THE “FISCAL CLIFF” IN THE UNITED STATES[1]

By Nicholas Economides[2]

Based on a law of 2011, the USA was required to make automatic increases of taxes and decreases in public spending, unless there was a superseding law by the end of 2012. This was called the “fiscal cliff,” because it would lead to a significant recession in the US, similar to the level of the recession in Greece in 2010. The creators of the “fiscal cliff” thought that, facing a catastrophic crisis, the President and Congress would use the last months of 2012 to create a compromise. Finally, on January 2, 2013, the Senate and the House passed a very limited law on the revenue side of the budget. The much more thorny issue of spending was left for March 2013.

The changes in taxation are as follows: First, the tax on income from employment increases significantly. Second, for the “wealthy” (those that have income above $400,000) there is an additional tax of 4.9%, and capital gains and dividends tax increased from 15% to 20%. Third, estate taxes increases from 35% to 40% above a tax free $5 million. Fourth, a new tax of 3.8% was imposed on incomes above $200,000 to cover the deficits of the new health care program. People are upset by the high taxes and because they believe (correctly or not) that the state (that is, the tax payers) paid for the 2008 crisis, and not the banks that caused the crisis. The resentment was expressed from the right by the populist Tea Party (which was absorbed in the Republican Party) and from the left by Pres. Obama and the Democrats, who also speak in a populist language as expressing the 98% “imposing taxes only on the upper 2%.”

In the political fight about the fiscal cliff, the Republicans failed to use the benefit of their House majority. Pres. Obama passed the positions he wanted on taxation, and more importantly, was able to split time-wise the vote for the revenue from the vote on spending. In this way, Pres. Obama passed his terms on revenue without any restrictions on spending. The biggest problem, that is, which spending programs will be curtailed, remains unsolved. The next few months will be spent in negotiations between the representatives of various lobbies and politicians. It will be in the middle of 2013 when we will know whether the United States surpassed the fiscal cliff. Right now, we have no idea which spending programs will survive.

All of the above are on the US budget deficits. But the US has another fiscal crisis too: that of its public debt. To surpass the crisis of 2008, the US spent over a trillion dollars, increasing significantly its public debt. This debt needs to be paid off sometime. Instead, it is increasing from the budget deficits. So that pubic debt does not spiral out of control, the House had passed a law setting a maximum amount for the US debt. If this maximum is not increased by a new law, the US will be forced not to pay its bonds (Treasuries). Because of this danger, the rating agencies have degraded the US below AAA.

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[2] Professor of Economics, Stern School of Business, New York University, and visiting professor, Haas School of Business, University of California, Berkeley.

Even though the US crisis looks like the Greek one, the US has three tremendous advantages compared to Greece. First, the dollar is traditionally a high quality reserve currency. In all crises, even in the 2008 crisis that started in the US, investors from around the world rushed to buy dollars. The second advantage is the immense economic power of the US. The third advantage is that the US has institutions, such as the Federal Reserve, that have dealt with economic crisis for a century and have tremendous experience compared to the ECB and Europe.

Nevertheless, the US is facing tough competition from China and the EU which, in the medium run, will shrink the share of wealth that accrues to the US. No American politician speaks about this unfortunate development. Like the EU kicked the Greek problem to the future many times, so do the US politicians with the fiscal problem. And, like the EU did not solve at a low cost the Greek crisis in 2009, moving the US fiscal problem to the future will make its solution more difficult and more costly.