Jumping the Fiscal Cliff: The Political Economy of Fiscal Policy-Making under President Obama

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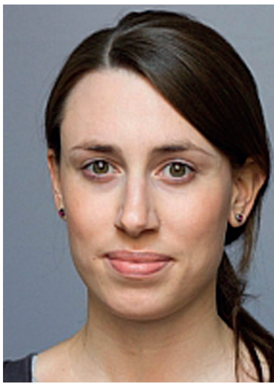

On New Year's Eve 2012, US Congress and the President narrowly avoided the fiscal cliff. A similar compromise, however, could not be struck in March 2013, and Washington plunged head long into painful budget cuts, the so-called sequester. The sequester is just the latest episode in the squabble between Democrats and Republicans on how to best reduce government debt and help to get the economy back onto a sound footing. While the sequester and previous budget measures have shown initial results – the Congressional Budget Office (CBO) expects the deficit for the fiscal year 2013 to fall to 4 percent – it not only dampens short-term economic growth prospects, but also severely prevents the government from making much needed investments in the country's deficient infrastructure and education system. No doubt, budget cuts were necessary as the debt-to-GDP ratio is not sustainable. But indiscriminative across-the-board cuts such as those under the sequester could prove a problem for the country's long-term competitiveness. How did we get here? Why has it been so difficult for Congress and the President to agree on a more sustainable fiscal policy path? The answer lies not only in deeply diverging ideologies, but also in a dysfunctional political system.

Phase 1: stabilizing the economy 2008–2010

At the beginning of the financial and economic crisis, Republicans and Democrats agreed that swift and meaningful actions were necessary to stabilize the economy. The situation could not have been more dramatic. During the last two quarters of 2008, US economic growth declined by 3.7 percent and 8.9 percent respectively – the US economy had not experienced a hit of such severity since 1982. In 2009, the US economy shrunk by another 3.1 percent (Bureau of Economic Analysis 2013). The reasons for the contraction were first and foremost a large decline in private consumption – private consumption accounts for approximately 70 percent of US gross domestic product (GDP) – and fixed capital formation (caused, in particular, by the collapse of residential construction) – see Kirkegaard *et al.* (2011). Unemployment skyrocketed. In 2009 the rate climbed to 9.3 percent, averaging 9.6 percent in 2010 and 8.9 percent in 2011 (Bureau of Labor Statistics 2013).

To stabilize the financial sector and to rejuvenate economic growth, the US government passed several rescue and stimulus measures. Under the 700 billion US dollar Troubled Asset Relief Program (TARP, enacted on 3 October 2008), the Treasury invested in dozens of struggling banks and other financial institutions such as the insurance company AIG, as well as in the automobile industry (General Motors, Chrysler). In February 2009, Congress passed the American Recovery and Reinvestment Act (ARRA). The 787 billion US dollar stimulus package (later increased to 840 billion US dollars to be consistent with the President's 2012 budget) included federal tax incentives, an expansion of unemployment benefits and other social welfare provisions, as well as domestic spending in education, health care and infrastructure (Francoz 2010). The main focus, amounting to 290.7 billion US dollars, was on tax benefits, including individual tax credits, the Making Work Pay Program, as well as tax incentives for business and energy. Contracts, grants and loans for education, transportation, infrastructure, energy/environment, housing, health/family, research and development, public safety, and job training/unemployment amounted to 254.5 billion US dollars and entitlements (such as unemployment insurance and Medicaid/Medicare) to 250.8 billion US dollars (see

