Of Debts, Markets and 'Fiscal Cliffs' in Europe and the United States: Part II

William R. Cline says that expiring tax cuts and other changes due December 31 would add up to 5 percent of the US economy, but the United States can afford to go over the 'cliff' and then fix the problem.

Transcript of interview recorded July 5, 2012.

Steve Weisman: William Cline, senior fellow at the Peterson Institute, has the daunting task of looking at the fiscal and financial situation in both Europe and the United States. There are certainly many parallels. This is Steve Weisman. Bill, what everyone calls the "fiscal cliff" now looms at the end of 2012. The question is whether that "cliff" will bring action to avert disaster. First, what is the fiscal cliff?

William Cline: The fiscal cliff is mostly about the expiration date of the two Bush-era tax cuts. My calculations are that those tax cuts took away about two and one half percent of GDP of revenue on an ongoing basis. And the fiscal cliff also includes the end of the temporary payroll tax cut, the end of emergency unemployment benefits, and certain things that we make annual fixes for, like how much we pay the doctors under Medicare, and the Alternative Minimum Tax. And if you put these all together, they are worth five percent of GDP on an annual basis.

There are two problems. First of all is overkill. By my calculations, we need a three percent of GDP fiscal adjustment for long term stability. But secondly, it's too concentrated, too soon. My proposal is that this should be phased into three percent instead of five percent. Correction should be phased in over the four years of the next president's term because we still have high unemployment, and we know that under that circumstance, and with nothing we can do on the monetary side, or almost nothing, you better not strangle the economy by hitting it with a five percent shot.

Steve Weisman: Although this cliff is looming, you don't hear too many political leaders, certainly not President Obama and Governor Romney, saying what should be done in much detail. The fear is that we go over the cliff on December 31st. Is there enough time to fix it after that -- let's say in January or February?

William Cline: There certainly is. The reason is that the impact of all this occurs in an orderly, gradual way during the course of the year. There's an aspect of it that's terribly important. That's the political commitment of the vast majority of the Republican congressmen, senators, that they will not vote for anything that increases taxes. This is the Grover Norquist pledge. Now, if you think about it on January 1st, that pledge becomes a historical relic because the thing they would be voting for at that point would be to reduce taxes from the level they would have rebounded to.

Taxes are going to go up on the 1st of January. So it's no longer something they would vote for that raise the taxes; actually, their predecessors voted for this ten years ago when they put a sunset clause on these taxes. It's a good thing they did, because that's the second main point, is we need fiscal correction.

Now, there's another thing here: even if we went off the fiscal cliff and did nothing, just let this five percent shock grind it through. The CBO says that the price of that would be 1.6 percent of GDP—of one year's GDP. Well, that might arguably be worth it. I mean, Alan Greenspan at one point said, "We should just let these Bush tax cuts expire."

Steve Weisman You mean the tax cuts by themselves are 1.6 percent?

William Cline The CBO [Congressional Budget Office] says the difference between what growth next year would be if you let this happen, which would be almost zero (it would be half a percent of GDP), and the growth you otherwise achieve if you went business as usual, which is to make the Bush tax cuts continue, would be 1.6 percent of one year's GDP. And for that price, you would purchase debt-to-GDP ratio in 2022 that is about sixty percent of GDP rather than ninety-five percent of GDP. That might not be a bad bargain, but it's not the safe bargain because in a Keynesian situation of unemployment, it might be that they're not putting a large enough number on how much output you'd sacrifice.

Steve Weisman: Do you think that the prospect of doing that is going to bring about maybe a measure of agreement before the end of the year?

William Cline: I think the scenario depends completely on whether Obama wins the election or Romney wins the election. If Romney wins, and especially if the Senate goes Republican, it seems to me that there's no new legislation. On January 15th, there is a big push for new legislation that basically reinstates the Bush tax cuts full stop. Now, my fear about that is it will be connected with supposed promises of spending cuts that when the time comes to enact them, will not occur. And we'll be off to the races in mounting debt. We will not have solved a long term debt problem. So that's the scenario that I would see with a Romney victory.

With an Obama victory, then it seems to me that he can use the expiration of the Bush tax cuts which are just looming out there, just a few weeks ahead, some very strong leverage bargaining tool to get enough Republicans to sign on to his package. Now, I would prefer to see Obama not insist that everybody under $250,000 doesn't have to pay a cent more in taxes, that just the Bush tax cuts can continue for them, because that takes about two thirds of the potential revenue rebound off the table.

But I do think that there's a chance that an Obama second term, that they could get the legislation in place by the end of the year and that indeed you wouldn't even trigger the expiration of the tax cuts. I'd say it's still a little more likely given the very sharp conflict we've had, including the new possibility of another round of the debt ceiling fight, and the threatening of defaulting because the Republicans will not permit an increase in the debt ceiling if there's any change in the taxes.

There's some probability—I'd say as much as 50/50—that if Obama is elected, then he has to go through this exercise of letting Bush tax cuts expire, starting the first step down the fiscal cliff, but it's a long stairway down the fiscal cliff. And suddenly having a whole bunch of potential people who will vote for a tax reduction because it's no longer a tax increase; it's a tax reduction from the levels they will have returned to.

Steve Weisman: The debt ceiling legislation expires sometime after the first of the year, I think.

William Cline: I thought it was the first of the year. I may be wrong about that. But it's basically at the turn of the year.

Steve Weisman: Of course health care and the cost of that will have to be part of this mix, I would guess.

William Cline: One of the most extraordinary things of the most recent Congressional Budget Office report, their long term report, was that if you eliminate the Bush tax cuts, you no longer have the long term fiscal outlook looking so bleak. Now, I grant you, it only goes up to 2022. If you took it out to 2030, 2040, then the health stuff probably—

Steve Weisman: Right.

William Cline: Yeah, I think that's the best way to look at it is the health thing, I think, has time to be revisited. I don't think you have to solve the 2040 excess health cost problem on January 15th.

Steve Weisman: Bill, thanks very much.

William Cline: Good. Thanks, Steve.