American Incoherence

Eric M. Leeper

Winston Churchill was a flaming optimist. He quipped that you can always count on America to do the right thing, once all the other possibilities have been exhausted. The recent debt ceiling debacle in Washington, D.C. reveals how innovative Americans can be in creating “other possibilities.” Things once thought to be impossible, are now possible—perhaps even probable.

On the heels of the Washington debacle, Standard & Poor’s concluded that the impossible has become possible when it downgraded U.S. treasuries from AAA to AA+. This is a new first: American government debt is no longer risk-free. Whether or not you agree with S&P’s assessment, the action must be taken seriously as an early signal of how financial market perceptions of American economic policies can change. Equity markets have since amplified that signal by moving sharply lower.

Of course, financial markets can be wrong. Maybe this time around American political leaders won’t feel impelled to try everything else before they arrive at the right thing.

I may be a flaming pessimist, but I see no reason for such a Panglossian outlook. American politics are as fractious as ever. Tea Partiers have tasted blood and are circling to sink their teeth deeper into the American body politic. The debt deal was a can-kicker that pushed hard choices into the future and didn’t begin to confront the big fiscal issues. Acknowledging that the political process is dysfunctional, the deal creates yet another “commission” to make policy recommendations, subject to the severe constraint that tax increases are off the table (according to Republicans, but disputed by Democrats).

But my pessimism stems more from looming economic realities. U.S. economic and job growth remain weak, while the drumbeat of recession grows strong. Another recession—or a Japanese-style malaise of prolonged slow growth—will further deteriorate federal government revenues to raise the fiscal deficit and feed into further debt downgrades.

Declining revenues at the state level will trigger more cuts in infrastructure and education spending. It is hard to imagine a state of the world in which this time around those cuts will be offset by federal stimulus dollars.

The Federal Reserve’s policy interest rate remains at its lowest possible level, leaving only unconventional operations—“quantitative easing”—to combat slow growth. Evidence on the effectiveness of those operations has been mixed. But the Fed is unlikely to take those actions in any case: Washington’s political environment has seriously undermined the Fed’s ability to make independent policy choices.

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And those are just the short-run problems. Lurking just below the surface in the United States and most advanced economies is the fiscal iceberg of unfunded old-age benefits. Ageing populations mean that in coming decades there are far fewer workers per retiree, so promised benefits far outstrip current funding plans. All the fuss about the debt ceiling is a sideshow, but a sideshow that informs how the political system will tackle the really big issues that loom in the future.

It won’t. Until the resulting crises can no longer be ignored or denied.

At a time when the economy cries out for short-term fiscal stimulus and credible long-term fiscal reforms, the political process spits out ambiguous fiscal consolidation in the short term and utter silence about the long term.

Political realities in Washington leave the United States with no coherent economic policy. S&P’s downgrade was not about America’s ability to honor its debts. With massive taxing capacity and plenty of room for spending reforms, America can solve its fiscal problems. The downgrade reflects S&P’s assessment of America’s political willingness to adopt coherent fiscal plans.

America is not Greece. There is no history of defaulting on debt. There is plenty of fiscal room to maneuver. Monetary policy is not made by a supranational entity like the European Central Bank.

Then why is America acting like Greece? Because the politics prevent a coherent alternative.

The Obama Administration’s economic policies have been incoherent from the outset. Within a week of passing an $800 billion stimulus package, President Obama pledged fiscal austerity. After the largest financial crisis since the Great Depression, the administration has done nothing to dissuade the perception that Wall Street is dictating the path of financial reforms. In the face of growing wealth inequality, the president extended tax cuts to the wealthiest Americans. This from a president the opposition labels “socialist.”

Obama’s incoherent economic narrative leaves a void that the Tea Party has filled with relish. The Tea Party narrative is easy to grasp: government is evil and the source of your economic woes; shrinking government—less spending, less regulation, less taxation—frees you to behave in your own self-interest; unfettered behavior produces the best outcomes. That nearly all of the Tea Party’s precepts are contradicted by historical evidence and economic reasoning does not diminish the appeal of the narrative for some voters.

In a bizarre way, the ruthless but consistent policies of the Tea Party harmonize with Obama’s aversion to conflict and his unflinching (and unexamined) faith in compromise.

Together they have delivered economic policy paralysis.

This may please Tea Party zealots, but it is unlikely to resonate well with other Americans. Nor is it reassuring to the rest of the world.