America’s fiscal headache

By Christine Rifflart

Before next December 13th, the Budget Conference Committee must present the results of the discussions begun following the shutdown and debt crisis in October 2013. The objective of the negotiations is to enable Congress to approve the 2014 Budget, for which the fiscal year began on October 1 [1], and find an alternative to the automatic cuts in federal spending that are to take effect on 1 January 2014. An agreement does not seem out of reach. Even if sharp opposition between Republicans and Democrats remains, reason should prevail and the risk of a new budget crisis seems excluded. At worst a new Continuing Resolution [2] will be passed that allows institutions to continue to function and the arbitrary nature of automatic budget cuts in structural expenditure to guide government policy. At best, the negotiations will lead to reasoned cuts in expenditure, and even to increases in some revenues that will then curb the violence of the adjustment, a violence that is amplified by the ending of the exceptional measures to support income and activity that were enacted at the heart of the crisis.

There is little room for negotiation. In fiscal year 2013, the deficit for the entire public sector reached 7% of GDP (after 12.8% in fiscal year 2009), and the federal deficit came to 4.1% of GDP (after 9.8%). The federal debt currently comes to 72.7% of GDP, and is rising. Moreover, growth remains weak: 2.2% at an annual average since the 2010 recovery, with 1.8% expected in 2013, which in particular is insufficient to revitalize the job market. How then is it possible to come up with a budget policy to support growth in a context of fiscal austerity and deficit reduction while complying with the commitments previously made by Congress[3], in particular the Budget Control Act of 2011? Following the crisis concerning the federal debt ceiling in July 2011, on 2 August 2011 President Obama signed the Budget Control Act of 2011, which conditioned any increase in the federal debt ceiling on a massive reduction in government spending over 10 years. In addition to the introduction of caps on discretionary spending [4], 1200 billion dollars in automatic cuts (sequestrations) in expenditures were planned for the period 2013 to 2021 based on a principle of parity between defense and non-defense budgets. A number of social programs (pension insurance, Medicaid, income guarantees, etc.) were exempted, while cuts to the Medicare program for the elderly were limited to 2%. In total, the cuts will apply to a little less than half of federal spending and will represent 109 billion per year in savings on the deficit, *i.e.* 0.6% of GDP.

For the 2014 fiscal year, according to the CBO the combination of these two measures (capped discretionary spending and automatic cuts in unprotected budgets) as well as the renewal of the amount of credits from 2013 to 2014 (*i.e.* a constant nominal budget) will lead to cuts in discretionary spending of 20 billion dollars that will have to be borne entirely by the Pentagon. On this basis, if the cuts are maintained, discretionary spending in the defense and non-defense budgets will have declined by 17% and 17.8%, respectively, in real terms between 2010 and 2014.

But in addition to these brutal cuts, other programs, in particular those primarily intended for low-income households, will experience a reduction in their budget in 2014 because of the expiration of the exceptional measures they previously enjoyed. Thus, the program to extend unemployment benefits created on 30 June 2008 for unemployed people who had exhausted their rights (Emergency Unemployment Compensation) ends on 1 January 2014. In the absence of other plans, this will hit 4 million people.

This is also the case of the Supplemental Nutrition Assistance Program (SNAP), which had benefited under the American

Recovery and Reinvestment Act of 2009 from additional funding that elapsed on 1 November. Yet 47.7 million beneficiaries (15% of the population) received food stamps this year. According to the CBPP, the 7% cut in the program's funds should result in a decrease of 4 million in the number of beneficiaries.

Another example: the housing benefits for the 2.1 million families who cannot find decent housing will also be affected by the termination of the budget extensions introduced in 2009 and the automatic cuts. If the budget is not renewed, from 125,000 to 185,000 of the families receiving benefits at end 2012 will no longer receive aid at end 2014.

According to the information currently available, a minimum agreement on the Budget Conference Committee seems to be emerging. The cuts in the defense budget could be approved [5], while eventual increases in public utility charges would be used to fund budget extensions for some social programs and lighten the impact of the automatic cuts. Last April, President Obama presented his Draft 2014 Budget to Congress. At that time he proposed to remove the procedures for automatic cuts, to reduce the debt in the long term through an extensive fiscal reform, and in the shorter term to defer a portion of the 2014 budget cuts to fiscal years 2015 and 2016 in order to boost growth. The agreement, which is likely to be presented to Congress by 13 December, will undoubtedly not be this ambitious. Faced with Republican (the majority in the House of Representatives) partisans of additional savings, the Democrats (the majority in the Senate) will find it difficult to defend an increase in public spending in 2014 and to adopt a fiscal policy that is less harmful to growth this year than it was in 2013.

