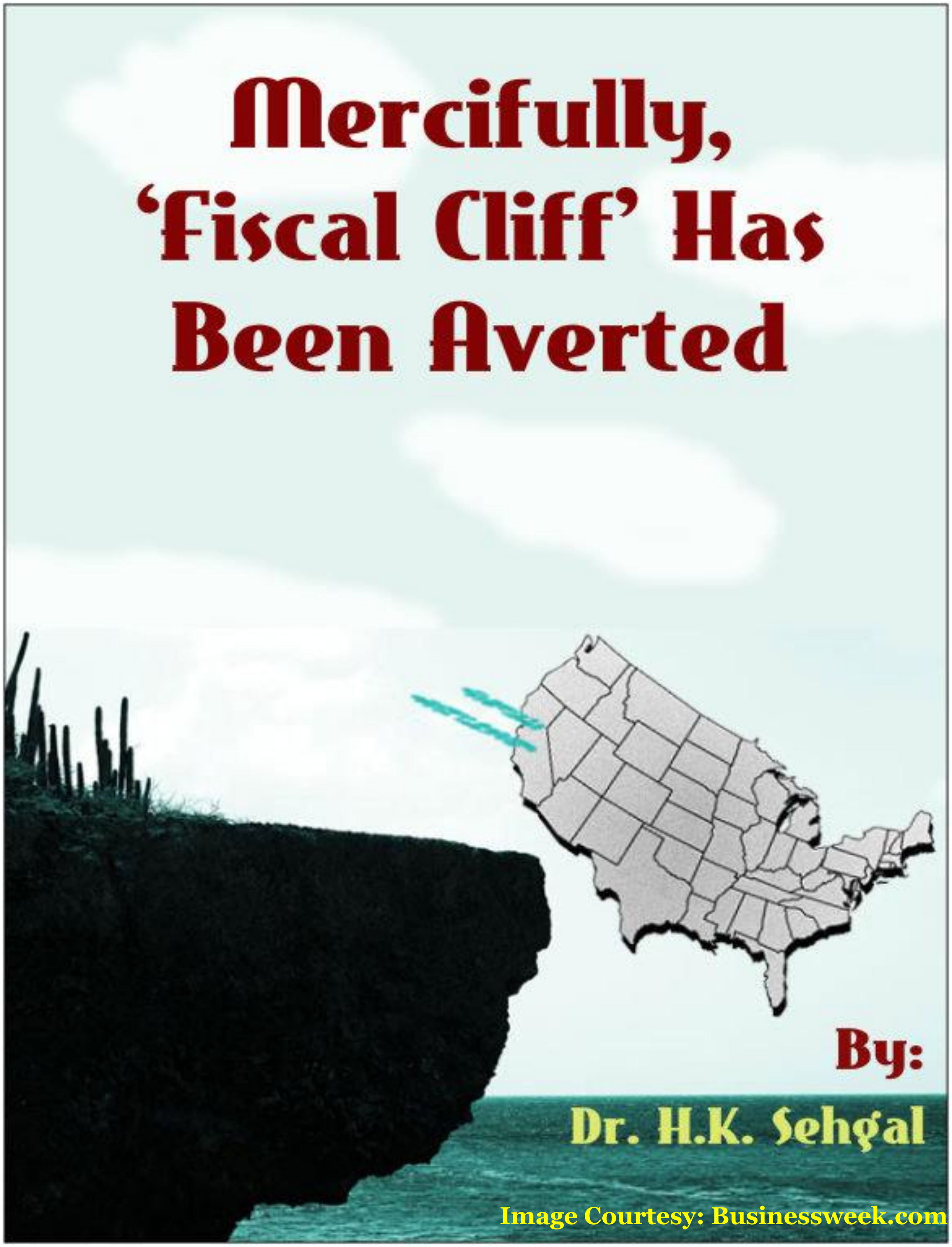

Image Courtesy: Businessweek.com

Mercifully, 'Fiscal Cliff' Has Been Averted

By: Dr. H.K. Sehgal

(Views expressed in this article are the personal opinion of the author.)