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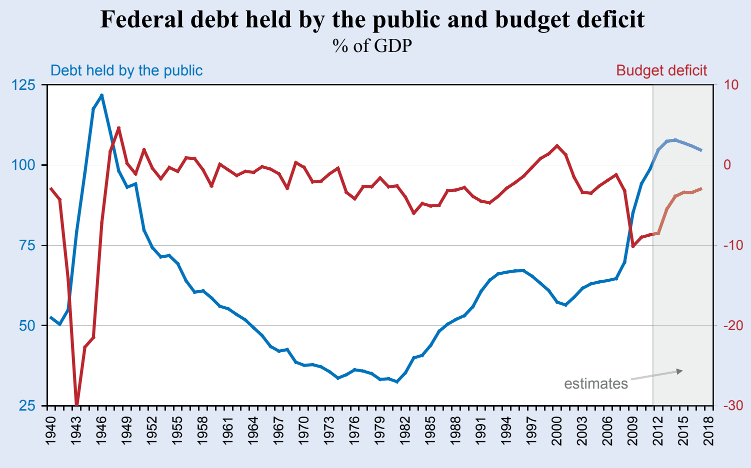
Recovery.gov 2012). The vote on ARRA already showed, however, that fiscal policy-making would not be easy for President Obama. Of the 264 affirmative votes in the House, all came from Democrats – 176 House Republicans voted against the bill (plus 7 Democrats). The Senate vote looked similar: 56 Democrats and 2 Republicans voted for the bill, but most Republicans (38) voted against it (Govtrack.us 2009).

Figure 1



Source: Office of Management and Budget.

Given high unemployment and the persistent problems in the housing sector, Congress passed a second stimulus bill in mid-December 2010, shortly after the midterm elections: the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. Its passage, however, was neither smooth nor easy. As the Democrats had lost the majority in the House to the Republicans in the midterm elections, they were keen to pass the legislation before the new government took over in January 2013. To secure the necessary votes, Democrats agreed to a compromise: in return for an extension of unemployment aid and tax cuts for the lower and middle income class, they agreed to extend President Bush's 2001 and 2003 tax cuts for higher income households. The 858 billion US dollar package thus included a reauthorization of federal unemployment benefits for another 13 months amounting to 56 billion US dollars and 802 billion US dollars of tax cuts (The White House 2010). The passage of the bill was thus more bipartisan than the vote on ARRA: in the House, 139 Democrats and 138 Republicans supported the legislation; in the Senate, 43 Democrats and 37 Republicans voted for the bill (Govtrack.us 2010). This is not too surprising as both parties got what they wanted without having to make excessively large concessions. Moreover, the looming debt problem was not addressed.

The tide was already turning at that point, however, and fiscal sustainability gained in prominence. When the fiscal year ended in September 2010, the budget deficit stood at 8.9 percent of GDP; for FY 2011, the CBO estimated a budget deficit of 8.5 percent (see Congressional Budget Office 2011b). The CBO also forecasted that federal debt held by the public could reach almost 101 percent of GDP by 2021 and 187 percent by 2030 (Congressional Budget Office 2011a), up from about 63 percent at the end of fiscal year 2010 (Office of Management and Budget 2013a). The public grew increasingly discontent with the situation. While in March 2009 52 percent of US citizens believed that Obama was handling the budget well, this percentage shrank to 36 percent in November 2010, according to a survey conducted by CNN/Opinion Research Corporation.[2] While in 2009 the budget deficit ranked only ninth among the 20 top priorities (53 percent of the population believed that it was a top priority), it ranked seventh (60 percent) in 2010 poll and sixth (64 percent) in 2011 according to polls conducted by Pew (2009, 2010 and 2011).

Phase 2: from fiscal expansion to fiscal contraction

While both Democrats and Republicans agreed on the severity of the problem, they greatly differed in their views on how to best balance the budget and reduce debt. In early December 2010, the bipartisan National Commission on Fiscal Responsibility and Reform (often called Simpson-Bowles according to the names of co-chairs Alan Simpson and Erskine Bowles) released its report 'The Moment of Truth', but failed to reach the 14 votes necessary to move its deficit-reduction proposal to Congress, with a final tally of 11 members voting in support of and 7 against the proposal. The plan was ambitious: it proposed nearly 4 trillion US dollars in deficit reduction by 2020, recommended reduced tax rates, broad

[2] CNN Opinion Research Poll, 15 November 2010, http://i2.cdn.turner.com/cnn/2010/images/11/15/rel16a.pdf.

spending cuts and tax expenditure changes, as well as health care and entitlement reforms. According to the proposal, the deficit would have been cut to 2.3 percent of GDP by 2015, while the debt would have been stabilized by 2014, reducing it to 60 percent of GDP by 2023 and 40 percent of GDP by 2035.