[1] After not having been adopted by Congress, the 2014 budget has been financed since 16 October by a Continuing Resolution (see note 2) on the basis of the 2013 budget amounts. The Resolution is retroactive from the 1st day of the 2014 fiscal year, *i.e.* 1 October 2013, until 15 January 2014.

[2] A Continuing Resolution is a temporary resolution passed by Congress that is used to extend the appropriations made the previous fiscal year to the current fiscal year, while waiting for new measures to be approved.

[3] According to the CBPP, if all the deficit reduction measures adopted since 2010 in the 2011 Budget, the Budget Control Act of 2011 and the American Taxpayer Relief Act of 2012 are taken into account, the cumulative impact on the deficit would be 4000 billion over the period 2014-2023, *i.e.* the equivalent of 24% of 2013 GDP.

[4] Discretionary spending (33% of federal spending) is spending for which the budgets are voted on an annual basis, unlike mandatory spending (61%), which is based on programs covered by prior law. The spending side of the government's fiscal policy rests mainly on changes in discretionary spending, which are structural expenditure.

[5] Expenditure related to defense had already fallen by 13.1% in real terms between Q3 2010 and Q3 2013.

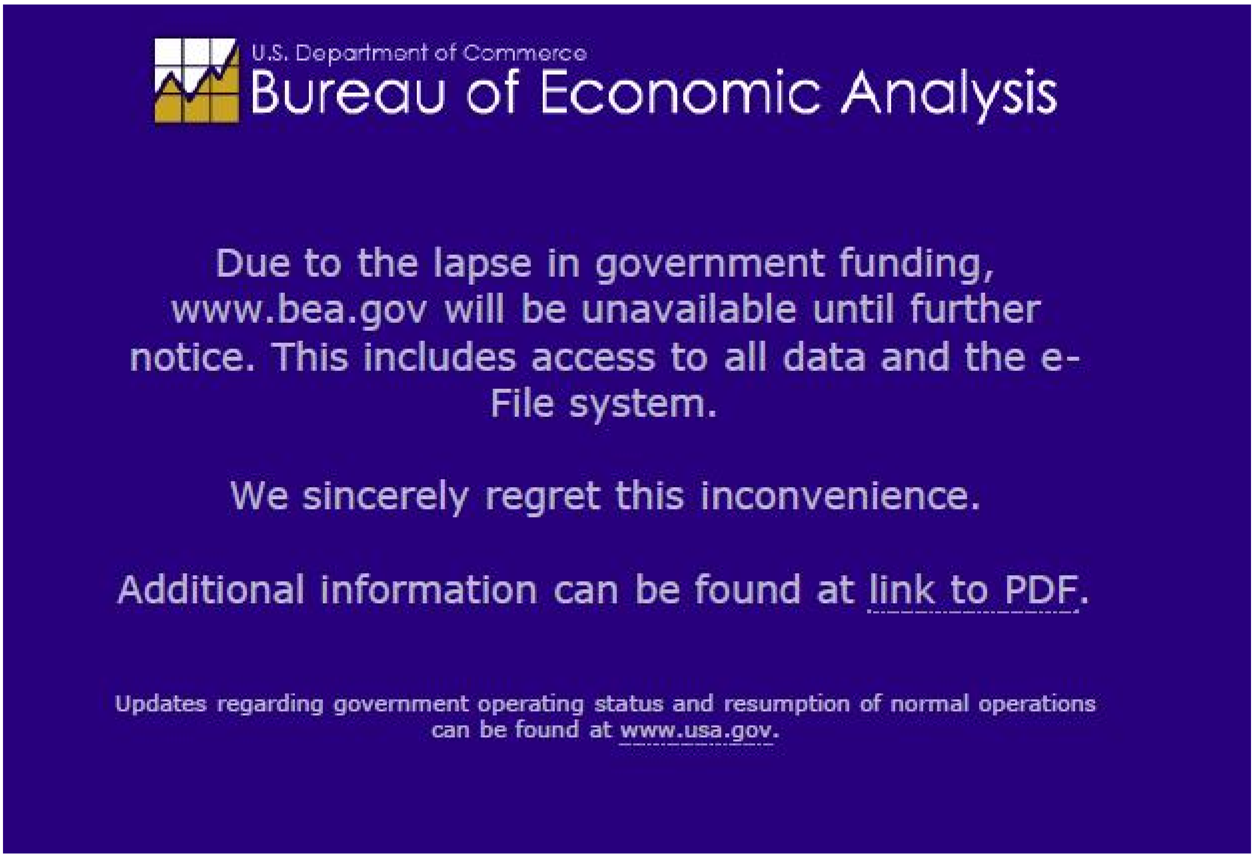
Shut down: America in the spotlight

By Christine Rifflart

A State that asks a third of its civil servants to stay home because it can't pay them is in a critical situation. When it's the United States, it's the whole world that worries.

