

ISSUE BRIEF

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Fiscal Cliff: What Congress Should Do

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Having squandered most of 2012 with posturing and delay, Congress and the President are now careening toward a budgetary precipice of their own making. The so-called fiscal cliff will be reached just after New Year's Eve—bringing a nearly \$500 billion tax hike in 2013 and a devastating 10 percent reduction in national defense spending—unless lawmakers and the White House change course.

They need to act swiftly but not hastily, nor should they overreach. Lawmakers ought to take care of the task at hand, focusing solely on stabilizing the immediate situation. They should:

- Preclude the huge tax hike known as Taxmageddon;
- Prevent the reckless, automatic

defense cuts, preferably by choosing alternative savings;

- Renounce any other tax increases;
- Resist the temptation to conjure further ad hoc budget schemes and grand bargains; and
- Return as soon as possible to the regular practice of congressional budgeting.

A Crisis of Their Own Making.

A brief review of recent history shows how Congress and the President consciously manufactured the current dilemma.

After the sweeping Republican takeover of the House in the November 2010 election, lawmakers faced the expiration of a broad set of tax policies enacted in 2001 and 2003. The result would have been across-the-board tax rate increases and a range of other economically damaging tax hikes.¹

Then, as now, President Obama sought to raise taxes on higher incomes, but congressional Republicans refused to support any tax hikes. During what some called the “Zombie Congress” of December 2010—due to its large group of “walking dead” defeated

Members—Obama relented, citing a weak economy.

The two sides agreed to extend all the tax policies but for only two years, dropping the issue squarely in the middle of this year's political campaign and thereby ensuring that it would not get resolved until after the election. Meanwhile, the uncertainty over tax policy sapped the economy, making employers reluctant to hire—a key contributor to slow job growth in the current recovery.² Growth in real gross domestic product plunged from 3.9 percent in the first quarter of 2010 to 2.3 percent in the fourth quarter. That was still better, though, than the 2.0 percent growth in the third quarter of this year. Preventing tax hikes is just as crucial now as it was two years ago.

When 2011 arrived, leaders of the freshly minted House Republican majority targeted the government's debt ceiling, which would need to be raised later in the year, to reach an agreement to reduce entitlement spending. After much haggling throughout the summer, no final agreement emerged, so as the August 1 deadline for a debt-ceiling increase approached, congressional leaders spawned the Budget Control Act (BCA). It contained an Administration-proposed

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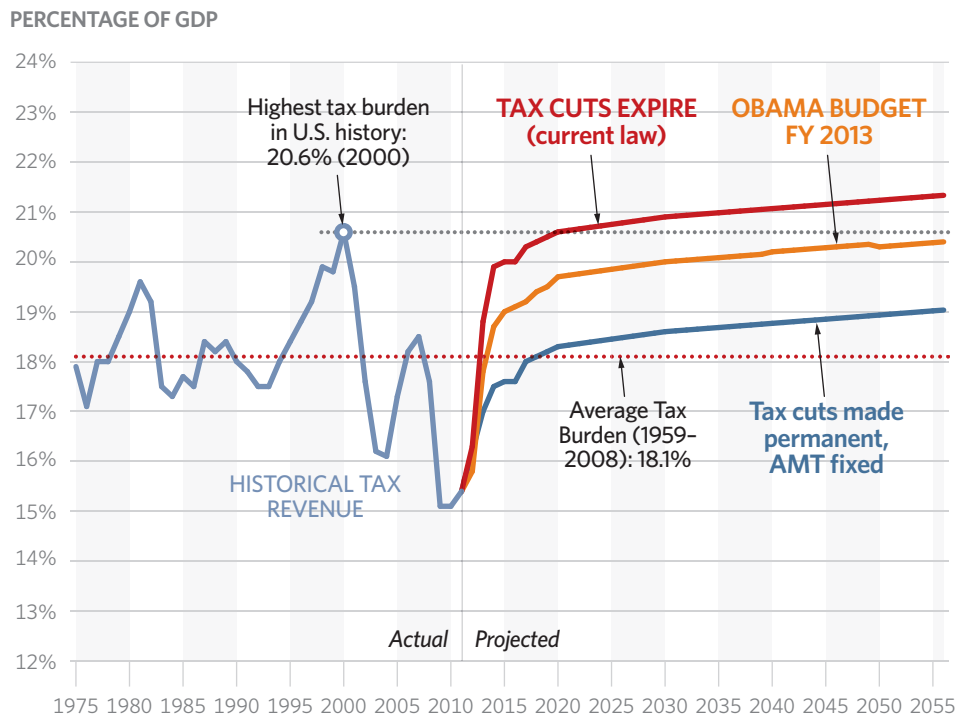
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CHART 1

