Contact: Mark Primoff
845-758-7412
primoff@bard.edu

FOR IMMEDIATE RELEASE

LOOMING AUTOMATIC TAX INCREASES AND BUDGET CUTS WILL HAVE DEVASTATING CONSEQUENCES FOR U.S. ECONOMY, LEVY STUDY SAYS

U.S. Policymakers Should Take Hard Look at the Failure of Austerity in Europe With Budget Control Act "Fiscal Cliff" Arriving in January

ANNANDALE-ON-HUDSON, N.Y.—On January 2, the U.S. Budget Control Act will take effect, with $500 billion in across-the-board budget cuts and tax increases. If these cuts are allowed to occur, the Congressional Budget Office predicts a recession for the U.S. economy in 2013. Despite that dire outlook, the demand to "live within our means" and fiscally conservative economic doctrine continues to garner support. A new paper from the Levy Economics Institute of Bard College argues that calls for American austerity represent a fundamental misunderstanding of the role and function of fiscal policy during times of weakness that will push the United States into a "fiscal trap"—a vicious cycle of mutually reinforcing forces that takes an economy from an initial position of weakness to the level of economic distress seen in the eurozone periphery.

"American austerity is precisely the wrong policy at precisely the wrong time," write Levy President Dimitri B. Papadimitriou and Research Scholar Greg Hannsgen in their new Public Policy Brief, *Fiscal Traps and Macro Policy after the Eurozone Crisis.* "Austerity policies can only make a recession worse, as government layoffs and wage cuts undermine already-weak consumer demand, investment, and tax revenues."

In their paper, Papadimitriou and Hannsgen write that U.S. policymakers should repeal the budget sequester and focus on prudent fiscal stimulus policies to promote growth and prevent the U.S. economy from entering into the vicious cycle of a fiscal trap. The push for austerity in the United States, they write, represents a misunderstanding of three crucial points: the results of austerity in Europe, the differences between economies whose currencies are constrained versus sovereign-currency countries, and the consequences of federal spending cuts in the current economic environment. Looking at Europe, they note that austerity measures, which had been prescribed as an economic cure, have been disastrous, with unemployment reaching record levels (25.1 and 24.4 percent, respectively,

-continued-

in Greece and Spain). The authors maintain that austerity policies there have made the recession worse by pushing countries into a "fiscal trap"—a self-imposed, self-reinforcing spiral of economic contraction, the basic version of which they describe as a "cycle that moves from a decline in demand to falling tax revenues, which in turn engender spending cuts and tax increases. Spending cuts and tax increases undercut the economy further, and the cycle continues." Papadimitriou and Hannsgen contend that the trap in EU countries is exacerbated by a unified currency that, because it prevents individual countries from regulating their currencies and interest rates, creates a situation in which fears of a government default push interests rates higher, which in turn increases the cost of servicing debt, which raises deficits, which then raises greater fears about default.

Countries with a sovereign currency and flexible exchange rates, like the United States, have the ability to use open market operations to keep interest rates stable and control the cost of servicing debt, the authors argue. "Providing solvency in times of economic weakness is a traditional, even ancient, role of central banks," write Papadimitriou and Hannsgen. "Central banks ensure that central governments can make all of their scheduled payments on debt denominated in their own currencies and at the same time permit their monetary authorities to set interest rates at desired levels. This is both a prudent and a proven system, but its distinctive workings are sometimes forgotten in times of economic turmoil."

Because the U.S. government faces no "solvency constraint" on its spending and tax policies and has successfully managed its debt in the past, policymakers can and should use fiscal policy to promote growth and full employment, and thus escape the fiscal trap. They argue that U.S. observers frequently misconstrue the big issue facing the economy as a failure to control spending, whereas there is strong evidence showing that tax revenue losses due to financial crisis have had a much larger impact. Specifically, the Levy scholars recommend, among other steps, repealing and not replacing the budget sequester, keeping the payroll tax holiday, and creating stabilizers to ensure spending is increased appropriately and responsibly when the economy contracts. Examples include creating an employer-of-last-resort policy, an infrastructure banking agency, and countercyclical assistance to state and local governments. The $500 million budget cuts and tax increases to take effect in January will push the U.S. economy into recession and a self-defeating fiscal trap, they write. "The current outlook for the US economy is dire, unless the federal government uses fiscal stimulus policy to increase total demand and employment. As John Maynard Keynes advised, 'The boom, not the slump, is the time for austerity,'" they write. "The failure of Pollyannaish orthodox economics, the same perspective that brought us the financial crisis and the Great Recession of 2007–09, to provide an effective strategy for economic growth argues for another approach."

# # #

Public Policy Brief No. 127: *Fiscal Traps and Macro Policy after the Eurozone Crisis*

(10.27.12)

To read the full text of this policy paper, go to http://www.levyinstitute.org/publications/?docid=1592.