However, the inability of the Simpson-Bowles Commission to come to an agreement was only the prelude to a year of Democrats and Republicans fighting tooth and nail for their deficit and debt reduction visions, cumulating in a near government shutdown in April and government default in August 2011. In mid-January 2011, Treasury Secretary Timothy Geithner warned Congress in a letter that a delay in raising the 14.29 trillion dollar US statutory debt limit could make markets price in the risks of a default and undermine economic recovery.

The Republicans used the debt limit as leverage to push the Obama administration into accepting severe spending cuts for the 2011 FY budget as well as a bargaining chip for the 2012 FY budget. The fight over the 2011 budget was reminiscent of the 1995 government shutdown under the Clinton administration, when Republicans and Democrats could not agree on budget cuts. The fiscal year had started on 1 October 2010. As Congress had failed to pass some of the spending bills comprising the annual federal budget, the government had to operate under 'continuing resolutions'. According to the Constitution, Article I, Section 9, "[n]o money shall be drawn from the Treasury, but in consequence of appropriations made by law", meaning that if the government fails to pass a budget, it also cannot spend. On 8 April 2011, Congress passed a last-minute budget deal, thus narrowly avoiding a government shutdown by extending federal government funding. Democrats and Republicans found a compromise: discretionary spending for the rest of FY 2011 was to be nearly 39 billion US dollars less than had been budgeted for the previous year, and 79 billion US dollars less than Obama had wanted for 2011 (see also Bendavid and Hook 2011).

The next showdown came in July/August 2011 when time ran short to find a compromise on raising the debt limit. The US government had hit the debt ceiling on 17 May, triggering a series of measures to stave off a default. According to the Treasury, the ultimate deadline for technically defaulting on its debt was early 2 August 2011. Only in the eleventh hour did Congress vote for the Budget Control Act of 2011: the law immediately raised the debt ceiling by 400 billion US dollars. In addition, the debt ceiling was to be increased further in two steps: by 500 billion US dollars in September 2011 and by 1.2 trillion US dollars in January 2012. The law initiated these two increases to automatically take effect unless Congress would prevent them through a disapproval process. The House, in fact, passed a 'resolution of disapproval' on 18 January 2012, to prevent the 1.2 trillion US dollar increase in the debt ceiling, but the resolution died in the Senate (Govtrack.us 2012). Overall, the Budget Control Act of 2011 thus raised the debt limit from 14.3 trillion to 16.4 trillion US dollars.

The Act also called for spending cuts amounting to 917 billion US dollars over the next ten years. Furthermore, a bipartisan 12-person House and Senate special committee, the Joint Select Committee on Deficit Reduction, was created to identify further spending cuts to reduce the federal deficit by at least 1.5 trillion US dollars over the years 2012-2021. The so called 'Super Committee' was to complete its work and present a proposal cutting the deficit by at least 1.2 trillion US dollars by Thanksgiving 2011, and Congress was then to hold an up or down vote on the committee's recommendations by 23 December. The legislation was to be fast tracked through Congress with protections against filibustering and amendments. Hoping to incentivize an agreement, the compromise included a considerable threat: if an agreement was not signed into law by 15 January 2012, automatic cuts were to be triggered starting in 2013 (after the presidential election), equally divided between defense and non-defense spending (Social Security, Medicaid, Military Retirement and some other social programs were exempted from these cuts) – see Heniff *et. al.* (2011). Nonetheless, the Super Committee failed, and the Thanksgiving deadline passed without results. The committee was terminated on 31 January 2012, as mandated by the Budget Control Act.

The only way for Congress to avoid the automatic spending cuts to take effect in 2013 was to pass a bill some time in 2012 that would replace the sequester with otherwise specified cuts. In May 2012, US Congressman Paul Ryan (Mitt Romney's running mate in the 2012 presidential elections) introduced the Sequester Replacement and Reconciliation Act of 2012 in the House to do just that. The bill passed the House, but not the Senate. With the presidential elections scheduled for November 2012 and a divided government in place, all attempts to reach a bipartisan agreement failed. Only at the very last minute – on the morning of 1 January 2013 – was Congress able to reach a compromise that at least kept sequestration from taking effect right away. The American Taxpayer Relief Act of 2012 (ATRA) postponed sequestration by two months, thereby allowing for more time to find an alternative solution. ATRA was mainly negotiated by Vice President Joe Biden and the Republican Party whip in the Senate, Mitch McConnell. The compromise also raised taxes for top earners – a significant concession by the Republicans – while at the same time keeping the temporary income tax cuts that had been enacted by George W. Bush in 2001 and 2003 in place for the bulk of the population; these tax cuts otherwise would have expired at the end of 2012.