The absence of an agreement on the 2014 budget, which was to take lawful effect as of Tuesday, 1 October 2013, shows the standoff in Congress between Democrats and Republicans. This kind of contention over the budget is not new: no budget has been passed since 2011, and the federal government has worked up to now through "continuing resolutions" that are used to release the funds needed for the government to function and operate, on a provisional basis. Today's blockage is on a different scale, and parts of the administration have had to close their doors due to lack of funds. This exceptional situation is not unprecedented: 17 shutdowns have occurred since 1976, the last two under the Clinton administration, lasting, respectively, one week (from 13 to 18 November 1995) and three weeks (from 15 December 1995 to 6 January 1996).

According to the Office of Management and Budget, of a total of 2.1 million federal government employees, more than 800,000 have been prohibited from working, while others have come to work with no guarantee that they will be paid. For example, those being told not to work include 97% of NASA employees, 93% of the Environmental Protection Agency, 87% of the Department of Commerce, 90% of the IRS, etc. Each of these received a letter from the President expressing his bitterness. In practice, this also means that some social services are no longer assured, some government call centres are closed, and the national monuments and 368 national parks are no longer open to the public. Applications for subsidized loans, housing grants, and loan guarantees are no longer being taken, and some government services are closed:



Vital services and programs for which funding is not linked to the vote on the annual budget (so-called mandatory spending), which account for over 60% of pre-interest expenditure and represent 12.7% of GDP, have nevertheless been spared. Some social security programs (Medicare, Medicaid), the postal service, national security, and military operations have thus been protected from shutdown, at least in so far as they are not affected by restrictions on staff whose salaries are covered in the 2014 budget.

Another political and fiscal crisis is looming: the US government could go into default from October 17 if the authorized debt ceiling is not raised. The uncertainty surrounding this situation is fraying nerves on the financial markets, and the frozen political climate in Congress does not seem to herald an honourable end to what the media are calling a “game of chicken” [1]. In 1995, however, Clinton emerged victorious from this crisis with the Republicans, and was re-elected in 1996, despite the Republican majority in Congress.

The economy could be seriously affected while awaiting an end to this crisis. If the salaries and benefits of federal civil servants are not paid, the loss in earnings would come to an average of 1500 dollars per week for each family affected. Given the total of 2.1 million federal employees, this would represent 0.08% of quarterly GDP. In three weeks, this would amount to a loss of 0.25% of GDP for the economy in the 4th quarter. Congress could, however, approve retroactive payment of the salaries, which is what generally took place during previous shutdowns.

But this still does not take account of the more important issue of the disorganization of the economy. Considering that on an annual basis half of the federal government’s discretionary spending (*i.e.* 37% of federal spending, or 7.6% of GDP) [2] is affected by the shutdown, since it is financed out of the 2014 budget, this loss in expenditure represents 0.15 GDP point per week. Given the disorganization represented by the government closures (and using a fiscal multiplier of 1.5), the impact on growth could then come to at least 0.22 GDP point per week. If the crisis lasts 3 weeks, then the impact on 4th quarter GDP would be at least 0.7 GDP point – which would mean a recession for the US economy by the end of the year!

Other estimates do exist. The Office of Management and Budget evaluated the cost of the 1995 shutdowns (from 13 to 18 November 1995 and then from 15 December to 6 January 1996) at 1.4 billion in 1995 dollars (*i.e.* 0.5 % of quarterly GDP). Based on the 1995 shutdowns, Goldman Sachs evaluates the current weekly cost to the US economy at 8 billion dollars, equivalent to an impact of 0.2% of 4th quarter GDP. Moody’s Analytic Inc. estimates that the shutdown will have an impact of 0.35% of quarterly GDP per week.

If the budget crisis lasts only a few days, its repercussions on the French economy will be minimal, *i.e.* a reduction in US growth of 1 percentage point would cut French growth by 0.17%. But if the crisis lasts several weeks and overlaps with a crisis over the ceiling on the government debt, which is quickly approaching, then the consequences could be very different. The two crises the (blocked budget and the failure to pay the public debt) would combine and fuel one another, as is emphasized by this New York Times post. It is difficult to imagine the panic this could cause on the financial markets, as interest rates soar and the dollar collapses. This would be a very different story indeed….

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[1] In game theory, a game of chicken is a game of influence between two players in which neither must yield. When for example two cars are racing towards a head-on collision, the “chicken” is the driver who veers off course in order to avoid dying.

[2] A major part of spending by the Department of Defence is approved on a multiyear basis and is not subject to being blocked due to the shutdown. Over half of DoD spending is composed of this discretionary expenditure. Furthermore, mandatory outlays are not financed out of credits subject to the vote on the Budget.