THE CENTURY FOUNDATION
EPI
ISSUE BRIEF
ISSUE BRIEF #311 AUGUST 4, 2011

DEBT CEILING DEAL THREATENS DEEP JOB LOSSES AND LOWER LONG-RUN ECONOMIC GROWTH

BY ANDREW FIELDHOUSE AND ETHAN POLLACK

Months of deficit hysteria have culminated in a debt ceiling deal that will boost joblessness in the short run and depress economic growth in the long run. By reducing economic output by more than $40 billion in 2012 ($241 billion when counting key measures rejected in the deal), and cutting the non-security discretionary budget as a share of gross domestic product in half by 2021, the deficit-reduction package poses a serious risk to the already-stagnant economic recovery. According to revised data, GDP grew at an annualized rate of 0.8% in the first half of 2011, about one-third of the economic growth needed to keep unemployment from rising further.[1] The new data also indicate that the economy shrank 24% more during the downturn than previously measured.[2] These numbers, combined with dismal May and June employment reports, should have focused Congress on the jobs crisis. Instead, Congress fixated on deficit reduction and enacted legislation that will exacerbate the jobs crisis by eliminating roughly 1.8 million jobs, and significantly impede our capacity to regrow the economy.

The deal

The debt ceiling legislation, which allows the debt ceiling to rise, in three phases, through the end of 2012, has two steps. The first step cuts the discretionary budget by almost $1 trillion over the next 10 years, with most of the cuts coming from the non-security discretionary budget (the portion of the budget that funds education, infrastructure, and the social safety net, among other things). The second step requires a joint committee of three Democrats and three Republicans from each chamber to negotiate an additional $1.2 trillion to $1.5 trillion in cuts by 2021, and gives the negotiated package a procedural fast-track in Congress.

The committee's failure to reach an agreement exceeding $1.2 trillion in savings would trigger up to $1.2 trillion in automatic cuts[3], half of which would come from defense. Each budget within the defense and non-defense categories would be cut by a uniform percentage, though Social Security, Medicare benefits, Medicaid, low-income programs, and civilian and military retirement would be exempt (and Medicare provider cuts would be limited to 2%).

Immediate impact on jobs and the economy

The initial spending cut will reduce outlays by $30.5 billion in calendar year 2012, leading directly to job losses. In addition, Congress missed a key opportunity to generate jobs by failing to include in the deal extensions of emergency unemployment benefits and the employee payroll tax holiday—both of which the president strongly supported. Although the debt ceiling deal creates undesirable obstacles to continuing emergency unemployment benefits and the payroll tax holiday, the joint committee should prioritize these desperately needed stimulus measures in any second phase of long-term deficit reduction.[4]

Relative to current budget policy, the spending cut in the debt ceiling deal plus the failure to extend the payroll tax holiday and emergency unemployment insurance would reduce U.S. GDP by $241 billion in calendar year 2012, a decrease of 1.5%, relative to projected levels. This estimate (detailed below) is consistent with private estimates by, for example, J.P. Morgan Chase (Goldfarb 2011). This decline in economic activity would reduce nonfarm payroll employment by roughly 1.8 million jobs and correspondingly increase the unemployment rate by 0.6 percentage points, relative to current budget policy[5] (see **Table 1**).

TABLE 1

Impact of debt ceiling deal on GDP and jobs in 2012

	Cost	Multiplier	GDP impact	Job impact
Discretionary cuts	$30.5 billion	1.40	-$43 billion (-0.3%)	-323,000
No payroll tax holiday	$118 billion	1.09	-$128 billion (-0.8%)	-972,000
No extended unemployment insurance	$45 billion	1.55	-$70 billion (-0.4%)	-528,000
Total	**$193 billion**		**-$241 billion (-1.5%)**	**-1,822,000**

Note: Totals may not sum due to rounding.

SOURCE: Multipliers from Zandi (2010, 2011); budgetary cost and economic impact reflect author's calculations based on the Joint Committee on Taxation's analysis of December's tax cut and unemployment insurance deal (2010), the Congressional Budget Office's analysis of the August 1 Budget Control Act (2011), and CBO's economic projections (2011). See EPI Briefing Paper 315, *Why Spending Caps Are Poor Policy*, footnote six for methodology of translating GDP to employment.

To put these numbers in context, the U.S. economy created only 18,000 jobs in June 2011, and the economy has generated *fewer than 1.8 million jobs since* employment bottomed out in early 2010. More than 11 million jobs are needed to bring the unemployment rate back down to pre-recession levels (Shierholz 2011), but government policy is instead moving in reverse.

