A Bad Deal to Avoid Default Would Hurt the Economy

The last debt-ceiling crisis produced an outcome nobody was supposed to want — sequestration — because of political gridlock over a long-term solution. The Center on Budget & Policy Priorities (CBPP) has developed four criteria for evaluating any deal that emerges as we head toward zero hour for authorizing government spending for fiscal year 2014 and raising the debt ceiling, or as part of later negotiations after any temporary stopgap measures:

1) Does it strengthen or weaken the economic recovery?

The Federal Reserve's monetary-policy-making committee decided that the economic recovery is not solid enough to start phasing down any of the measures it's been using to stimulate economic activity. One factor influencing the Fed's decision was a concern with the damage to the recovery that a government shutdown, or worse, a debt default would cause.

That damage would come on top of the drag on economic growth from fiscal tightening at the federal and state and local levels that's been underway since the stimulus from the 2009 Recovery Act peaked in 2010, including sequestration.

An ideal budget plan would replace sequestration with sizeable deficit-reduction measures that take effect gradually as the economy and labor market strengthen as well as temporary, up-front measures to boost job creation now. Such a policy would both strengthen the economy in the short term and produce more total deficit reduction and a better long-run debt trajectory than sequestration beyond the first decade.

Such a solution is fully consistent with the International Monetary Fund (IMF) analysis cited of what we have learned about fiscal policy in the wake of the financial crisis:

The design of fiscal adjustment programs, and particularly the merit of frontloading, has returned to the forefront of the policy debate. Given the nonlinear costs of excessive frontloading or delay, countries that are not under market pressure can proceed with fiscal adjustment at a moderate pace and within a medium-term adjustment plan to enhance credibility. Frontloading is more justifiable in countries under market pressure, though even these countries face “speed limits” that govern the desirable pace of adjustment. The proper mix of expenditure and revenue measures is likely to vary, depending on the initial ratio of government spending to Gross Domestic Product (GDP), and must take into account equity considerations.

The United States is not under market pressure and hence has no need to pursue short-term
deficit reduction aggressively. In fact, given the IMF’s assessment of fiscal multipliers in a weak economy with very low interest rates and inflation, such a policy would be counterproductive. Issues of equity and the proper mix of expenditure and revenue measures deserve careful evaluation.

The IMF was very pointed about this following its latest annual consultation mission with U.S. policymakers:

On the fiscal front, the deficit reduction in 2013 has been excessively rapid and ill-designed. In particular, the automatic spending cuts (“sequester”) not only exert a heavy toll on growth in the short term, but the indiscriminate reductions in education, science, and infrastructure spending could also reduce medium-term potential growth. These cuts should be replaced with a back-loaded mix of entitlement savings and new revenues, along the lines of the Administration’s budget proposal. At the same time, the expiration of the payroll tax cut and the increase in high-end marginal tax rates also imply some further drag on economic activity. A slower pace of deficit reduction would help the recovery at a time when monetary policy has limited room to support it further.

2) Does it protect low-income Americans and avoid increasing poverty and hardship?

In deficit-reduction efforts in 1990, 1993, and 1997, leaders of both parties embraced the principle that any deal should not increase poverty or impose additional hardship on low-income Americans. Fiscal commission co-chairs Alan Simpson and Erskine Bowles embraced the same principle in their plan.

The recent Census Bureau report on income, poverty, and health insurance suggests that any upcoming budget deal should adhere to the same principle. As CBPP President Robert Greenstein noted, “the new Census figures demonstrate that the painfully slow and uneven economic recovery has yet to produce significant gains for Americans in the bottom and middle of the economic scale.”

“Shutting down the government will do real damage,” said Rev. David Beckmann, president of Bread for the World. “Risking our nation’s creditworthiness will do even more damage. Most clearly, the disruption and uncertainty will put the brakes on our economy.”

3) Does it adequately fund public services?

Yielding to Republicans’ demands for more large immediate spending cuts would not only threaten the recovery but also savage important government services. The House-passed budget resolution of this spring would set overall discretionary (non-entitlement) funding at the post-sequestration level but shift tens of billions of dollars from non-defense programs to defense. That would require programs in the Departments of Labor, Health and Human
Services and Education be cut 18.6% below their 2013 post-sequestration levels.

Discretionary funding would shrink even without such large cuts. The cuts required under the Budget Control Act that President Obama and Congress enacted after their last debt-ceiling showdown would, by 2017, reduce non-defense discretionary spending — even without sequestration — to its lowest level on record as a percent of GDP, with data going back to 1962.

4) Does it strike a reasonable balance between spending and revenues and between defense and non-defense?

Deficit-reduction efforts since 2010 have tilted heavily toward spending cuts. Excluding sequestration, roughly 70% of the policy savings have come from program cuts and 30% from revenue increases. If sequestration continues, the ratio will move closer to 80-20. Revenues should account for a larger portion of future policy savings if we are to avoid savage cuts to important government services, anti-poverty programs and key entitlement benefits — and, thus to avoid exacerbating inequality and constraining opportunity.

Policymakers designed sequestration to pressure both parties to reach a budget deal by requiring that cuts come half from defense and half from non-defense programs, thus giving both conservatives and liberals a reason to replace sequestration with a more thoughtful approach. Efforts to shield defense and put all of the burden on non-defense would reduce conservative incentives to compromise.

“Our democracy rests on principles of reason, compromise, and a commitment to the common good. To hold our governance processes and financial credibility hostage to narrow priorities is not only dangerous to the nation’s near term financial being, it threatens the very foundations of our democratic process and our capacity to live united. We ask that congressional leadership of both parties stand strong in opposing efforts to allow the will of the few to threaten the common good.”

Rev. Beckmann said, “in fact, the Tea Party caucus is mainly responsible for our political dysfunction.”

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