

“Fiscal cliff” explained in 700 words

By Jim Nowlan

A reader asked if I could explain the “fiscal cliff” issue succinctly and clearly, if at all.

The answer is “probably not,” but here goes anyway.

The fiscal cliff term suggests that if the Congress and the President fail to act in the next few months, the federal government will fall over a cliff into an abyss of tax increases as well as sharp spending cuts in military spending and many popular programs. It is feared failure to act would throw the country back into recession.

The underlying, fundamental issue is the inability of Washington to address the persistent gap between federal spending and revenue. In recent years, the federal government has had to borrow between 30 and 40 cents of every dollar it spends. Much of this growing, unsustainable debt has been purchased by China, our major economic competitor, which is both embarrassing and troublesome.

At the end of this year, a series of tax cuts enacted in the past decade will expire, which would result in increases in income taxes and payroll taxes, not only for the wealthy but for the middle class as well. The Tax Foundation in Washington, D.C. estimates that a household in Illinois with the state’s median income of \$79,318 would pay \$3,417 more in federal income taxes.

On the spending side, a special committee of the Congress failed in 2011 to enact significant cuts in the budget. As a fallback position, the Congress adopted deep cuts in defense

and other programs that would go into effect automatically at the beginning of 2013, absent other action in the meantime.

These automatic spending cuts are referred to as “sequestration,” a 25-cent word if ever I heard one.

Most economists believe that going over the cliff, i.e. failing to take action, would be bad for our fragile economy in the short term. The big tax increases and large spending cuts would take money out of the economy, reducing demand for goods and eliminating jobs.

At the same time, these same economists feel that a credible plan for spending reductions and revenue increases over the long term must be enacted, to reduce our debt relative to the size of the economy.

Neither Obama nor Republicans in Congress want to be blamed for going over the fiscal cliff. So a game of political chicken will take place over the coming weeks. Obama will pressure Republicans for revenue increases from the wealthy. Republicans will declare no deal is possible unless Democrats cut spending sharply.

The best resolution of the situation would be a “grand bargain” in which tax increases and spending cuts are generally avoided for the short-term, say maybe the coming year, with significant revenue increases and spending cuts enacted for the longer-term.

Such a grand compromise will be extremely difficult to achieve in short order. Scores, probably hundreds, of interest groups will be resisting changes that affect their respective incomes and programs. Farmers will fight more cuts in ag programs; doctors will object to cuts in reimbursement rates for Medicare, and seniors will fight efforts to increase the age for Medicare coverage, among hundreds of special issues.

I talked with my astute congressman, Aaron Schock (R-Peoria), about the political situation. “I hope the President has an epiphany,” said Schock, “and lays entitlement reform details on the table. You’re not going to get a deal from Republicans without some movement on Social Security and Medicare. If the President were forthcoming, the House GOP would deal with the revenue issue by closing tax loopholes.”

Schock would like to see a grand bargain by the end of the year, but I think that is too ambitious, given the complexities of the situation.

Economist Christina Romer, Obama’s first chief economic advisor, has suggested a combination of actions. First, agree rather quickly on the broad components of a compromise plan, with hard numbers for deficit reduction, and then over a longer period of time hammer out a detailed agreement.

Responsible compromise on the fiscal cliff and deficit issues would also set a positive tone for bi-partisanship throughout the coming Congress. The bargaining will be bare knuckles tough, but I doubt we will go over the fiscal cliff.