FINANCIAL TIMES

Doubt cast on 'wisdom' of plan for cuts

By James Politi in Washington

November 11 2010

The call from Erskine Bowles and Alan Simpson, co-chairs of the fiscal commission, for massive restraint in US government spending to cut the budget deficit seems at first glance to be at odds with economic reality.

The US economy is suffering from 9.6 per cent unemployment and sluggish third-quarter growth of 2 per cent . While policymakers and politicians in Washington have spent a lot of time talking about reducing the deficit, their immediate concern has been how to stimulate the economy.

Last week, the Federal Reserve announced plans to inject some $600bn into the economy through a new round of government bond purchases, in the hope that lowering borrowing costs will spur the recovery.

Meanwhile, on Capitol Hill, Democrats and Republicans argue over the extension of more than $3,000bn in Bush-era tax cuts, which will stimulate the economy in the short-term but add significantly to the deficit during the next decade.

Mr Bowles and Mr Simpson have said they did not want to "disrupt a fragile economic recovery". The cuts will not begin until fiscal year 2012 and will be somewhat modest that year, accounting for $69bn of the $3,831bn in total savings that will be achieved during the next 10 years, according to their plan.

They will more than double to $158bn in 2013, bringing the deficit down to 3.5 per cent by then, and accelerate from there – with $255bn in cuts in 2014 and $372bn in 2015. By 2020, cuts will amount to $761bn under the draft by Mr Bowles and Mr Simpson, and the budget deficit will be 1.6 per cent of GDP.

But critics question whether – because of the plan's sheer size and signal of looming austerity – even these gradual and back-ended budget cuts could hurt the US economy.

"I question the wisdom of using this period as the starting point with which to quantify how many trillions in spending cuts and revenue increases will be necessary over the next 10 years to correct both the cyclical and structural imbalances in the budget," said **Bernard Baumohl,** chief global economist at the Economic Outlook Group in Princeton, New Jersey.

"Clearly reforms are needed, but the scale of the proposed changes needed to restore some budgetary discipline is so huge that it will affect every American in a dramatic and material way for decades to come."

The co-chairs calculate that lawmakers will be much more concerned by the possibility that the US could face the prospect of higher interest rates in the future and even a potential international bond market shock if they fail to act.

John Canally, economist at LPL Financial, said the plan's simplified tax code could help business and households plan better. But he also added: "None of this is going to be implemented until 2013 – and if we go back into recession this has to be put off the table."