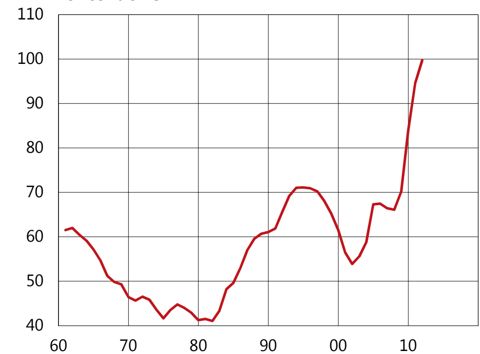
Severe fiscal tightening avoided in the United States

The Riksbank has for some time made assumptions concerning fiscal tightening in the US economy which have proved to be in line with the decisions made by Congress to date. The tightening measures outlined in the new bill are significantly smaller than the tax increases that would have come into force if Congress had not reached an agreement, increases that would have risked throwing the US economy back into recession in the short term. The US debt ceiling, which was reached at the end of December, has been temporarily removed. The original bill also included decisions on automatic cuts in expenditure which Congress chose to postpone for two months. In the longer term, major challenges will have to be faced in the effort to reduce the US sovereign debt to a long-run sustainable level. Important questions therefore remain concerning US fiscal policy, despite the fact that Congress managed to avoid the fiscal cliff this time.

Figure A1. Development of debt in the USA
Per cent of GDP



Note. Public debt.
Source: OECD

The background to the fiscal cliff

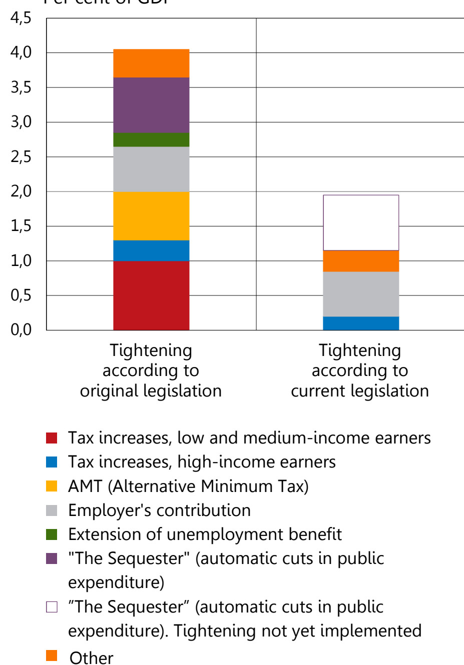
The United States has substantial deficits in its public finances and a growing sovereign debt (see Figure A1). It is estimated that public debt will increase to almost 200 per cent of GDP by 2037 unless changes are made to the current regulatory framework for government expenditure.[6] The growing debt is partly due to rising federal costs relating to the increase in the percentage of elderly people in the population. The parties in Congress agree that this increase in the debt is not sustainable in the long run, but are finding it difficult to agree on how central government income and expenditure should be adjusted.

One component of the fiscal-policy framework in the United States is a self-imposed debt ceiling, which means that the US Department of the Treasury must get permission from Congress to borrow money to cover a federal-budget deficit. Problems arose in August 2011 when the United States came close to reaching the debt ceiling. Congress did not want to raise the ceiling without at the same time being able to present a plan to reduce the federal debt as a percentage of GDP in the long term. The debt ceiling was raised at the eleventh hour. In order to avoid this scenario the next time the debt ceiling was reached at the end of 2012, Congress legislated on substantial automatic cuts in public expenditure that would come into force if no long-term agreement was reached. The legislation stipulated that these cuts, which mainly relate to defence spending but also to healthcare, would come into force on 1 January 2013. Several temporary forms of tax relief would also be withdrawn at the same time.

It was estimated that the tax increases and the cuts in expenditure, together referred to as the fiscal cliff, would correspond

[6] For a detailed description of this scenario, see Congressional Budget Office (2012), "The 2012 Long-term Budget Outlook", www.cbo.gov.

Figure A2. Components of the fiscal cliff and tightening according to new legal bill 1 January 2013
Per cent of GDP



Note. Rough calculations.
Sources: IMF and the Riksbank

to just over 4 per cent of the United States' GDP. If all the tightening measures had come into force at the turn of the year, this would probably have led to a new recession in the United States.[7]

Agreement in Congress after the New Year

The tightening on the income side constituted almost three-quarters of the fiscal cliff. To avoid a new recession, but also to ensure an increase in central-government income, the Democrats and Republicans agreed, following prolonged negotiations in Congress in early January, to increase certain tax rates. The main point of the agreement was that income-tax rates were increased for the two per cent of the US population that earn most. The current tax rates for the rest of the population were made permanent. Other parts of the agreement relate to the so-called Alternative Minimum Tax, which was adjusted upwards in line with inflation so that it will not affect medium-income earners.[8] Federal unemployment benefits were extended for a further year and payroll taxes, which were temporarily reduced during the financial crisis, were restored to their previous levels.[9] In total, these tightening measures on the income side correspond to approximately 1 per cent of GDP (see Figure A2). The decision on the automatic tightening measures on the expenditure side has been postponed for two months, until 1 March at the latest.

Important decisions remain to be made

The automatic reductions in expenditure amount to approximately 0.8 per cent of GDP and consist of cuts in the public sector, mainly with regard to defence but also to healthcare. If Congress fails to make a decision about these reductions in expenditure before 1 March, they will automatically come into force.

In practice, the United States hit the federal debt ceiling at the end of December 2012. Using extraordinary measures, the Department of the Treasury prevented federal funds from running out until the end of January, when Congress decided to remove the debt ceiling until 18 May. If Congress fails to agree on a long-term plan to reduce government expenditure by then, the ceiling will eventually have to be raised once again. This will have to be done to avoid defaulting on the sovereign debt and closing down public operations.

The Riksbank's forecast is in line with the agreement in Congress

The agreement in Congress on the income side means in practice that fiscal-policy tightening measures comprising 4 per cent of GDP have been avoided. The agreement, together with previous decisions to reduce public expenditure during 2013, represents fiscal tightening amounting to just over 1 per cent of GDP. If the automatic cuts on the expenditure side come into force, as would appear to be

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[7] See Congressional Budget Office (2012),"An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022", www.cbo.gov.
[8] The Alternative Minimum Tax (AMT) is a federal income tax on incomes above a certain level, mainly intended for high-income earners. The wage earner pays this tax over and above the "regular" income tax.
[9] Payroll taxes are shared equally between employers and employees.

the case at the time of writing, then the total tightening programme for 2013 will amount to approximately 2 per cent of GDP. However, if the Democrats and Republicans in Congress reach another agreement, it is possible that the cuts will be somewhat smaller. All in all, it appears that the tightening measures in US fiscal policy in 2013 will correspond to approximately 1.5 per cent of GDP, which is largely in line with the assumptions the Riksbank has been making for some time.

The Riksbank's forecast assumes that US budget consolidation will continue in the years ahead. This is necessary to enable the United States to come to terms with its public finances in the long term in light of the rapidly increasing federal debt as a percentage of GDP and the long-term challenge to finance the public welfare systems.