It is somewhat surprising that the "Fiscal Cliff" which has been the hottest topic in the US for several weeks failed to evoke any interest in Indian business circles, particularly the exporters of consumer goods, who know quite well, how important the US retail market is for them. As this phenomenon entailed no less than going out of something like $600 billion, which would have particularly hit the US middle and upper middle class, could have had a serious impact in terms of their purchasing power, on which the US spending rests, for the major part.

It is not that the threat is completely over, but, yes, one hurdle has been overcome which enabled the US public to heave a sign of relief. President Obama and Senate leaders struck a bipartisan agreement to let income taxes rise sharply for the first time in two decades, fulfilling Obama's promise to raise taxes on the rich and avoiding the worst effects of the 'fiscal cliff. The agreement, brokered by Vice President Biden and Senate Minority Leader Mitch McConnell (R-Ky.) passed 89 to 8 in a highly unusual New Year's morning vote. It now heads to the House, where leaders have not guaranteed passage but top officials believe it could win passage in the next few days.

The working poor would benefit significantly from an extension of tax breaks for low-income families: The proposed deal includes a five-year extension of tax credits that Obama had expanded in the 2009 stimulus. The Earned Income Tax Credit was expanded to help more working poor, particularly those with big families; the Child Tax Credit was expanded to help the poorest Americans; and a more generous tax credit was given to families for college tuition. "For millions of wage earners, the most immediate effect would be the lapse of a two-percentage-point payroll-tax cut that was part of a deal President Barack Obama struck with Republicans late in 2010. It lowered to 4.2% from 6.2% the employee portion of the Social Security tax, allowing workers to keep more take-home pay.

However, this 'cliff' deal still raises taxes on the middle class. "Taxes will rise on the middle class even if this deal passes, because it doesn't include an extension of the payroll tax holiday. That means that the paychecks for more than 160 million Americans will be 2 percent smaller starting in January, as the payroll tax will jump from 4.2 percent to 6.2 percent. And a huge number of those hit will be middle class or working poor.

However, the conclusion that by and large, a major portion of US consumers would be spared of the taxes that would have burnt holes in their wallets could be true for the short term, but this may hold true in the long run. The Indian concern is limited to this point only that the spending power or take-home salary cheques have not undergone the serious cuts that seemed inevitable, had the agreement between the President and the Senate not reached.

Debt Ceiling Hit

On top of everything else, the United States officially hit its debt ceiling, starting a countdown clock that ends in a cash management crisis in a matter of weeks…Right now, the Treasury is undertaking 'extraordinary measures' to give the government enough breathing room to pay all of its bills. But such measures buy Washington only so much time. In February or March, the Treasury Secretary would need to decide which payments to delay or default on.

White House, Republicans Share Cold Comfort

If one were to consider the fiscal cliff negotiations from the White House's perspective, it raises taxes by $600 billion over 10 years; secures important Democratic priorities like unemployment insurance and the stimulus tax credits and doesn't include any spending cuts of note…It would be going too far to say White House officials are thrilled with this package. But it looks pretty good to them. As they see it, it sets up a three-part deficit reduction process." On the other hand, if one were to view the whole exercise from the Republican Party's perspective, no one ever they'd need to compromise, but the realists who knew, when they lost the election, that compromise was inevitable…The question for Republicans has always been how to get to the debt ceiling while giving up the minimum in tax increases. Many of them figured that they'd at least have to give in to tax cuts for income over $250,000…All this raised the tantalizing prospect for Republicans that they could end these negotiations having given up less tax revenue than they ever thought possible.

Lasting Solution

However, has the settlement between two warring groups led to any permanent or least lasting solution ? Probably no. The fiscal cliff negotiations have not been directed toward the deep structural reforms that will eventually be needed. But they could have begun the reform process, as the settlement arrived at is not a balance of taxes and spending cuts. It doesn't involve a single hard decision. It does little to control spending. It abandons all of the entitlement reform ideas that had been thrown around. It locks in low tax rates on families making less than around $450,000; it is simply impossible to avert catastrophe unless tax increases go below that line.

