being raised through tax increases on America’s richest 2 per cent. Obama wants the top rate of income tax to increase to 39 per cent, while Republicans want the 35 per cent rate inherited from the Bush era extended.

Boehner has rejected a White House demand for \$1.4 trillion in higher taxes over a decade, down from its initial proposal for \$1.6 trillion; he instead wants \$800 billion in revenue to come from tax reforms.

This week Boehner said he had “frank conversation” about the gulf in his position with Obama, saying that the President’s plan didn’t go far enough to tackle the federal deficit.

The Republicans believe that the fiscal cliff can be lowered by simply closing tax loopholes or capping deductions, not by direct increases in taxes – a plan ridiculed by the White House.

“Those magic beans are just beans, and that fairy dust is just dust,” said White House spokesman Jay Carney in response.

The Republicans want to cut government spending by \$1.4 trillion, raising the eligible age for Medicare healthcare for the elderly from 65 to 67 and adjusting how annual increases in Social Security payments are calculated for welfare recipients.

Flush with victory in the presidential election, Democrats are loath to consider reforms within major government spending programmes as part of the negotiations.

Any hope that the Federal Reserve could rescue the situation were dashed this week when its chairman Ben Bernanke warned that bond-buying, effectively printing money by the central bank, would not offset the economic damage if politicians fail to reach a deal to close the \$1 trillion federal deficit.

The Fed is already taking extraordinary action in its efforts to keep the US economic recovery on track. This week the central bank said that it would buy a further \$45 billion of government bonds every month on top of the \$40 billion of mortgage debt that it is already buying.

It even took the unprecedented step of signalling that interest rates would remain near zero until unemployment falls to at least 6.5 per cent from the present level of 7.7 per cent.

Against that backdrop, there is a growing acceptance among Republicans that they must reluctantly swallow tax increases but they are still holding out for spending reforms in exchange.

Democrats may, as part of a deal to avoid the “cliff”, push for agreement on the longer-term problem of the \$16.4 billion debt ceiling, which is just \$67 billion of debt away and is likely to be hit in mid-February.

Political posturing over how the split between spending cuts and tax hikes will ultimately fall in a deal may push negotiations right to the wire and the threat of a self-inflicted recession will increase the pressure on both sides to reach a compromise.

In the meantime, the ugliness of political battle between a Democratic White House and Republican Congress will be a taste of the challenges to come for Obama in his second term.

“It is a huge test,” said a US diplomatic figure. “If they fail to reach a deal, there are going to be big questions about governance and if politics cannot take a split, there will be terrible implications.”