Back from the 'fiscal cliff'

EDITORIAL (January 06, 2013) : The US was finally able to avert economic calamity on 1st January, 2013 when law-makers approved a deal to prevent huge tax hikes and spending cuts amounting to about $600 billion which would have pushed the world's largest economy off a "fiscal cliff" and into recession. The issue of spending cuts however will surface again when the US Congressional approval will be sought for increasing the limit on debt that the federal government can incur. The agreement was a sort of victory for President Barack Obama and his democratic party who had won re-election on the promise to address budgetary woes, partly by raising taxes on the wealthiest Americans. Important points of the new agreement are that income tax rates will increase for families earning more than $450,000 per annum and the amount of deductions they can claim to lower their tax bills will be limited. Low temporary rates that have been in place for the past decade will be made permanent for less-affluent taxpayers, along with a range of targeted tax breaks put in place to fight the 2009 economic downturn. However, ordinary workers will see up to $2,000 more taken out of their paychecks annually with the expiration of a temporary payroll tax cut. As for the impact of the agreed measures, the non-partisan Congressional Budget Office said that the new bill would increase budget deficits by nearly $4 trillion over the coming ten years, compared to the budget savings that would have occurred if the extreme measures of the cliff were to kick in. The new measure could, however, save $650 billion during that time period when measured against the tax and spending policies that were in vogue on 31st December, 2012. The agreement was, nonetheless, not reached without dramatics. As the rest of the country celebrated New Year's Day with parties, the Senate stayed up past 2.00 am and House Republicans were forced to decide whether to accept a $620 billion tax hike over 10 years on the wealthiest or shoulder the blame for letting the country slip into a budget chaos. Republican House Speaker John Boehner sought to negotiate a bargain with Obama to overhaul the US tax code and rein in health and retirement programmes that are due to balloon as the population ages but was not able to unite his members behind an alternative to Obama's tax measures. In the end, Republicans had also to join to approve the Senate bill by a bipartisan vote of 257 to 167, adding with some degree of grace that "we are ensuring that taxes aren't increased on 99 percent of our fellow Americans." The deal on the "fiscal cliff" has obviously resolved, at least for now, the question whether Washington had the necessary will and flexibility to overcome deep ideological differences to avoid harming the economy that had begun to pick up some steam after a long recession. As is well known, businesses, consumers and financial markets had been rattled by months of brinkmanship, both within the US and other countries. The vote on 1st January, 2013 has to a large extent ended uncertainty and averted a crisis situation looming on the horizon. After the agreement, though the richer US households, earning more than $450,000 per annum, would be subjected to higher taxes, other sections of society and the rest of the world would now feel much more relaxed. Most of the developed countries, particularly the Eurozone and emerging economies, who are bigger players on the global economic scene, would especially welcome the move due to its positive impact on their exports to the US market. However, it needs to be stressed that the US policy planners, instead of claiming a big victory and being satisfied, must begin to do some soul-searching and make certain tough decisions to avoid the possibility of another "fiscal cliff" and contain aggregate debt of the country within reasonable limits in future. The US is, of course, consuming much more than its income and the same applies to most of its households. The US must get to grips with this structural issue that has the potential to push the country to a crisis once again, if not properly taken care of. Yes, spending on health and retirement programmes is important and politically rewarding but it has to be contained within the available resources. Another aspect which needs to be thought through is that majority of the surplus countries are heavily dependent on the US currency for all kinds of transactions and have stored a large part of their foreign exchange reserves in US dollars. Most of the China's dollar 3.3 trillion foreign exchange reserves, for instance, are held in dollars. Any sudden and substantial change in the dollar parity due to fiscal or other problems in the US economy would not only hurt China but could disturb the world's monetary and trading order in numerous ways. Obviously, if US economy falters, it would take years to put in place a new global mechanism to restore the health of the world economy. There is no doubt that any fault in the engine of the world's largest economy could bring the whole system to a halt or at least slow it down to an undesirable pace. The deal over the 'fiscal cliff' could address tax issues to a certain extent but critical problems of debt and external deficits still hang over the US economy.