Taxes Soaring Past Highest Level Ever

Taxes are projected to increase rapidly under different policy scenarios. If the 2001 and 2003 tax cuts expire and more middle-income Americans are required to pay the alternative minimum tax (AMT), taxes will reach unprecedented levels. The tax burden will climb even if those tax breaks are extended. President Obama's budget, which cuts some taxes and raises others, increases the overall tax burden.

Source: Heritage Foundation calculations based on data from the Office of Management and Budget, *Budget of the U.S. Government, FY 2013, Historical Tables*, February 2012, <http://www.whitehouse.gov/omb/budget/Historicals> (accessed April 8, 2012); and Congressional Budget Office, *2011 Long-Term Budget Outlook*, June 2011, <http://www.cbo.gov/publication/43288> (accessed April 8, 2012).



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enforcement procedure, called “sequestration,”³ that would automatically slash \$1.2 trillion in spending starting on January 2, 2013. Half the cuts were to come from national defense—which represents less than 17 percent of total federal spending—and the other half from non-defense.

Although the House passed legislation this year replacing the across-the-board cuts with specific policy changes, the Senate refused to act, forcing any resolution to wait until after this year’s election. Now this large problem joins with other unresolved issues, such as the “doc

fix” (extending Medicare physicians’ payment rates) and extended unemployment benefits—and another debt-ceiling increase looms early next year as well.

Finish the Unfinished Business.

To address these matters responsibly and without further complicating the situation, lawmakers should focus on the task at hand, leaving other challenges for another day under regular budget procedures.

- **Preclude Taxmageddon.** Ideally, Congress should extend all current tax policies permanently.

This would remove the economically debilitating uncertainty generated by temporary measures and provide a degree of stability (and sanity) in fiscal policy. Nevertheless, if lawmakers fail to achieve a permanent resolution, they should extend all current tax policies for no less than a year—and with the aim of establishing a foundation for tax reform.

- **Prevent the defense sequestration.** Again, the best option is a permanent one: adopting a set of spending reductions to

1. Congressional Budget Office, *The Budget and Economic Outlook: An Update*, August 2010, <http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/117xx/doc11705/08-18-update.pdf> (accessed November 13, 2012).

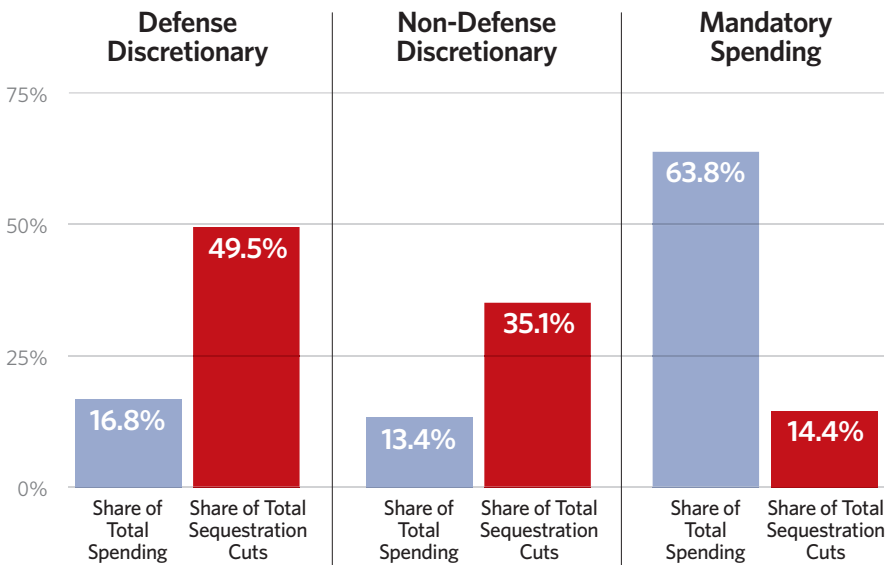
2. J. D. Foster, “Obama Could Prevent a Made-in-Washington Recession,” Heritage Foundation *Issue Brief* No. 3742, <http://www.heritage.org/research/reports/2012/09/recession-2013-washington-policies-and-cbo-s-recession-forecast>.