Methodology

Under the debt ceiling deal, discretionary spending relative to CBO's Adjusted March 2011 Baseline (CBO 2011a) will be cut $30.5 billion in calendar year 2012.[6] Using a fiscal multiplier of 1.4 for general government spending (Zandi 2011), the discretionary spending cut for 2012 alone will reduce output by $43 billion (-0.3%) and lower employment by roughly 323,000 jobs.

As part of December's deal to extend the Bush-era tax cuts for two years, Congress enacted a 2 percentage-point reduction in the Social Security payroll tax for all workers, and it is set to expire at the end of the year. The cost of failing to extend the payroll tax cut is estimated by adjusting the cost of the 2011 payroll tax cut (JCT 2010) by CBO's projection of wage and salary growth (CBO 2011b), resulting in a cost of $117.8 billion. Applying a fiscal multiplier of 1.09 (Zandi 2010), we estimate that the failure to extend the payroll tax cut would decrease GDP by $128 billion (-0.8%) and lower nonfarm employment by 972,000 jobs.

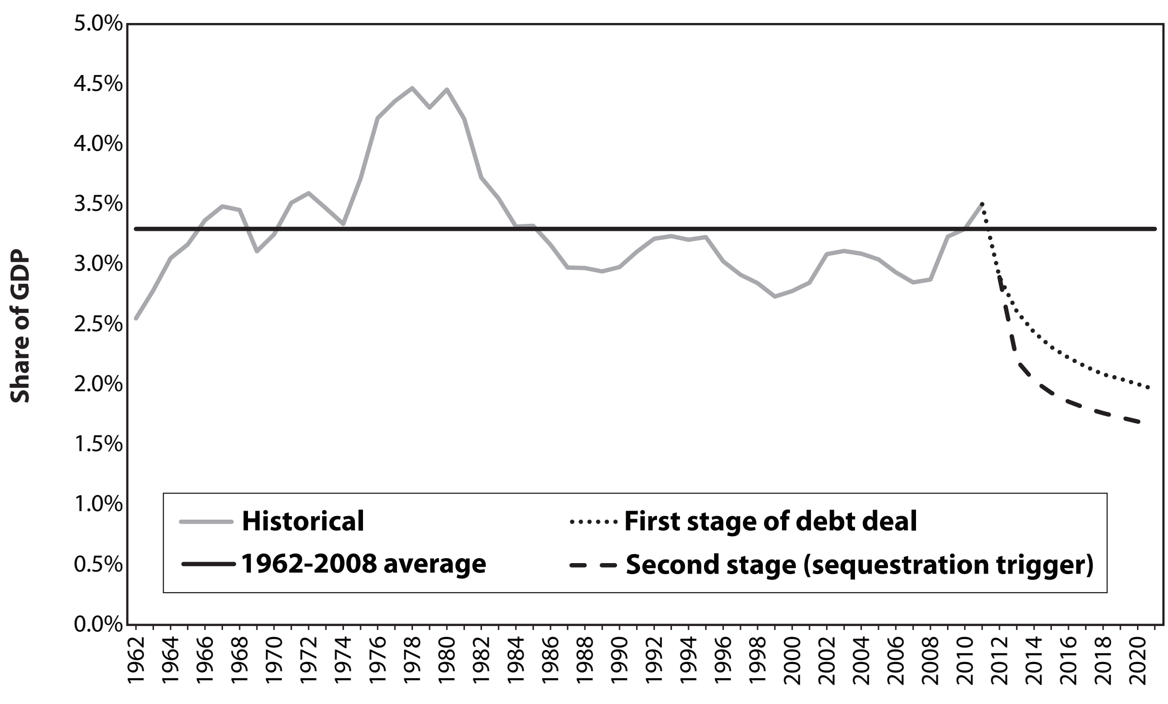
Another provision of the December deal set to expire at the end of the year is the continuation of unemployment insurance to people who have been unemployed for up to 99 weeks. The cost of failing to continue Emergency Unemployment Compensation (EUC) and fully federally funded Extended Benefits (EB) is estimated by the CBO to be roughly $45 billion.[7] By applying a fiscal multiplier of 1.55 (Zandi 2011), we estimate that failure to continue the EUC and EB would decrease economic activity by $70 billion (-0.4%) and decrease employment by roughly 528,000 jobs. Unemployment benefits are among the most cost-effective economic remedies, and failure to continue emergency benefits will come as a blow to the long-term unemployed at a time of near-record long-term unemployment; recipients of emergency EUC and EB benefits account for half of the 7.6 million Americans currently claiming unemployment insurance benefits (Department of Labor 2011).

