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Avoiding a New American Recession
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CAMBRIDGE – The United States may be headed for a recession in 2013. Even if the country avoids going over the "fiscal cliff," a poorly designed political compromise that cuts the deficit too quickly could push an already weak economy into recession. But a gradual phase-in of an overall cap on tax deductions and exclusions (so-called tax expenditures), combined with reform of entitlement spending, could achieve the long-run fiscal consolidation that America needs without risking a new recession.

The US economy has been limping along with a growth rate of less than 2% during the past year, with similarly dim prospects in 2013, even without the shock of the fiscal cliff. That is much too weak a pace of expansion to tolerate the fiscal cliff's increase in tax rates and spending cuts, which would reduce demand by a total of $600 billion – about 4% of GDP – next year, and by larger sums in subsequent years.

President Barack Obama's proposed alternative to the fiscal cliff would substantially increase tax rates and limit tax deductions for the top 2% of earners, who now pay more than 45% of total federal personal-income taxes. His budget would also increase taxes on corporations, and would end the current payroll-tax "holiday," imposing an additional 2% tax on all wage earners.

Together, these changes could lower total demand by nearly 2% of GDP. And the higher marginal tax rates would reduce incentives to work and to invest, further impeding economic activity. All of that could be fateful for an economy that is still struggling to sustain a growth rate of less than 2%.

The Congressional Budget Office and the Federal Reserve predict that going over the fiscal cliff would cause a recession in 2013, with Fed Chairman Ben Bernanke recently saying that the Fed would be unable to offset the adverse effect on the economy. He could have said the same thing about the fiscal drag that would be created by Obama's budget proposal.

Although Congressional Republicans rightly object to raising tax rates, they appear willing to raise revenue through tax reform if that is part of a deal that also includes reductions in the long-run cost of the major entitlement programs, Medicare and Social Security. Although some Republicans would like to see revenue increased only by stimulating faster economic growth, that cannot be achieved without the reductions in marginal tax rates and improvements in corporate taxation that the Democrats are unlikely to accept. Raising revenue through tax reform will have to mean reducing the special deductions and exclusions that now lower tax receipts.

The potential recession risk of a budget deal can be avoided by phasing in the base-broadening that is used to raise revenue. A desirable way to broaden the tax base would be to put an overall cap on the amount of tax reduction that each taxpayer can achieve through deductions and exclusions. Such an overall cap would allow each taxpayer to retain all of his existing deductions and exclusions but would limit the amount by which he could reduce his tax liability in this way. An overall cap would also cause many individuals who now itemize deductions to shift to the standard deduction – implying significant simplification in record-keeping and thus an improvement in incentives.

A cap on the tax reductions derived from tax expenditures that is equal to 2% of each individual's

adjusted gross income would raise more than $200 billion in 2013 if applied to all of the current deductions and to the exclusions for municipal-bond interest and employer-paid health insurance. Even if the full deduction for charitable gifts is preserved and only high-value health insurance is regarded as a tax expenditure, the extra revenue in 2013 would be about $150 billion. Over a decade, that implies nearly $2 trillion in additional revenue without any increase in tax rates from today's levels.

Extra revenue of $150 billion in 2013 would be 1% of GDP, and could be too much for the economy to swallow, particularly if combined with reductions in government spending and a rise in the payroll tax. But the same basic framework could be used by starting with a higher cap and gradually reducing it over several years. A 5% cap on the tax-expenditure benefits would raise only $75 billion in 2013, about 0.5% of GDP; but the cap could be reduced from 5% to 2% over the next few years, raising substantially more revenue when the economy is stronger.

Slowing the growth of government spending for Medicare and Social Security is necessary to prevent a long-term explosion of the national debt or dramatic increases in personal tax rates. Those changes should also be phased in gradually to protect beneficiaries and avoid an economic downturn.

America's national debt has more than doubled in the past five years, and is set to rise to more than 100% of GDP over the next decade unless changes in spending and taxes are implemented. A well-designed combination of caps to limit tax expenditures and a gradual slowing of growth in outlays for entitlement programs could reverse the rise in the debt and strengthen the US economy. America's current budget negotiations should focus on achieving a credible long-term decline in the national debt, while protecting economic expansion in the near term.
