THE HILL'S Congress Blog
Where lawmakers come to blog

Caught in a budget trap

By Jagadeesh Gokhale - 11/29/2012

The recent drumbeat from the political left on the disastrous effects of "austere" budget-cutting in European economies is intended to sandbag against similar policies in the United States. The key contention is that spending cuts have made budget balancing more difficult in European countries: supposedly, lower public spending in those countries reduced employment and income, reduced government revenues and increased the ratio of government debt to Gross Domestic Product. The left concludes that, to avoid a similar experience, the U.S. should increase spending in the short term, instead of cutting it, and attempt a "grand bargain" to balance long-term spending and taxes.

The problem is there may never be a "right" time to transition to the promised long-term structural budget resolution.

The left's policy prescription does not acknowledge that higher spending, deficits and debt in the near term will increase economic uncertainty about future tax policies — whether and how much they will bite into returns from investments made today. This uncertainty is likely to reduce investment today, offsetting higher government spending. Higher government spending also generally triggers expectations of higher inflation, inducing the Fed to tighten monetary policy to dampen any emerging inflation. Those reactions will act as a further drag on output and employment growth.

The Fed has announced that it will not increase interest rates for many more months, and it seems unlikely to reverse its latest quantitative easing policy of gradually expanding its portfolio of mortgage backed securities anytime soon. But the negative effects of economic uncertainty on private investment become especially potent in precisely this type of high-debt, low-interest-rate environment. Coupling that with the already ample uncertainty over how government will handle the massive shortfalls in entitlement programs creates a toxic brew for private-sector investment decisions.

This reasoning continues to elude analysts on the left, despite failure of two massive economic bailouts to gin up an economic recovery thus far. Instead, they try to explain away the economy's current struggles by claiming that the earlier bailouts and stimulus efforts weren’t large enough and that those efforts prevented a worse recession or depression. While neither of these claims can be tested directly, evidence from earlier recessions suggests low multipliers associated with higher government spending. The empirical economics literature has even the most careful analysts concluding that, overall, it is difficult to argue that the government spending multiplier substantially exceeds one--which it must for government spending to jumpstart growth.

Increased near-term spending, then, would only increase already sky-high deficits and debt and heighten uncertainty about the future course of budget policy, interest rates and the economy. Those effects could reduce already fragile private investment. This is reflected in the massive hoards of liquid cash reserves in the coffers of private corporations and banks, reserves that they are unwilling to commit to invest in expanding their production capacities.

As to the long-term, lawmakers on both sides of the aisle have paid pious lip service to achieving a grand bargain, followed by deliberate abandonment of sensibly crafted frameworks to achieve long-term budget reforms: Recall that the Obama administration willfully spurned the Bowles-Simpson fiscal reform framework last year.

With the upcoming "fiscal cliff," however, American lawmakers may be forced to follow the left's ill-fated economic prescription. Policies set to trigger in January of next year — expiring tax provisions, the spending sequester, the partial payroll tax reduction, reduced Medicare doctor reimbursements and other budget policies that would increase taxes and reduce spending — are estimated to cut federal deficits by 5 percent of GDP next year. Many observers fear that these would trigger another major recession, and therefore force lawmakers into another postponement of the scheduled triggers.

But will piling on more short-term debt effectively spur an economic revival? And will lawmakers agree to adopt a sensible long-term budget resolution within the next year?

Past experience is not encouraging. Even a fully Democratic Congress and presidency during the first two years of the Obama administration did not reverse the Bush tax cuts. We have now postponed the expiration of the Bush tax cuts several times and reinforced that "fiscal stimulus" with TARP, other government bailouts, and a two-year partial payroll tax cut, all to no avail.

Postponing “fiscal cliff” policies without introducing significant entitlement reforms will only increase the sacrifices Americans must ultimately make. The overall federal fiscal imbalance stands at 9.0 percent of future GDP. Because taxes are imposed on only one-half of GDP, eliminating it would require more than doubling the payroll tax rate. Intense voter pressure to continue with unaffordable entitlement policies but postpone “fiscal cliff” policies will take us perilously close to the road well-traveled by European nations — to eventual forced austerity.

Gokhale is a senior fellow at the Cato Institute.