Impact on public investments and long-run growth

The spending cuts enacted under the deficit deal also threaten long-run economic growth. They cut disproportionately from the part of the budget known as "non-security discretionary" (NSD), which represents only 15% of the total federal budget, but more than 50% of the cuts. It is referred to as "discretionary" because it is

FIGURE A

Non-security discretionary outlays, share of GDP, 1962–2021



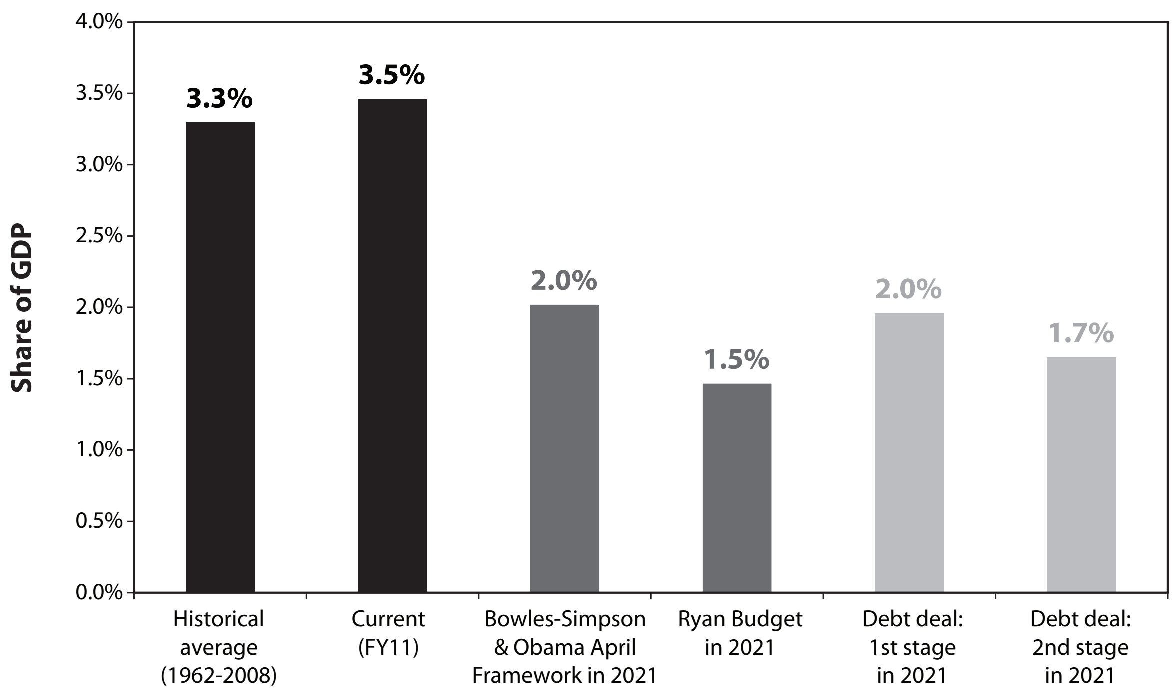
SOURCES: Budget Control Act of 2011, Office of Management and Budget Public Budget Database.

subject to annual appropriations, versus Social Security and other mandatory programs.[8] The NSD budget houses public goods benefiting all citizens, including nearly 90% of nondefense public investment (Pollack 2011). These include high-return investments in education, transportation infrastructure, and scientific and health research. The NSD budget also funds regulatory safeguards protecting our health, environment, and economy, such as food safety inspection, pollution control and abatement, and the Securities and Exchange Commission.

As previously noted, the deal makes massive cuts to the NSD budget. As **Figures A and B** show, the first stage of the deal (its discretionary caps) reduces NSD from 3.5% of GDP in 2011 to 2% of GDP in 2021, its lowest level in over half a century. The second stage—a cap that will automatically activate (via sequestration)[9] if the joint committee is not successful—would cut NSD down to 1.7% of GDP, a level comparable to the Republican budget resolution (Wisconsin Rep. Paul Ryan's budget) passed earlier this year and well below the Bowles-Simpson fiscal commission report.

