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The debt-ceiling deal

# No thanks to anyone

WASHINGTON, DC

America has avoided default, but political dysfunction is threatening its chances of economic recovery. Over five pages, we survey the sorry state of things

**T**HE deficit-reduction deal that finally raised America's debt ceiling and staved off the threat of default seemed to make no one happy. "A sugar-coated Satan sandwich," one Democratic congressman called it. Republican candidates for president lined up to denounce it.

But even less popular than the deal itself was the process that led up to it: months of partisan wrangling, broken deals and brinkmanship, with the threat of default hanging over an economy struggling to grow. "Our economy didn't need Washington to come along with a manufactured crisis to make things worse," Barack Obama noted as he signed the deal into law on August 2nd—the day the Treasury had warned that it would run out of cash to meet its obligations.

The deal, hammered out just days before that deadline, promises \$917 billion in spending cuts over the next decade in return for a two-stage increase in the debt ceiling of \$900 billion. After that, a 12-member congressional committee, equally composed of Republicans and Democrats, is to find \$1.5 trillion in further deficit reductions that Congress must approve by December 23rd, in return for a similar-sized increase in the debt ceiling. If the committee fails to reach agreement or its proposal is rejected, \$1.2 trillion in spending cuts will be triggered, drawn equally from domestic spending and defence.

This is far from a lasting solution to America's climbing debt. Neither Republi-

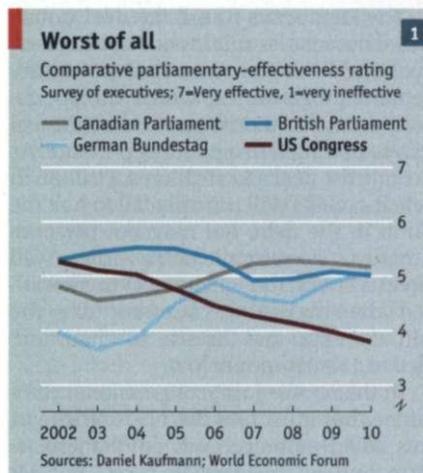
cans nor Democrats were forced to slaughter their sacred cows. Republicans kept higher taxes off the table, and Democrats did the same with the biggest entitlements: Medicaid (the federal-state health programme for the poor), Social Security (pensions) and most of Medicare, the federal health programme for the elderly. The deal also threatens to tighten fiscal policy further in 2012, when the recovery is still struggling to establish itself.

It marks, too, another deeply worrying change. The willingness of one party to use the threat of default, if not on government bonds then on other federal obligations such as pensions and pay-cheques, marked a dangerous escalation in the par-

tisan rancour that has come to bedevil policymaking. It is not just big, controversial things like tax reform and climate change that fall victim to gridlock, but smaller, routine matters where disagreements are often slight. Since 2007 the Federal Aviation Administration has operated on no less than 20 short-term funding authorisations; the latest finally ran out on July 22nd because of a congressional dispute, forcing the layoff of thousands of workers and a halt to airport building projects (see page 27). Many regulatory positions remain vacant because Senate Republicans are blocking appointments to them. Free-trade agreements with Colombia, South Korea and Panama, supported by both parties, have been stalled because the Democrats want ratification linked to renewal of a worker-training programme and Republicans do not.

American politics has always been fractious; that is part of its strength. Checks and balances prevent abuse of power and compel compromise. But checks and balances combined with polarisation allow a small number of legislators to bring government to a halt. Businessmen always and everywhere complain about politicians, but what is happening now in America seriously bothers them. Daniel Kaufmann of the Brookings Institution, examining surveys by the World Economic Forum, notes that the confidence of American business executives in their legislature has fallen steadily since 2002, while that of their Canadian, British and German peers has not (see chart 1). America's ranking in an annual World Bank survey of governance indicators has also fallen steadily since 2000. It then ranked 15th for "government effectiveness". In 2009 it was 24th.

