NATIONAL CENTER FOR POLICY ANALYSIS

The Fiscal Cliff and the Next Recession

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On January 1, 2013, taxes will go up and federal spending will be cut as a result of an agreement last summer between House Republicans and President Obama. Under current law, increases in the top rate of nearly every major federal tax will go into effect on January 1 because the Bush tax cuts expire and tax increases to pay for ObamaCare go into effect.

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Since the end of World War II, federal spending has been stable at around 20 percent of Gross Domestic Product. Currently, federal spending consumes about 23 percent of GDP, while federal revenues have been about 16 percent of GDP. The resulting budget deficit and growing federal debt have been financed by borrowing.

Under the deal made last summer, federal spending during fiscal year 2013 (which began October 1, 2012) will be cut $103 billion, with $61 billion in across the-board defense cuts, $26 billion from the expiration of emergency unemployment benefits and $11 billion from a reduction in Medicare payments to physicians.

Tax Hikes. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 will expire December 31, 2012, and as a result individual income tax rates will rise, the child tax credit will be reduced, the American Opportunity Tax Credit will be eliminated and estate tax rates will rise. In addition, the income threshold for the alternative minimum tax will be lower, affecting 26 million taxpayers. As a result [see Figure I]:

- The top two income tax rates will jump nearly 20 percent.
- The capital gains tax rate will soar by nearly 60 percent, and the tax on dividends will nearly triple.
- The Medicare payroll tax rate will skyrocket by 62 percent.
- The top rate on the estate tax with rise by 57 percent.

Effects of Falling off the Cliff. The Congressional Budget Office predicts that if nothing is done to avert this so-called fiscal cliff another recession will occur in the first half of 2013. As a result of spending reductions in last summer's agreement, federal spending will fall from 22.9 percent of GDP to 22.4 percent. As a result of the tax increases, GDP growth over the coming decade (2012-2022) is expected to be 2.2 percent per year — the lowest average of any post-World War II decade [see Figure II]. According to the CBO:

- There will be a recession in 2013, with GDP dropping by 0.5 percent between fourth quarter of 2012 and fourth quarter of 2013.
- Unemployment will rise to about 9 percent in 2013.
- Inflation — measured by the prices consumers pay — is expected to rise to 2 percent annually over the next few years.

Effects of Avoiding the Cliff. Over the past 45 years, every time capital gains tax rates have been increased, capital gains revenues have declined rather than increased. Moreover, when Bush slashed taxes

on dividends in 2003, dividends paid soared, as did the taxes paid on those dividends. Reversing that tax cut will have the opposite effect, and revenues from taxation of dividends will decline rather than rise as well. If a recession results from all the tax increases, total federal revenues will decline rather than rise.

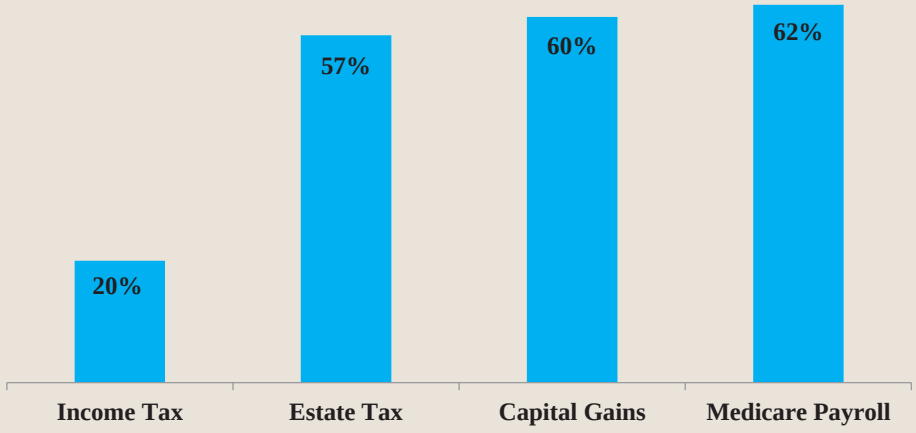
According to the CBO reversing the changes in taxes and spending that are expected to take place would boost real GDP by 1.4 percent and increase full-time employment by 1.8 million jobs by the end of 2013.

President Obama's Policies. To avoid the fiscal cliff, the president is proposing to maintain his first-term policies, which produced the weakest recovery from a recession since the Great Depression. He wants higher tax revenue and higher federal spending. He believes that the economy will grow faster "from the middle class out" — that is, if the middle class and the poor are given money to spend on consumption that "the rich" would otherwise save and invest.

However, in a market economy, consumer demand can never be inadequate for the economy to grow and prosper. If demand is insufficient to clear the market for any good or service, then the price of the good or service will fall until demand equals supply. But, if those who save and take the risk of investing believe that the government will seize their savings and investment when they are successful, they will sharply reduce their savings and investment. The poor and middle class will lose the jobs, wages and income essential to their own personal prosperity.

Figure I

Tax Hikes



Source: Author's calculations based on "The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010."

Conclusion. In addition to the fiscal cliff, Americans are facing a raft of new regulatory costs and burdens the Obama Administration delayed until after the election. Those burdens include new global warming regulations, which will raise costs for U.S. producers that manufacturers in growing economies from China to India to Brazil will not face. Still more regulations are slated to come from ObamaCare, including the costly employer mandate, which will require employers with 50 or more workers to buy expensive health insurance for their employees.

Economic growth and prosperity for working people and the middle class does not come from increased spending and consumption. It flows from increased savings and investment, which create new jobs and provide workers with the tools to be more productive. Increased productivity enables workers to earn higher wage.

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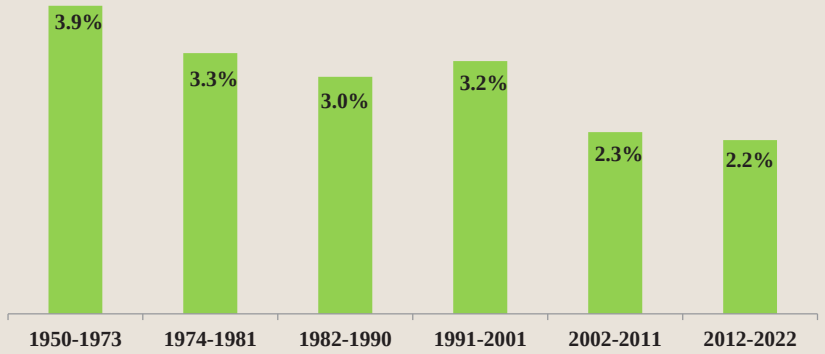
Figure II

Average Growth in Gross Domestic Product by Decade



Source: "An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022," Congressional Budget Office, Congress of the United States, August 2012.