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Worse Than Do-Nothing

With its corrosive divide, Washington does real damage to the economy. It would take very little for Congress to alter that.


By Mark Zandi, October 27th, 2013

It probably won't surprise you to hear that Washington right now represents far and away the most significant drag on the economy's growth. This seems obvious given Congress' recent behavior, which produced a 16-day government shutdown and threats to default on the nation's debt.

Yet it is also important to consider why Washington is such an impediment to growth. And if we think it through, the picture appears less bleak, and even surprisingly hopeful.

Washington affects the economy most directly through taxes and spending, and these policies currently create major headwinds to growth. Indeed, fiscal austerity this year has been more intense than at any time since the United States was demobilized after World War II.

Recent tax increases and spending reductions - of which the across-the-board cuts from budget sequestration are only a subset - hit the economy hard. This year, austerity will reduce the rate of growth in gross domestic product by 1.5 percentage points.

That's a lot. For context, consider that GDP is growing at a rate of nearly 2 percent per year, about the same pace it has maintained since the recovery began four years ago. If federal tax and spending policies were simply neutral, neither adding nor subtracting from GDP growth, the economy would be expanding at a healthy 3.5 percent pace. That's not bad by historical standards.

Note also that fiscal policies affect the rate of economic growth only when they change; if the level of taxes and spending remains the same from year to year, they become neutral for growth. Thus if lawmakers in Washington simply do nothing from here, the level of fiscal austerity will quickly fade. This is true even if the sequester remains in place.

Moreover, while the tax increases and spending cuts of the last two years were tough on the economy - it would have been better to phase them in more slowly - they did improve the government's fiscal outlook. The federal budget deficit is less than half what it was during the recession, and under current law using reasonable assumptions it will shrink again by half by mid-decade.

And despite the political vitriol that will surely be slung around Washington, odds are high that lawmakers will do nothing much of consequence over the next few months. They already have slashed those parts of the budget that require annual appropriations; what's left are the entitlement programs, including Social Security, Medicare, and Medicaid. While entitlement reform would be an economic boon, these programs are much too politically charged to change anytime soon. Ditto on tax reform.

That doesn't mean lawmakers won't battle over these issues as the deadline approaches for another potential government shutdown and Treasury debt default early next year. In the deal to reopen the government and avoid default earlier this month, the only thing Congress could agree on was to disagree again after Jan. 1.

All this has been painful to watch, which is the other way Washington has hurt the economy, making us all nervous and uncertain. The uncertainty created by political brinkmanship is corrosive to growth. Businesses are more reluctant to invest and hire, and entrepreneurs become less likely to attempt start-ups. Financial institutions grow cautious about lending and households are more restrained in spending. As long as lawmakers and their existential budget battles dominate the media, hiring will be weak and economic growth lackluster.

A Moody's Analytics statistical analysis indicates that increased political uncertainty since the Great Recession has cost the economy 1.3 million jobs and raised the unemployment rate by 0.8 percentage point. Unemployment would still be too high even if lawmakers were on their best behavior, but the economy would be much closer to full employment.

With the fight over entitlements, taxes, and Obamacare set to extend into 2014, political uncertainty will remain high and its weight on the economy heavy. But lawmakers are less likely to venture again down the dark path to a government shutdown and threat of default. Polls show these were extraordinarily unpopular tactics, and using them again could be politically lethal in next year's midterm elections.

It will also likely become clear soon that substantial entitlement and tax reform are not possible in this polarized environment. While reform would be a big plus for the economy, it isn't absolutely necessary. What is necessary is that lawmakers do no more harm. That is, fund the government so it remains open and raise the debt limit so the United States can make good on its obligations.

If lawmakers can just accomplish this in the next few weeks, and I think they can, it will be surprising how well the economy performs.

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