More than anything, businesses have hated the uncertainty of the weeks of posturing over the debt, which has caused many of them to put their plans on hold. ••



- Yet now that the stalemate is resolved and the deal signed, uncertainty is still rife—because the polarisation that made the stand-off possible is as sharp as ever.

It has been a long time forming. Most congressional seats are safely in the hands of one of the two parties, thanks to gerrymandering. The real election for many congressmen is the primary, when any representative who strays too far from the party line will face a challenge from an ideological purist. The Democratic landslide of 2008 and the Republican one of 2010 have also helped to weed out many centrists. The present House, according to *Congressional Quarterly*, a sister publication of *The Economist*, is the most starkly divided yet, with even the most liberal Republican now somewhere firmly to the right of the most conservative Democrat.

Economic weakness reinforces this dogmatism. Democrats blame the crisis on deregulation and private greed, and find it especially heartless to cut social services when the ranks of poor and jobless are growing. Republicans blame the weak recovery on misguided Keynesian pump-priming and government overreach, and think higher taxes perverse when the economy is struggling. Many on both sides conclude that their different visions of society cannot be reconciled. Voters will have to choose between them: defenders of the rich in the Republican corner, reckless spendthrifts in the Democratic one.

#### Les grandes illusions

Pundits and political wise men have long dreamed of a "grand bargain", which would arrest the growth of entitlement spending while raising tax revenue by closing loopholes. It is more or less the only formula that solves America's budget woes while sharing political pain equally between the two parties. It is no coincidence that such a bargain lies at the heart of most recent bipartisan deficit-reduction schemes, including those put forward by the Senate's "Gang of Six" and the president's own fiscal commission. Both plans would have cut the deficit by roughly \$4 trillion over the next decade, enough to put



Next year's Democratic rallying cry

the debt on a downward path relative to GDP. Many hoped the debt-ceiling increase would be the vehicle to deliver it.

But Mr Obama, despite much talk about the need for long-term fiscal consolidation, has done little to advance it. He ignored his commission's findings, and instead proposed a budget in February that left entitlements untouched. As for the Republicans, they have been as obdurate as Mr Obama was feckless. They walked out of negotiations no fewer than three times over the summer because the Democrats had the temerity to propose tax increases. Mr Obama and John Boehner, the Republican speaker of the House, came close to striking a grand bargain a few weeks ago that would have reformed entitlements and tamed future deficits; but they fell out, both sides agree, on the subject of tax.

The result was a deal that neither side believes can fix the deficit. All \$917 billion of the immediate spending cuts comes from discretionary outlays: items such as defence, law enforcement and research, which must be authorised each year by Congress. Spending on these was already heading downwards (see chart 2), and the deal accelerates the decline.

The Democrats found the deal unbalanced because it contains no tax increases. But nor does it guarantee changes to entitlement programmes, which do not require annual authorisation and are the real source of long-term spending pressure. As a result, the deal's \$2.1 trillion–2.4 trillion in deficit savings will not only fail to halt the climb in the debt, but may not preserve America's A A A credit rating either. Wall Street is jittery; though the stockmarket rallied when the deal was announced, by the end of August 2nd the S&P 500 had tumbled to a seven-month low.

In theory, the joint congressional committee that must find the next tranche of cuts could embrace both entitlement reform and an increase in taxes. But Mr

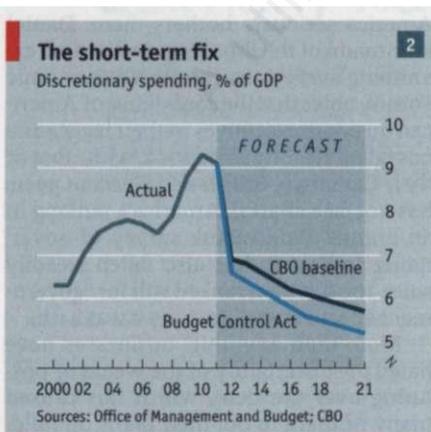
Boehner and Mitch McConnell, the Republican minority leader in the Senate, have made it clear that they do not want the committee to pursue tax increases. Since they will appoint the six Republican members, and since at least one Republican vote will be needed to put the committee's recommendations to Congress as a whole, they can presumably get their way. Democrats, in turn, have made it clear that they will not allow cuts to entitlements unless the Republicans give ground on taxes.