In more detail, ATRA increased the income tax rare for individuals earning over 400,000 US dollars annually and couples earning over 450,000 US dollars annually from 35 to 39.6 percent. Rates on capital gains and dividends rose from 15 to 20 percent. Certain tax deductions for individuals earning more than 250,000 US dollars and couples earning over 300,000 US dollars were scrapped. In addition, the estate tax for estates worth over 5 million US dollars rose from 35 to 40 percent. For all individuals and couples earning less than 400,000 US dollars and 450,000 US dollars respectively, the temporary Bush tax reductions were made permanent. Tax breaks for students and low-income families, which President Obama had enacted in 2009, were prolonged by five years. Certain benefits for the long-term unemployed were extended by one year, while business tax breaks aimed at promoting investment were also extended. Furthermore, ATRA permanently fixed the alternative minimum tax (AMT) exemption and established an automatic adjustment of the tax to inflation.

Taken together, these measures reduce the deficit by 737 billion US dollars over a period of ten years. If ATRA had not been enacted, on the other hand, sequestration and the expiration of the Bush-era tax cuts would have reduced the budget deficit by 560 billion US dollars in FY 2013 alone (in comparison to the previous year) – see Howald *et al.* (2013). At the same time, however, spending cuts and rising taxes would have caused a new recession, as the Congressional Budget Office warned in November 2012 (Sloan 2012).

While ATRA did not include a provision on the debt limit – public debt had reached the 16.4 trillion mark at the end of 2012 – the House passed a bill on 23 January that suspended the debt ceiling until 19 May. The Senate followed suit on 31 January, and on 4 February President Obama signed the No Budget, No Pay Act of 2013 (Govtrack.us 2013a). The title of the law stems from an unusual provision that is part of the bill, which was included on behalf of the Republican Party: should Congress fail to agree on a budget resolution for FY 2014 by 15 April, the salary rates of all members of Congress would be frozen (Govtrack.us 2013b). The Republican Party had initially demanded that raising the debt limit should be matched by spending cuts of the same size. Unlike in 2011, however, they finally decided against such a confrontative strategy, seeing the primary need to pass a budget for the running FY 2012 (Sherman 2013).

That Congress was able to pass ATRA and agree on a suspension of the debt limit gave fresh hope to the possibility of achieving a long-term solution regarding sequestration and the debt limit. A large number of Republican Congressmen and Senators actually broke the Taxpayer Protection Pledge in which they promised to never vote in favor of raising taxes; but hopes were soon to be disappointed.

Phase 3: fiscal impasse

On 1 March 2013, the automatic spending cuts of the sequester took effect. These cuts amount to 85 billion US dollars in fiscal year 2013 alone and 1.2 trillion US dollars in total over the next ten years. As the Budget Control Act of 2011 dictates, half of those cuts apply to the defense budget. The other programs affected are the Federal Bureau of Investigations (FBI), the Securities and Exchange Commission (SEC), the Federal Emergency Management Agency (FEMA), airport security, the Food and Drug Administration (FDA), and special education, just to mention a few (Matthews 2013).

The government only barely avoided another fiscal disaster. When the sequester took effect, the US government operated under the Continuing Appropriations Resolution, 2013, which it had passed in September 2012 to ensure government funding for the next six months (Govtrack.us 2013c). A new continuing resolution was thus urgently needed. On 4 March, Republican Representative Hal Rogers introduced the Consolidated and Further Continuing Appropriations Act, 2013 (H.R. 933) in the House, which according to the CBO, would result in 984 billion US dollars in new budget authority (Govtrack.us 2013d). It passed the House two days later. On 20 March the Senate passed the continuing resolution H.R. 933, but included some changes to Hal Roger's proposal, so that the bill had to be referred to the House once more. The House voted in favor a day later, and President Obama finally signed the bill into law on 26 March – the day before the federal government would have run out of funding. The bill now enables funding until the end of fiscal year 2013, which ends in September, and made some smaller changes to the automatic spending cuts introduced on 1 March (Govtrack.us 2013c).