It looks as it was a two-part fiscal cliff deal: Congress finished voting on part one and part two at some point in the near future, although it's possible they'll wind up getting merged. It's important to get all the details on these things, but based on what is being reported so far, it is the President's job to help Americans face unavoidable, if unpleasant, realities. Barack Obama has refused to play this role. Instead, he has cast the long-term budget problem as a question of whether the richest 1 percent or 2 percent of the population should pay more in taxes.

Slower Growth

However, the deal may mean slower growth. The biggest hit to 2013 growth appears likely to come from the payroll-tax holiday's expiration in January. The deal reached by the White House and Senate Republicans didn't extend this tax break.

As ugly as they were, the "fiscal cliff" negotiations produced something Washington hadn't seen in a long time: strongly bipartisan votes in the House and the Senate on a big, contentious issue. The best economic case for the agreement appears to be that things could have been worse.

White House officials see the deal brokered as a critical short-term victory with long-term consequences — forcing House Republicans to surrender on one of their party's core tenets. The agreement, approved with comfortable bipartisan majorities on New Year's Day, raised taxes on net income over $400,000 while holding rates steady for income below that amount.

A day after Congress managed to avert the fiscal cliff, business leaders warned that the agreement will hurt sales and hiring, won't unlock investment and leaves the economy riddled with congressionally imposed land mines for months to come. Markets responded much more favorably, relieved that the worst of the potential crisis had passed. The Standard & Poor's 500-stock index rose 2.5 percent, its best single-day gain since last summer, after the House approved a compromise bill to avert most of the tax increases and spending cuts that were scheduled to begin taking effect in the new year.
'Fiscal cliff' deal ignores threats to the economy both now and down the road. Analysts warned that the gains could evaporate, especially once lawmakers move on to their next economically perilous battle over raising the federal borrowing limit – a battle the cliff agreement did nothing to resolve. Business groups expressed relief that lawmakers had at least avoided catastrophe with the last-minute accord. The deal preserved lower income and investment tax rates for most Americans, extended a package of business tax breaks and bought a two-month delay in pending defense and domestic spending cuts. But business lobbyists said that because it does not stabilize rising federal debt levels, the deal could undermine economic growth. They also worried about the psychological effects on both businesses and consumers of watching lawmakers war again and again in the coming months over taxes and spending, under the cloud of a possible sovereign default if they fail to reach agreement.

Retailers, in particular, worry that future Washington brinkmanship will dissuade their customers from spending. The best economic case for the agreement appears to be that things could have been worse.

Nor does the package do anything to address stubbornly high levels of unemployment, with 12 million Americans out of work. Instead, the deal could aggravate the problem. By allowing the payroll tax cut to expire, the deal takes money out of the hands of many Americans, sucking it out of the economy and slowing economic activity. And, finally, the deal is too modest to fundamentally tame the government's soaring debt. It is a mantra among business groups that raising taxes kills jobs. But business advocates —

including Engler, Regalia, and French — expressed relatively little concern Wednesday over the loss of buying power in the economy that will result from the tax increases embedded in the cliff deal. Along with increasing some taxes on the wealthy, the deal fails to extend a 2 percentage-point reduction in taxes on workers' wages.

Vincent Reinhart, chief U.S. economist at Morgan Stanley, said the deal does not even relieve the anxiety of businesses and consumers because so many economic challenges are left unresolved. "There's an immediate fiscal drag, and there's no offsetting bonus in confidence because fiscal uncertainty is still considerable," he said.

Economists expressed greater concern that the increases, particularly the payroll tax hike, will crimp consumer spending. Payroll taxes are borne heavily by low- and middle-income workers, who are, in turn, the big drivers of consumer spending in the economy. The non-partisan Tax Policy Center estimates that taxes will rise for nearly eight in 10 households this year because of the payroll hike, with an average increase of $1,635. "Because it's such an acutely, perfectly designed tax to target consumer spending, and because it is regressive," Shepherdson said, "it will affect all consumer-facing businesses, but it will affect those serving lower-income customers most immediately."

Debt Limit

The largest lingering uncertainty remains the question of whether lawmakers can come together in time to solve big problems. The agreement leaves several of those problems for the months ahead, including passing a budget, funding the government and, most important, raising the debt limit. The agreement, which the Senate approved only hours after the government hit the limit on federal borrowing, fails to defuse the prospect of a catastrophic national default two months from now. The deal does not raise the debt ceiling, leaving the Treasury to use what it calls "extraordinary measures" as long as it can to pay the government's bills.

