Spending Battle Clouds Outlook for U.S. Growth

Without a deal this fall, programs vital to voters could face cuts, boosting pressure on lawmakers from both sides of the aisle

By Kate Davidson April 7, 2019 7:00 a.m. ET

One of the big unknowns for U.S. economic growth heading into the presidential election year needs to be sorted out by lawmakers in the coming months: the path for government spending.

Lawmakers agreed to cap spending in 2011 as part of a bruising fight over raising the debt limit, but they have struck three separate deals since then—in 2013, 2015 and 2018—to ease those caps and increase spending. The latest two-year deal, which boosted funding nearly $300 billion above the caps, expires in October.

If Congress doesn't reach another deal by then, the spending limits known as the sequester would kick back in, reducing discretionary spending by $125 billion, or 10%, from 2019 levels.

The path of federal spending has had an important impact on growth in this expansion. In quarters when discretionary spending was contracting, mostly between 2011 and 2014, the economy grew at a 2% rate. When it was expanding, including during the past two years, economic output has expanded at a 2.5% rate.

While it makes up only about a third of the federal budget, discretionary spending—the part of the budget Congress must approve each year—includes many of the programs and services voters care about, such as funding for the military, schools, clean water, cancer research, airport security and national parks. It doesn't include mandatory programs like Social Security and Medicare.

That provides lawmakers on both sides of the aisle a strong incentive to avoid new cuts.

"I think the spending caps will almost certainly be increased because Republican voters and Democratic voters want safe food, highways to drive on, national parks, the borders patrolled and other things that appropriations pay for," said Douglas Elmendorf, a former Congressional Budget Office director and dean of the Harvard Kennedy School. "The longer that we squeeze out those activities, the bigger the damage becomes."

Analysts in Washington and on Wall Street widely expect Congress to reach a bipartisan deal to extend current funding levels before the election cycle heats up. But they aren't ruling out the possibility that heightened tension between the White House and Democrats—on everything from immigration policy to the president's tax returns to the Russia probe—could get in the way of a new budget deal this fall.

The Congressional Budget Office estimates growth in year-over-year economic output would slow to 1.7% in 2020 if the automatic spending cuts kick in, down from a projected 2.3% in 2019 and 3.1% in 2018.

Extending the current budget deal—increasing spending only to adjust for inflation—would result in 2.2% annual GDP growth, according to Ernie Tedeschi, an economist at Evercore ISI, an investment research firm.

Fiscal stimulus has provided a boost to economic output since mid-2017, after weighing on GDP in the years following the financial crisis, when government spending contracted amid efforts to rein in federal deficits. Last year, federal spending contributed 0.17 percentage point to overall GDP growth. By contrast in 2013 it subtracted 0.44 percentage point.

Goldman Sachs economists say a return to sequester spending levels, or a partial sequester, could prompt a dramatic growth slowdown. While fiscal policy—including the tax law and spending deal—was adding more than half a percentage point to growth in the middle of last year, failure to reach a new budget deal could subtract nearly half a percentage point from GDP by the middle of 2020, at the height of the presidential campaign.

“We believe the probability of no deal—which would result in a cut in spending authority of 0.6% of GDP—is much greater than the probability of a substantial boost from current levels,” Goldman economist Alec Phillips said.

Spending contributes to growth in the short-run by pumping money into projects like highways or a researcher’s pay. Many Republicans say government-spending programs hurt the economy in the long-run because they are inefficient, while many Democrats say investments in roads or research improve worker productivity and growth in the long-run.

The House will take the first step toward a new deal as soon as this week when it votes on a bill that would boost defense and nondefense spending in 2020 by $88 billion each above the 2011 caps, providing a 2.6% increase for defense and a 5.6% increase for nondefense over 2019 levels.

Senate Republicans have said they plan to seek funding for the military above the current spending caps, but acknowledged Democrats have traditionally sought to match those increases with similar boosts for nondefense spending programs.

More difficult to predict is what the White House will do. President Trump’s budget last month proposed keeping discretionary spending at the capped levels, but effectively exempting the military from cuts by boosting an emergency war fund that isn’t subject to spending limits.
Administration officials have signaled the president, who bemoaned the large increases to nondefense spending in last year’s budget deal, may take a tougher position this time around by using the threat of the sequester to get what he wants. Congress must also fund the government by the end of September to avoid another shutdown, and raise the federal borrowing limit, which could complicate negotiations if the White House digs in.
Some Democrats were skeptical the strategy would work or that Mr. Trump would stick to it.

“If leverage means the threat of shutting our government down or defaulting on our debt, yeah they would have more leverage,” House Budget Committee Chairman John Yarmuth (D., Ky.) said Thursday. “Whether that’s something they really want to try to do, heading into an election year, it’s pretty stupid, as far as I’m concerned. It would be self-defeating.”

If he’s right, a deal for more spending is on the horizon.