FIGURE B

Comparing non-security discretionary outlays as a share of GDP



SOURCES: Budget Control Act of 2011, Pollack 2011.

Public investments in infrastructure, education and training, and research and development are critical components of the NSD budget. These investments, which represent half of the NSD budget, are vital to long-run economic growth and global competitiveness because they contribute to higher productivity, fueling higher incomes and raising living standards. A recent and comprehensive review of the literature on this topic finds that a sustained 1% increase in the public capital growth rate (in other words, expanding public investment spending) translates into a 0.6 percentage-point increase in the private-sector GDP growth rate, while certain investments—such as those in early childhood education—provide an even greater bang for the buck (Heintz 2010).

Underfunding public investments over the next decade or longer would have damaging consequences for future generations, who would be left with a smaller public capital stock and less human capital. Weaker economic growth also threatens future employment opportunities and wage growth. Leaving future generations with an unsustainable fiscal trajectory is irresponsible, but sacrificing their education, health, infrastructure, and environmental quality cannot be condoned as a sound budgeting tradeoff.

Cuts to public investments therefore do not actually reduce this country's overall debt burdens, they merely shift the burden from the present to future generations. Yet NSD levels of 2% of GDP falling to 1.7% of GDP would make it impossible for Congress to maintain current public investment levels, let alone increase investment to compensate for decades of underinvestment. Non-defense public investment in the NSD budget is now about 1.7% of GDP, and the current and future spending cuts likely under the debt ceiling deal would bring total NSD down to 1.7% of GDP in 2021. Therefore, just maintaining current non-defense public investment levels would require cutting virtually everything else, including Congress itself. However, we are more likely to see public investments cut significantly, leading to depressed long-run economic growth and poorer living standards for future generations.

Conclusion

The unemployment rate currently hovers above 9%, and consensus forecasts project that it will remain heightened through 2012, and likely beyond. Budget shortfalls are causing state and local governments to cut budgets and raise taxes, sucking even more demand out of the economy and causing more job loss. The federal government is the only body in a position to help restart the American economy.

Yet Congress is moving in precisely the wrong direction. First, it's cutting its own budget and so far refusing to renew necessary recovery measures like the payroll tax cut and the unemployment benefit extensions. This will lead to job losses immediately. Second, it's disproportionately cutting the NSD budget—despite NSD already being small—down to unprecedentedly low levels, levels that would likely force deep cuts to public investments. This would lead to slower long-run economic growth and lower living standards for future generations.

Thus, Congress is embarking on a path to lose both the future and the present. In light of this debt ceiling deal, it is now more important than ever to renew the payroll tax cut and unemployment extensions for at least another year. But Congress should not limit itself only to these measures—the hole is deep, and we need an ambitious jobs agenda to get us out.

Endnotes

1. Multiyear revisions to the Bureau of Economic Analysis National Income and Product Accounts Table were released on July 29, 2011 (Department of Commerce 2011). See Krugman (2011) on the relation between growth and unemployment (Okun's law).
2. Between the fourth quarter of 2007 (peak) and the second quarter of 2009 (trough) the economy shrank by 5% rather than the previously-estimated 4%.
3. The cuts would be triggered through a process called sequestration, an enforcement mechanism by which the president orders the cancellation of spending authority.
4. Though it is possible to avoid any additional debt ceiling increase by fully offsetting the extensions of unemployment benefits and the tax holiday with other spending cuts and tax increases, this would partially or largely offset their stimulative effect.
5. Specifically, we assume a 1% reduction in gross domestic product corresponds with 1.2 million full-time nonfarm payroll job losses. This is consistent with CBO estimates of the impact of the 2009 Recovery Act and private sector forecasts. The change in the unemployment rate is modeled using Okun's rule of thumb. Specifically, the projected increase reflects the difference between the projected GDP gap for calendar year 2012 (CBO 2011b, 2011c) and counterfactual GDP gap (GDP with an extension of the payroll tax cut and unemployment insurance and without the discretionary spending cut) divided by 2.5. This is meant as a conservative estimate, assuming the labor market is relatively unresponsive to growth.
6. This assumes a 75-25 split between FY2012 and FY2013 outlays to convert from fiscal year to calendar year (CBO 2011b).
7. Private CBO estimate provided to the Senate Finance Committee.
8. Social Security, Medicare, Medicaid, and other mandatory programs such as food assistance represent 57% of the federal budget, and net interest payments another 6%. The rest of the budget is discretionary, meaning that it is subject to annual appropriations. About 60% of the discretionary budget (22% of the total) is security related: the Department of Defense, Homeland Security, Veterans Affairs, nuclear weapon security (which is within the Department of Energy budget), and foreign affairs. The rest of the budget is NSD.
9. See note three.