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President Obama had sought a larger agreement that would raise taxes by more than double what he got in the deal. He also wanted to take the debt ceiling off the table and offset deep spending cuts with more taxes and more targeted savings in entitlements — including Medicare and Social Security. He also asked for new economic stimulus measures to help bring down unemployment, including an extension of the payroll tax holiday.

In many ways, the threat of default in two months is a more serious risk than the Jan. 1 fiscal cliff deadline. If Congress does not increase the debt ceiling, the government will quickly run out of ways to pay the nation's bills and make interest payments on the nation's outstanding debt. Any failure by the government to meet its financial obligations could be seen as a default, shaking world financial markets, given the special role that U.S. government bonds play in the global economy.

And while a default would be all but certain to push the economy into recession, growth is likely to be slow — and job-market improvement slight — even without such a cataclysmic event. The unemployment rate, which stands at 7.7 percent, is not expected to fall below 7.4 percent by the end of this year, and not below 6 percent until at least 2016 or later.

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Some benefits

Despite the drawbacks, the bipartisan deal may well have been the heaviest lift a deeply divided Congress could have accomplished. And the package, no doubt, has its benefits. It is likely to prevent the nation from dipping back into recession. It cancels massive tax increases facing middle-class and poor Americans. And it delays deep and blunt government spending cuts for two months. And while the agreement does nothing to reduce joblessness, it renews unemployment benefits that would have otherwise expired, offering vital help to the jobless and averting another blow to economic activity. And finally, by raising a little more than $600 billion in fresh tax revenue from the wealthy, the deal takes a step toward bringing spending and taxes into line for the next few years — though economists say much more needs to be done over the long run.

In the midst of the recession, the government stepped in with spending programs and deep tax cuts to lift growth and reduce unemployment. A majority of economists say those efforts worked. But federal stimulus has been winding down. And the spending cuts and tax hikes set for 2013 are expected to be a drag on the economy — with government policy offsetting much of the robust recovery being experienced in the private sector. Nor does the agreement do what many analysts say is necessary to achieve long-term budget savings and tame the federal debt, which is projected to grow rapidly as a percentage of the economy in the coming decades.

Both Obama and House Speaker John A. Boehner (R-Ohio) have proposed plans to trim just enough from federal deficits during the next decade to stabilize borrowing over that period — though not reduce it. In general, economists worry that when the debt gets too large, it slows economic growth — though defining "too large" is a matter of much debate. Today, the debt stands at about 73 percent of gross domestic product — the size of the overall economy — and is projected to rise rapidly over coming years. The plans from Obama and Boehner, over the next decade, would each bring the ratio of debt to

GDP back down to about where it is today, according to rough estimates from the Committee for a Responsible Federal Budget, a group advocating a big deal to tame the debt. The Senate package is also projected to come close to achieving that, though not quite as close as Obama's and Boehner's plans. And even that relies on allowing the deep sequester spending cuts to happen or replacing them with other spending cuts or tax hikes.

None of the plans under discussion would keep borrowing a decade from now from starting to soar again. Much of the budget is projected to be consumed by health-care spending over the coming three decades.

Gerry Rice, Director of External Relations at the International Monetary Fund (IMF) commented "We welcome the action by the U.S. Congress to avoid sudden tax increases and spending cuts, including through an extension of unemployment benefits during 2013. In the absence of Congressional action the economic recovery would have been derailed.

"However, more remains to be done to put U.S. public finances back on a sustainable path without harming the still fragile recovery. Specifically, a comprehensive plan that ensures both higher revenues and containment of entitlement spending over the medium term should be approved as soon as possible. In addition, it is crucial to raise the debt ceiling expeditiously and remove remaining uncertainties about the spending sequester and expiring appropriation bills."

A final word can best emerge only after the clearance by the proposals by the House and settlement of important issues like Debt limits.

On this would also depend on the direction and volume of the world trade, including on garments, in which the interests of several developing economies would rest.