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Cliff Schmiff

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Worried about the fiscal cliff? You are not alone. Going over the "cliff," we are told, will plunge the U.S. economy into recession, and perhaps even rend the very fabric of our society. What could be worse than falling over this cliff? That, actually, is an easy question. The answer: *not* falling over it. I will explain.

First, though, what is the fiscal cliff? The cliff is a broad array of tax increases and spending cuts that will take effect automatically at the end of 2012 absent congressional action. Without some palliative measure, the full amount of higher taxes and spending cuts will total $560 billion in 2013. A widely held fear is lower demand and loss of output—recession, in short—ensuing from a fall over the cliff.

The Congressional Budget Office estimates that after an uncushioned fall over the cliff GDP growth in 2013 would be a mere 0.5 percent, which breaks down further into a contraction at an annual rate of 1.3 percent in the first half of 2013 followed by an expansion at an annual rate of 2.3 percent in the second half.[1] While that sounds bad enough, other forecasters predict far worse effects.

Therefore, shouldn't we avoid the cliff at all cost? To answer that question we must also ask: compared to what? With that in mind, and considering the policies and ideas floated publicly across the ideological spectrum, I contend that we should accept, even embrace, the fiscal cliff.

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[1] ***Economic Effects of Reducing the Fiscal Restraint That Is Scheduled to Occur in 2013*** http://www.cbo.gov/publication/43262.

Dread of the cliff rests in considerable part on an illusion: that its dire effects can be avoided by stepping away from it. The cliff is not an ailment, however, but a symptom. The true ailment, a cancer on the U.S. economy, is our compulsive profligacy, both public and private. The only remedy—and an overriding imperative—is to rein in public debt. Any mechanism to that end, whether the fiscal cliff or a more gradual mix of tax increases and spending cuts, will entail fiscal drag, and therefore a loss of current output in some future period.

Hence the pain of the fiscal cliff cannot be eliminated, only deferred by unwinding public debt more gradually. Fiscal drag inheres in the removal of stimulus contributed by deficit spending. The case for deferring it is that the pain can be minimized overall by regrading the cliff into a gentler slope. In cliffese, that would mean fewer broken bones and a smoother return to mobility.

In theory this is a possibility. If taxes and spending are increased by the exact same amount, there may still be a net gain in the fiscal ledger of the U.S. economy. To put the point more technically, well-chosen public investment could induce greater growth—immediately through a multiplier effect and over time by increased output—than the offsetting drag of an equivalent rise in taxes. Although some economists dispute it (on the right, naturally) this is a respectable view.

Wholly apart from the validity of the theory, however, I doubt that in the current environment any such policies could be filtered through our political process without considerable misallocative side effects that would negate all potential fiscal gain and then some. Remember how the implied stimulus of the Bush-era tax cuts was largely wasted in support of a housing and credit boom, with various public and private institutions cheerleading from the sidelines.

This jaundiced expectation is reinforced by more specific focus on the policies that have been advanced lately by the presidential candidates and in Congress.

President Obama's tax plan for 2013 and beyond is to perpetuate the current (Bush era) income tax rates for families making less than $250,000 a year, but not above.[2] On the extension of the current payroll tax reductions into 2013 the administration has been unclear, deliberately so I suspect. Either way, this is more of a fiscal dip than a cliff.

It is also a pretty bad plan. While higher tax revenues are essential, lest we suffer the fate of Greece, the administration arrives at them in a way that will burden the economy significantly more than other tax measures of equal size. The tax increases in the plan are entirely tilted toward the upper end, which already pays a far larger share of income taxes than any other group. More importantly, the increases bear harder on capital income. This is the opposite of what should be done. Higher taxes, which we urgently need, should bear entirely (or nearly so) on consumption. Taxes on capital income should actually be *lower*. While it may not seem immediately intuitive, our economic future will be brighter if investment gains and savings of individuals (yes, including the one percent) are allowed to pile up at benign tax cost until committed to personal consumption.

On the other side of the aisle, however, Governor Romney's stated tax proposals are far worse. To the extent one can discern a plan through the indistinct contours of the tax and fiscal policies he has embraced in recent months, Governor Romney appears to prescribe tax rates lower by 20 percent across the board, coupled with unspecified base broadening and spending cuts. These proposals hardly qualify as a plan. They are a rough sketch at best, designed solely—for transparent electoral purposes—to prevent Romney himself from falling to a fatwa issued by the anti-tax mullahs of the far right. The very same supply-siders who deny that stimulus spending has any positive effect now contend that the implied stimulus of hefty tax cuts will bring the economy roaring back. This fantasy lacks even minimal arithmetic plausibility.

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[2] Sometimes the cut-off for single taxpayers is given as $200,000.

Thus, on the basis of the stated policies of those vying for control of our economic future, our practical choices appear to be: 1) a bad tax and fiscal policy (President Obama's); 2) a calamitously bad tax and fiscal policy (Governor Romney's); or 3) the fiscal cliff. This is not a hard call.

Even Simpson-Bowles, beloved of those who fancy themselves the voices of reason on fiscal matters, falls considerably short of what is needed. It may be slightly better than the fiscal cliff (although five years from now it would probably be hard to tell the difference in net effect between the two), but it is not good enough to justify a heavy and likely unsuccessful effort to move it forward.

One last word. Taking only my selfish personal interest into account, I have little reason for concern over the fiscal policies (or lack thereof) that will prevail in the next 20 years. My income and medical care in retirement are adequately protected against all but the most extreme and implausible scenarios. For Americans under 30, however, or even 40, the stakes are heavy. For them, the positions floated by both sides in the upcoming election are pathetically inadequate. As they look out to futures blighted by the greed and profligacy of their elders, the fiscal cliff is the least of their problems.

Readers with comments should address them to:

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