Who's Afraid of the Fiscal Cliff?

By Editor Test *Tue, Jul 31, 2012*

Not Bill Gale of the Brookings Institution. He recommends that we let the Bush tax cuts expire and the automatic spending cuts occur—and then to build a more sensible fiscal compromise on top of their ruins.

At the end of this year, the U.S. economy faces the so-called "fiscal cliff": the Bush tax cuts will expire, and as a result of the 2011 deal that raised the debt ceiling, automatic spending cuts will begin.

Policymakers are considering how to respond, given the weak prospects for the economy in the short-run, and the dismal prospects for the federal budget in the medium- and long-term. President Obama has proposed extending most of the Bush-era tax cuts, but not the tax rate cuts for the highest-income households, whereas Congressional Republicans would like to extend all of the tax cuts.

A better approach would be to go over the fiscal cliff—that is, let the tax cuts expire and the automatic spending cuts occur—and to enact a temporary stimulus package.

Going over the cliff is the only way to get the economy on a good long-term budget path with a deficit reduction package that balances revenue increases and spending cuts.

It would put the economy on a better long-term path through cutting deficits by about $4 trillion over the next 10 years relative to current policy and by stabilizing the ratio of debt to GDP. This is no small feat. It would be the opposite of "kicking the can down the road," which is what Congress has done in the past and has been roundly criticized by experts and others.

It is the only way to get a deficit reduction package that is fairly balanced between spending cuts and revenue increases. About 90% of Republicans in Congress have signed the "No New Taxes" pledge. This is a mainstream Republican position, not some fringe part of the party.

The signers pledge to oppose any net tax increases, regardless of the situation. (Think about this: even if we were being invaded and needed revenues to defend the homeland, the Pledge would require its signees to eschew tax increases.)

That means that, although an overwhelming majority of Americans—70% in a recent Pew survey—would like to see revenues account for a significant share of a long-term budget agreement, there is no way to achieve that outcome via a budget "deal" in the current situation. Going over the cliff solves that problem, raising revenue by about $2.8 trillion over the next decade. And, of course, we don't need a vote to achieve that. Just doing nothing—letting the tax cuts expire—suffices.

Going over the fiscal cliff *does* create two problems, however, both of which are solvable.

The first is that although it would put the overall budget on a good long-term path, the structure of the resulting tax or spending policies may find disfavor. The revenue increases would come from tax rate increases, rather than deduction-reducing, base-broadening efforts that would make taxes simpler and fairer. The spending cuts would come from military and domestic discretionary spending—where most government investments occur—rather than from the chief drivers of long-term spending growth, Medicare and Medicaid.

The key point, though, is that having the additional revenues and lower spending path that comes from going over the cliff would give policymakers the opportunity—the budget resources —to strike a budget deal, and the less-than-ideal structure of the tax and spending changes would give them the incentive. And because the "No New Taxes" pledge makes it impossible to include significant revenues as part of a budget deal now, it will be easier to reach a balanced deficit reduction package if we go over the cliff first and then negotiate spending up a little and taxes down a little, rather than trying to reach balanced deal now by negotiating taxes up and spending down.

The second problem is that going over the fiscal cliff, without enacting other policy changes, would likely hurt the economy in the short-run, as the Congressional Budget Office and others have noted. This is basically an argument that spending cuts and tax increases will hurt the economy in the short-run, and therefore it is an argument that a stimulus package—that is, tax cuts and spending increases—could help the economy in the short-run.

A stimulus package that stays away from the partisan wrangling over the Bush tax cuts, and consists instead of payroll tax cuts, infrastructure investment and aid to the states could be structured as temporary and would have a bigger "bang for the buck" than extending the Bush tax cuts, while also being more progressive.

The expiration of the Bush tax cuts and the automatic spending cuts slated to take effect in a few months offer a rare chance to do what policymakers have not, so far, been able to do—deal seriously with the 10-year budget deficits looming over the economy. Legislators should embrace that opportunity while also tending to the short-term needs of the economy.