By that time, Congress was also far behind in its schedule to draw up a budget for FY 2014. On 15 March, both parties officially introduced budget proposals: Rep. Representative Paul Ryan, who is the current chairman of the House Budget Committee, presented his bill in the Republican-controlled House, whereas Democratic Senator Patty Murray introduced her proposal in the Democrat-controlled Senate. Paul Ryan's proposal includes cuts to Medicaid and food stamps and would repeal Obama's health care reform ('Obamacare'). Ryan's bill passed the House on 21 March, but is highly unlikely to ever pass in the Senate. Patty Murray's bill passed in the Senate on 23 March; it is the first budget proposal in four years to reach a majority in the Senate. Nevertheless, the bill is just as unlikely to ever be signed into law. No Republican Senator voted for it (Govtrack.us 2013e and 2013f). The plans reveal the stark differences between the Democrats and the Republicans: the former want to reduce the deficit by 1.9 trillion US dollars over a ten-year-period through an even mix of tax increases for the rich and spending cuts. Still opposing any tax increases, the GOP, on the other hand, wants to reduce the deficit by 4.6 trillion US dollars over the same period (Nather 2013).

On 10 April, President Obama finally presented his budget proposal for fiscal year 2014, two months after the legal deadline. The proposal plans for 1.8 trillion US dollars of deficit reduction over the next ten years – a number slightly below Patty Murray's and significantly below Paul Ryan's target. Spending cuts together with tax increases would thus reduce the deficit to 2.8 percent of GDP by 2016 and 1.7 percent by 2023. The implementation of the 'Buffet Rule' would require households with incomes above 1 million US dollars per year to pay income taxes of at least 30 percent (Office of Management and Budget 2013b).

At present, it cannot be expected that the President's proposal will pass the Republican-controlled House of Representatives. Of the three budget proposals on the table – Paul Ryan's, Patty Murray's, and President Obama's – not one seems to have realistic chances of ever being implemented. Moreover, the problem of the debt ceiling is again pressing as the suspension under the No Budget, No Pay Act ended on 19 May. The Bipartisan Policy Center estimates that the government will find ways to pay its bills until October or November, with the Treasury deploying 'extraordinary measures' (Akabas and Collins 2013). To avoid risking the creditworthiness of the country and driving away investors in case the debt ceiling was reached, the House on 9 May passed the Full Faith and Credit Act. The bill, as the full title describes, would "require that the Government prioritize all obligations on the debt held by the public in the event that the debt limit is reached" (Govtrack.us 2013g). Given that it would prioritize bond holders' interests, Democratic opponents of the bill labeled it 'Pay China First Act', and President Obama announced that he would veto the bill if it was ever passed by the Senate.

Congress has thus neither been able to find a solution to the debt limit problem to date, nor have Democrats and Republicans come anywhere near to agreeing on a budget for fiscal year 2014. On a positive note, the Congressional Budget Office estimated the budget deficit for the fiscal year 2013 at 4 percent (or 642 billion US dollars) of GDP. Earlier this year it had still expected a deficit of 5.3 percent of GDP. The reasons for this downward correction are an improving economy, the tax increases that were introduced by the ATRA, the spending cuts enacted on 1 March, and above all an increase in dividend payments to the US Treasury by the mortgage agencies Fannie Mae and Freddie Mac (Congressional Budget Office 2013a and 2013b; The Economist 2013). While the budget cuts will slow real GDP growth down to 1.4 percent this year, CBO expects growth to recover to 3.4 percent in 2014 (Congressional Budget Office (2013c). However, this positive outlook should not obscure the fact that the budget cuts severely impede the government to make the necessary investments into the country's education system as well as transportation and energy infrastructure, which show severe deficits.