3. Glenn Kessler, “Obama’s Fanciful Claim That Congress ‘Proposed’ the Sequester,” *The Washington Post*, October 26, 2012, http://www.washingtonpost.com/blogs/fact-checker/post/obamas-fanciful-claim-that-congress-proposed-the-sequester/2012/10/25/8651dc6a-1eed-11e2-ba31-3083ca97c314_blog.html (accessed November 13, 2012).

CHART 2

Sequester Cuts Are Unbalanced

PERCENTAGE OF BUDGET AUTHORITY



Source: Congressional Budget Office, *An Update to the Economic and Budget Outlook: Fiscal Years 2012 to 2022*, Tables 1-3 and 1-4, <http://cbo.gov/publication/43543> (accessed August 23, 2012).

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replace the entire \$492 billion of indiscriminate cuts facing the Pentagon. If, however, a full substitution is too heavy a lift, Congress should replace the first year's \$55 billion. The House reconciliation bill, while imperfect, offers a range of savings that can at least start the process. In addition, the House budget resolution called for spending \$19 billion less than the Senate's level in the current continuing resolution, and House appropriators wrote their versions of annual spending bills to that lower level. So lawmakers have all the tools they need to identify adequate savings.

- **Do not raise taxes.** In addition to extending current tax policies, lawmakers should reject any other proposals to raise taxes. Taxes are not the answer to trillion-dollar deficits; spending control is. A tax "increase" occurs any time a change in tax law results in a net revenue increase to the federal government from the same level of economic activity. This is different from a change in tax policy that yields higher revenue due to improved economic performance.⁴
- **Reject "grand bargains" and chimerical "bridges."** Both on and off Capitol Hill, budgeteers

are conjuring special, ad hoc procedures to dodge the fiscal cliff coupled with another new process leading toward a "grand bargain" on deficit reduction. Though offered by earnest people with long experience in federal budgeting, such "frameworks" or "bridges" should be resisted. They do not work, as demonstrated by the Bowles-Simpson Commission—whose proposals were ignored by the President—and the BCA. Instead, they simply give lawmakers cover to neglect their normal budgeting practices and further delay the serious policy choices needed to get spending under control. They should take care of the immediate problem without fabricating more quasi-budgetary schemes.

- **Then return to regular budgeting.** Congress already has a suitable mechanism for doing the work that needs to be done. It is called a budget resolution. Congress's deliberate failure since 2009 to adopt such a measure (as required by law) has enabled and encouraged lawmakers toward the incoherent tax and spending practices that have destabilized fiscal policy. Congress needs to restore a sound and regular practice of congressional budgeting to have any chance of controlling spending for the long term. The time to start that restoration is now.

Fix the Problem, Then Move On. While many lawmakers like to complain that "the budget process is broken," it is they who have broken

4. J. D. Foster, "A Rose by Any Other Name: Clarity on Tax Hikes," Heritage Foundation *WebMemo* No. 3232, April 25, 2011, <http://www.heritage.org/research/reports/2011/04/understanding-tax-hikes-and-why-taxes-rise>; Steven P. Bucci and Alison Acosta Fraser, "Fix Defense Sequestration—Without Tax Increases," Heritage Foundation *Issue Brief* No. 3672, July 19, 2012, <http://www.heritage.org/research/reports/2012/07/fix-defense-sequestration-without-tax-increases>.

it. The fast-approaching fiscal cliff is a product of their deliberate fiscal malpractice—and even now Congress does not have a budget resolution to guide its choices.

Congress should act but stay focused: Prevent the steep defense cuts and huge tax hikes hanging over the country and establish a stable foundation for tackling the much bigger fiscal challenges ahead through the regular order of responsible, systematic budgeting.

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