Obama, Romney and squaring the deficit

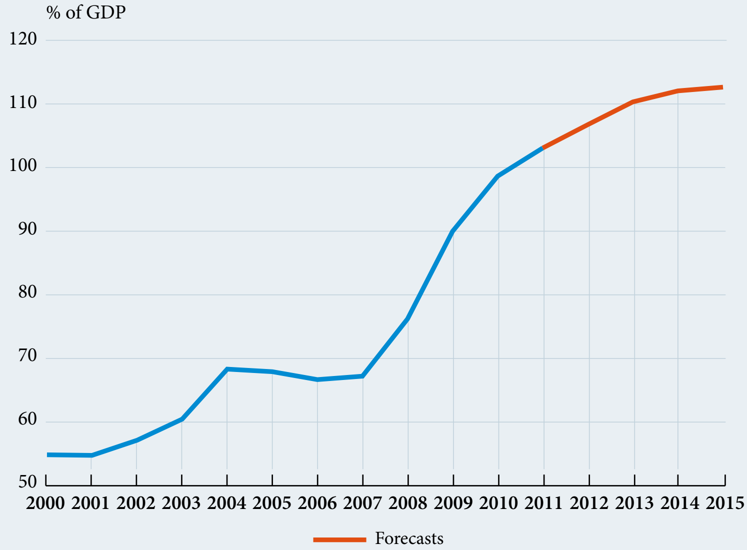
In 1992, with the United States in the midst of recession and presidential elections just around the corner, James Carville, excellent advisor, hung a famous sign in the office of the Democrat candidate to make sure he understood what his campaign's focus should be: «it's the economy, stupid!». Bill Clinton took this seriously, defeated President Bush senior and the rest is history. Twenty years on and just one month from the elections, with the general government deficit close to 8% of GDP and debt above 105% of GDP (see the graph below), the epicentre of the electoral debate is once again obvious: it's the deficit! The United States is facing a huge challenge of fiscal consolidation within an economic situation that is still being hindered by the consequences of the great recession, and the candidates disagree as to how this should be done: Obama believes that revenue should be increased while Romney wants to cut spending. In the fray are two models that differ on fundamental issues: the size of government, the composition of spending and which taxes to use.

At the beginning of 2013, an incredibly extensive and sudden fiscal adjustment is expected but, nevertheless, it is not credible, desirable nor would it be enough to restore the sustainability of public finances. This adjustment would result from the end of a series of fiscal stimuli and automatic cuts in spending legislated during the summer of 2011, when Congress raised the federal government's debt ceiling. This would result in a correction equivalent to 4% of GDP, which would very likely push the American economy back into recession. It's not surprising that this adjustment has been called the «fiscal cliff» and the new administration's number one priority will undoubtedly be to avoid such a precipice. Moreover, it would be a good idea to do so within the framework of a plan that ensures the sustainability of public debt in the medium term.

The outcome of the elections could make it easier or harder to handle this «fiscal cliff». The vast majority of analysts (including ourselves) expect an agreement to be reached in Congress (the House of Representatives and

PUBLIC DEBT IN THE UNITED STATES: AN EXPLOSIVE SITUATION?

Gross debt of public administrations



SOURCE: IMF.

the Senate) to postpone the automatic spending cuts and extend some of the stimuli that end in January, but the composition of the new Congress and the identity of the President will be decisive in this respect. If one of the parties receives a clear mandate from the electorate, an agreement will probably be reached relatively quickly to avoid the «cliff». However, a relatively unclear mandate (with the houses divided and only a minimal victory by either of the presidential candidates) could prolong negotiations, leading to uncertainty and a lack of confidence. Moreover, in February, the federal government will need to approve a further increase in the debt ceiling, providing an additional source of uncertainty.

Having dodged the cliff, the composition of the houses and the President's identity will obviously determine the fiscal adjustment strategy in the short and medium term. Obama proposes increasing the relative weight of the federal government's revenue (which currently accounts for around half the total public administration revenue) from the 15.7% of GDP estimated in 2012 to 19.4% of GDP in 2015. With regard to spending, he proposes reducing its relative weight from 22.9% of GDP in 2012 to 22.4%. So the federal deficit would fall from 7.2% estimated for the 2012 fiscal year to 3% of GDP in 2015, and 85% of this adjustment would fall on revenue. Romney proposes reducing the relative weight of spending much further, down to 20% of GDP, and increasing revenue to 18% of GDP (the average in the two decades prior to the 2008 crisis). The Republican candidate's aim is to reduce the deficit to 2% in 2015 and 55% of this adjustment would be carried out via spending. The cut in spending would be achieved via extensive adjustments in so-called discretionary spending (including investment) and other measures such as public healthcare reform. In the plan of both candidates, the increase in revenue would mostly, or totally in the case of Romney, come automatically as a result of the economic recovery.

In fact, the Republican candidate proposes a tax reform that would significantly reduce income tax by cutting, for example, the highest marginal rate for income tax from 35% to 28%. According to Romney, the loss of revenue associated with such a tax cut would be offset by eliminating deductions or exemptions and with greater economic growth resulting from less distorting levels of taxation. However, it's not at all clear whether this would be possible. Deductions for interest paid on mortgage loans for first and second homes, with a principal up to 1 million dollars, and for medical insurance premia paid by companies for their employees, which is not taxed as payment in kind, are the most costly deductions and exemptions for the US Treasury. Revenue losses from both measures taken together amount to almost 2% of GDP, but they are also politically very popular and Congress is very unlikely to get rid of them. On the other hand, although it's true that lower marginal rates would stimulate economic activity, the net effect is unlikely to be an increase in revenue, as the original marginal rate is not excessively high.

Obama, however, is keen on raising taxes for higher income brackets. In particular, he would raise the highest marginal income tax up to 39.6% (the rate before Bush's tax cuts in 2001) and would introduce the so-called «Buffett» rule, so that all individuals earning more than 1 million dollars would pay at least 30% to the Treasury (at present, deductions and low rates on capital earnings tend to reduce the effective rate paid by the highest income brackets). However, neither is it clear, in this case, that the increase in revenue resulting from these tax hikes would be as great as the candidate supposes. The forecast increase in revenue is unlikely to be achieved without a tax hike that would also affect the middle classes.

The proposals of both candidates also have points in common or at least less acute differences. For example, both call for a far-reaching reform of the corporate income tax, which currently has the highest rate in the OECD (39.2% compared with an average in the rest of the OECD of 25%) and one of the lowest revenues (1.7% of GDP compared with 2.8% in the OECD). On the other hand, neither of them dares to propose an increase in federal taxes on gasoline, one of the lowest in the OECD.

In spite of their differences, both candidates are aware that the country needs a credible adjustment plan. And, in fact, neither the United States nor the world economy can allow themselves to prolong, for too long, the uncertainty regarding the sustainability of the public finances of the world's leading economy. It would be naive to believe that the indulgence with which investors have treated this issue to date will continue indefinitely.

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