Conclusion: diverging ideologies and party polarization

US fiscal policy is symbolic of the reform deadlock in Congress; the 112th Congress was the least productive on record both in terms of the number of laws passed and the number of formal negotiations held (Dinan 2013). While Obama was able to push through several large bills (health care and financial regulatory reform) during the first two years of his first term – Democrats held the majority in both chambers of Congress –, no meaningful legislation was passed in 2011/2012; and the start of his second term does not look too hopeful.

What explains the current paralysis in Washington? The US political system is based on the principle of checks and balances. The founding fathers of the United States were careful to prevent the concentration of power within one of the branches of government. As a result, a divided government – currently, the President is a Democrat while the Republicans hold the majority in the House and the Democrats in the Senate – is not uncommon in the United States. This in itself is not a problem as long as the parliamentarians are willing to compromise. In the past, Representatives and Senators have tended to vote according to the interests of their districts/states rather than along party lines. Party discipline has been comparatively weak – an important prerequisite for bipartisan decision-making and finding compromises. This has changed, however, and votes have become increasingly partisan. In addition, the ideological distance between the two parties in Congress has grown steadily in recent decades. The polarization today has reached a level that is comparable only to the period after the end of the American Civil War. As during that period, there are hardly any ideological intersections between the two parties today. Contributing to the polarization was the increasing popularity of the conservative Tea Party, which gained in power in particular in the 2010 midterm elections, while the Democrats seemed to have moved further to the political left. Furthermore, the passage of the health care reform, the Patent Protection and Affordable Care Act ('Obamacare'), and the financial overhaul bill (Wall Street Reform and Consumer Protection Act) left the Republicans highly frustrated. Republican Senate Minority Leader Mitch McConnell's statement: "the single most important thing we want to achieve is for President Obama to be a one-term president" is paradigmatic for the position most Republicans held, consequently blocking any kind of legislation proposed by the Democrats.

A lack of personal contact between the parliamentarians has contributed to the deepening of the political divide. The fluctuation in Congress has increased considerably, which, in turn, means that many parliamentarians are spending a growing amount of time in their districts, as the struggle for re-election requires not only a high presence in the home, but also a growing fundraising effort to finance the ever increasing campaign costs.

Last but not least, deeply diverging beliefs and ideologies must be made responsible for Washington's inability to govern on fiscal issues: arguing that higher taxes and deficits strangled private business, Republicans believe too much public spending destroys jobs and hinders economic growth, which is why they reject measures of this kind. In their 'Pledge to America' agenda, Republicans called for an end to what they labeled the 'Keynesian experiment'. They want government spending to be reduced to pre-crisis levels and view tax cuts (including tax cuts for wealthy Americans) as the appropriate means to increase domestic demand and stimulate the economy. The conservative wing of the Republicans, the Tea Party, goes one step further. In their 'Contract from America', they argue for making a balanced budget a constitutional requirement. Tax increases should only be passed by a two-thirds majority in Congress. The Democrats, on the other hand, assign the state a greater role in regulating and stimulating the economy. They believe that a safety net consisting of basic entitlement programs such as Medicare, Medicaid and Social Security is necessary to ensure a certain level of equality and fairness in society. They also campaign for higher taxes for the rich and a greater redistribution of wealth to prevent economic inequality from growing too much. In his Inaugural Address of 2013, Obama strongly defended these welfare programs, saying "they free us to take the risks that make this country so great" (The White House 2013).

The tax compromise achieved on New Year had raised some hopes that Democrats and Republicans might start to work together more productively on fiscal matters. Instead, however, it might actually have added to the polarization of the two political parties. With ATRA, the Republican Speaker of the House, John Boehner, had brought a bill to the floor that the majority of his party opposed. Before pushing for further compromises with the Democrats, Boehner had to prove that the concessions he negotiated paid off – at least if he wanted to keep his position as Speaker. For those Republicans who had voted for ATRA and were still in office after the new government took over in early 2013, their room to maneuver was exhausted, having broken the tax pledge and fearing for their reputation.

It currently does not seem very likely that any major reforms (including a much-needed reform of the tax code) can be achieved before the midterm elections in 2014.

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