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The US is unlikely to avoid "fiscal cliff"

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The United States is rapidly approaching the "fiscal cliff," a dangerous combination of increased taxes and decreased government spending scheduled for January 1 that would reduce the budget deficit by five percent of GDP between 2012 and 2013. Although reducing America's budget deficit is necessary, such a sharp cut now while the economy is still very weak would be a serious mistake.

If the fiscal cliff is not avoided or rapidly reversed, the American economy would soon be in a new recession with substantially higher unemployment. That would have a negative impact on the global economy. There is nothing that the Federal Reserve could do to prevent such a renewed economic downturn.

So just what is the "fiscal cliff," why is it scheduled to happen now, and what can be done to prevent it?

The biggest piece of the "fiscal cliff" is the automatic expiration of the tax rate cuts enacted when George W Bush was president. They were scheduled to end in 2012 in order to limit the official projected revenue loss. Subsequent legislation provided additional tax cuts that will also end this year. Expiration would involve higher taxes on personal incomes, on estates, on corporate profits, and on payroll earnings.

Going over the fiscal cliff also includes cuts in government spending – half in defense and half in non-defense "discretionary" programmes (i.e., all programmes excluding Social Security and Medicare). This "sequester" will automatically start with $109bn of spending cuts in 2013. Over nine years it will lead to total cuts of $1.2tn unless Congress enacts a different multi-year budget plan that reduces the deficit by $1.2tn over those years.

The fiscal cliff can only be avoided by legislation passed by both houses of Congress and signed by the President. The critical issue that prevents such legislation is a conflict over tax rates between President Obama and Republicans in the Senate and House of Representatives. President Obama wants to extend the current tax rates for taxpayers with incomes below $250,000 but to raise taxes for those with incomes above that level to the higher rates that prevailed before the Bush tax cuts. The Republicans want to extend the current tax rates for everyone and can use their majority in the House to prevent the Obama plan from becoming law.

The conflict is important economically as well as politically. Although the high-income group represents only about three percent of all taxpayers, they pay more than 40 percent of all personal income taxes.

The election on November 6 will determine how the issue of the cliff is resolved. Although the Republicans will retain control of the House of Representatives, the outcome is uncertain for the Senate and for the presidency.

If Romney is elected and the Republicans win a majority in the Senate, the conflict over tax rates will not persist after the president's inauguration in January. Even if President Obama were to block Republican-sponsored legislation to eliminate or postpone the fiscal cliff in the two months after the election when he is still president, the new Republican administration and Congress would rapidly reverse the automatic tax increases once Romney takes office. Doing so retroactively to January 1 would avoid most of the adverse short-run effect of going over the cliff. Postponing final legislation until mid-summer would give time to craft compromise reforms of taxes and entitlements that would have a positive effect on the economy.

If Romney is elected but fails to carry the Senate, a stalemate could remain. A bipartisan group in the Senate is working on a plan to postpone the fiscal cliff, substituting a combination of reforms to taxes and entitlements that would be a desirable alternative. It is too soon to know what the prospects are for such a compromise.

If President Obama is re-elected, he would regard that as a mandate to raise taxes on high income taxpayers. Since the Republicans will still control the House, he may not be able to enact such a tax bill before the end of the year. Some Democrats advocate that the President allow the current tax law to expire and then propose new legislation in January to cut taxes on everyone with income below $250,000, daring House Republicans to vote against a bill that lowers taxes on 97 percent of taxpayers while raising taxes on no one. That same legislation could avoid triggering the sequester if it also broadens the tax base and cuts government spending.

But avoiding the adverse effects of the fiscal cliff under any of the scenarios would still not deal with America's long run fiscal problems. The United States needs to slow the growth of the middle-class retiree programs and raise revenue by limiting tax expenditures in a framework of fundamental tax reform. Dealing with the fiscal cliff is just the first act of a play with many acts.