



## Fiscal Consolidation: Its Impact on the Economy

*Michael Mussa says that federal and local budget cuts and tax increases may slow economic growth next year, but his forecast on unemployment is for it to dip below 8 percent in 2012.*

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Steve Weisman: This is Steve Weisman at the Peterson Institute for International Economics with Mike Mussa, senior fellow at the Institute, to talk about recent economic numbers and how they affect the near-term and medium-term outlook. Mike, what are some of the most important recent numbers that might affect the near-term forecast of the economy?

Michael Mussa: For the US, of course, the Commerce Department confirmed the 1.8 percent growth rate in the first quarter, which was lower than most people's expectations. And recent data, particularly for the labor market, have been weakening with the initial unemployment claims. This morning the ADP report came out, which showed relatively weak private job creation. We'll learn more about that on Friday with the Labor Department's regular monthly report.

Steve Weisman: We're speaking June 1st ?

Michael Mussa: Yes. So other economic data, durable goods, a variety of things suggest a weaker tone to the US economy, and this has been now quite general. A number of countries have reported significantly weaker manufacturing activity in May.

Steve Weisman: What's going on?

Michael Mussa: Things are slower than people expected, basically. Some of it-- Australia: it's the floods--where we got that first quarter data that showed that Japan was hit harder than most people estimated by the earthquake and tsunami in terms of the first quarter GDP.

Steve Weisman: There's also been some weather in the United States.

Michael Mussa: Yes, there are lots of stories and lots of events, but partly it's just that things are weaker than people expected. And we don't know entirely why.

Steve Weisman: Weaker than you expected too?

Michael Mussa: Certainly weaker than I expected, yes. I was a little above the sort of the consensus forecast, though not as much as I had been in the past couple of years.

Steve Weisman: The debate in Washington over what to do focuses on cutting the budget. That's a disagreement about how far to cut is holding up the talks over extending the debt limit. What's the outlook coming out of these discussions?

Michael Mussa: Even without further action, we have in store a significant tightening of fiscal policy by the federal government next year, because the two percentage point reduction in the payroll tax, which was part of the budget deal of December, goes away next year.

Steve Weisman: It goes away at the end of this calendar year?

Michael Mussa: At the end of this calendar year, yes. And similarly the expensing privileges for most business in-

vestment will disappear and they will return to the normal depreciation allowance framework. So those are significant increases in the effective tax rate as we move across the calendar year.

Steve Weisman: And on the spending side?

Michael Mussa: On the spending side, the fiscal tightening actually – [the measure that] they just recently passed-- does very little this year and has a little more of an impact next year. It's not big, though. It's probably on the order of \$15 or \$20 billion. But some of the things that were extended in the budget deal, the extended unemployment benefits and healthcare benefits and so forth, those will probably be trimmed back. They will not be renewed to the full extent for 2012. So there will be further tightening through the spending side even without any deal over the debt limit.

Steve Weisman: But there's also a lot of tightening going on in state and local governments.

Michael Mussa: Yes, they clearly have been continuing to cut back their spending and their employment levels. The budgetary situation is beginning to improve a little bit. Their revenues pick up with a bit of a lag after the recovery of the economy and it shows up in the budgeting process only after a year. So the fiscal year, which starts for most states and localities this July 1st, is still going to be very tight. By July 1st of next year it will depend on how the economy is doing, whether we get further reductions of employment in the state and local level, or if we return to at least some small increases.

Steve Weisman: Some liberal economists like Paul Krugman deride the idea that tightening and reducing the budget deficit is going to somehow impress the "confidence fairy," as he calls it --making people more confident about the future of the economy. That is vehemently disputed by those who think that interest rates and general confidence are affected by seeing that the government is consolidating. What do you think is going to be the real impact of the consolidation?

Michael Mussa: I'm expecting that it will slow things down a bit over the next 18 months relative to what would be the case if we were, say, maintaining the existing fiscal policy stance. But the stance is unsustainable in the longer term. We're just running too big a deficit. And we need at some point to begin bringing them down pretty significantly, or we will at some point begin to see a serious erosion of financial market economies.

Steve Weisman: The question always is what's the right point?

Michael Mussa: I think that we're probably getting it about right. We're getting a little bit of a boost this year and we're taking it back next year--on balance probably about right. But we can't keep on continuing to give the economy additional boosts. That's at some point--I think before very much longer--going to cause financial markets to begin to become more skeptical about the U.S. fiscal prudence in the long run.

Steve Weisman: And your latest sense of growth and unemployment numbers in 2012?

Michael Mussa: Well, I'm still hopeful that we'll get down to around 7 ½ percent.

Steve Weisman: On the unemployment?

Michael Mussa: On the unemployment rate. We're about 9, now. We'll get another measure on Friday, and we'll see. If the unemployment rate sticks above 8, as a general index of how the economy is performing, I think President Obama is going to have some real problems with re-election. If it gets down below 7 then Republican challengers are going to have a very steep hill to climb. My guess is we'll be somewhere between 7 and 8.

Steve Weisman: Thanks, Mike.