References

Congressional Budget Office (CBO). 2011a. *CBO Analysis of August 1 Budget Control Act.* Washington, D.C.: CBO. http://www.cbo.gov/ftpdocs/123xx/doc12357/BudgetControlActAug1.pdf

Congressional Budget Office (CBO). 2011b. *The Budget and Economic Outlook: Fiscal Years 2011 to 2021.* Washington, D.C.: CBO. http://www.cbo.gov/ftpdocs/120xx/doc12039/01-26_FY2011Outlook.pdf

Congressional Budget Office (CBO). 2011c. "Key Assumptions in Projecting Potential Output." Backup data for Table 2.2, published in *The Budget and Economic Outlook: Fiscal Years 2011 to 2021* Washington, D.C.: CBO. http://www.cbo.gov/ftpdocs/120xx/doc12039/KeyAssumptionsPotentialGDP_110125.xls

Department of Commerce, Bureau of Economic Analysis. 2011. "Table 1.1.6. Real Gross Domestic Product, Chained Dollars." National Income and Product Accounts, Revised on July 29.

Department of Labor, Employment and Training Administration. 2011. "ETA Press Release: Unemployment Insurance Weekly Claims Report, July 28, 2011." Washington, D.C.: DOL. http://www.dol.gov/opa/media/press/eta/ui/current.htm

Goldfarb, Zachary A. 2011. "Debt-ceiling deal risks compromising fragile economic growth." *The Washington Post*, August 1. http://www.washingtonpost.com/business/economy/debt-ceiling-deal-risks-compromising-fragile-economic-growth/2011/08/01/gIQA9phUoI_story.html

Heintz, James. 2010. "The Impact of Public Capital on the U.S. Private Economy: New Evidence and Analysis." International Review of Applied Economics, 24(5): 619-32.

Joint Committee on Taxation (JCT). 2010. "Estimated Budget Effects Of The "Tax Relief, Unemployment Insurance Reauthorization, And Job Creation Act Of 2010," Scheduled For Consideration By The United States Senate." Washington, D.C.: JCT. http://www.jct.gov/publications.html?func=download&id=3715&chk=3715&no_html=1

Krugman, Paul. 2011. "The Long Road Ahead." The Conscience of a Liberal blog on the New York Times Online, January 1. http://krugman.blogs.nytimes.com/2011/01/01/the-long-road-ahead/

Pollack, Ethan. 2011. "Major budget proposals pit public investment against vital services." Economic Policy Institute, Washington, D.C. July 13th. http://www.epi.org/publications/entry/major_budget_proposals_pit_public_investment_against_vital_services/

Shierholz, Heidi. 2011. "Labor market in full retreat." Commentary on Economic Policy Institute website, July 8. http://www.epi.org/publications/entry/labor_market_in_full_retreat/

Zandi, Mark. 2010. "U.S. Macro Outlook: Compromise Boosts Stimulus." Moody's Analytics' Dismal Scientist website. December 8. http://www.economy.com/dismal/article_free.asp?cid=195470

Zandi, Mark. 2011. "At Last, the U.S. Begins a Serious Fiscal Debate." Moody's Analytics' Dismal Scientist website. April 14. http://www.economy.com/dismal/article_free.asp?cid=198972&src=msnbc

Andrew Fieldhouse is a Federal Budget Policy Analyst with The Century Foundation and the Economic Policy Institute.

Ethan Pollack is the Senior Policy Analyst with the Economic Policy Institute.

About The Century Foundation

The Century Foundation conducts public policy research and analyses of economic, social, and foreign policy issues, including inequality, retirement security, election reform, media studies, homeland security, and international affairs. With offices in New York City and Washington, D.C., The Century Foundation is nonprofit and nonpartisan and was founded in 1919 by Edward A. Filene.

About the Economic Policy Institute

The **Economic Policy Institute** is a nonprofit, nonpartisan think tank that seeks to broaden the public debate about strategies to achieve a prosperous and fair economy. EPI stresses real world analysis and a concern for the living standards of working people, and it makes its findings accessible to the general public, the media, and policymakers. EPI's books, studies, and popular education materials address important economic issues, analyze pressing problems facing the U.S. economy, and propose new policies.