The debt deal's triggers are meant to be fearsome enough to prevent that kind of deadlock. But for many Republicans, voting for a tax increase would be a bigger sin than allowing vicious cuts in the defence budget. Many Democrats, in turn, think they have been too quick to compromise in recent budget battles and are determined to call the Republicans' bluff for once. Some—Mr Obama among them—welcome the idea of campaigning for next year's elections with huge and doubtless unpopular budget cuts looming, while the rich are spared any rise in taxes.

Furthermore, there is always the chance that Congress, when faced with big cuts to cherished programmes, will simply reverse itself and disconnect the triggers. Past schemes designed to instil fiscal discipline have frequently come unstuck sooner or later. The triggers are meant to be pulled on December 23rd, but if no agreement has been reached, the cuts do not take effect for over a year after that, leaving Congress plenty of time to reconsider.

#### Small comforts

Mr Obama did secure his priorities: the debt ceiling will not be an issue again until after the next election, and programmes for the poor were largely protected. He did not fully shield the recovery, though. Michael Feroli of JPMorgan Chase reckons the spending caps will subtract 0.3 percentage points from growth in 2012 (see chart 3). ••



• Fiscal policy was already on course to knock 1.4 points off growth, as last year's payroll-tax cut and extension to unemployment benefits reach their expiry date. Administration officials hope to persuade Congress to keep both for one more year. But if they fail, then fiscal tightening poses a serious obstacle for an economy already growing at "stall speed": that is, slowly enough to fall back into recession.

The president counts as perhaps his biggest victory the reprieve from debt-ceiling blackmail for two more years. To be sure, the Republicans holding out against an increase assumed, probably correctly, that the Treasury would have found a way to pay interest on the debt. But it would have had to default on many other obligations. That the Republicans deployed such a threat so successfully will encourage both parties to try it again. Indeed, Mr McConnell proudly declared the strategy "a new template". "In the future", he added, "any president, this one or another one, when they request us to raise the debt ceiling, it will not be clean any more...we will go through the process again and see what we can continue to achieve."

The two parties' disagreements on economic policy are likely to surface time and again between now and the election. Besides the various votes on whatever the joint committee comes up with, a budget is due by October 1st; part of the petrol (gasoline) tax is up for renewal next month; unemployment benefits will become much less generous at the end of the year; and the tax cuts enacted under George Bush and extended last year will expire again at the end of 2012. Each of these events will provide an excuse to repeat all the partisan posturing of the past few months.

The outlook, then, is that America's political dysfunction will only get worse, and with it the burden on economic growth. Some may think that too gloomy a view. The debt-ceiling farrago showed that old-fashioned bargaining could still work, and both Mr Obama and Mr Boehner showed themselves open to a grand bargain, if only for a time. A day after the debt deal, Senate leaders reached a sort of pact on moving

the free-trade agreements forward.

Round the country, too, there are gleams of useful reform. Both Florida and California are experimenting with less partisan forms of redistricting, which should lead to more competitive elections in which congressmen have to cater to the average voter rather than the extreme wings of their parties. If other states follow suit, it could slowly reverse the ideological duopoly that has taken over the House. Even without that, many tea-party Repub-

licans, who won their seats in districts that were recently Democratic, have a high risk of being turfed out next year if they fail to learn the fine art of compromise.

But all that is 15 months in the future. And congressmen who have left Washington in a glow of relief and self-congratulation should have no illusions. The political dysfunctionality of America has been on display as never before, to the nation's shame. And it can still do plenty of harm to a very sick economy.

## The Federal Aviation Administration

# Wings clipped

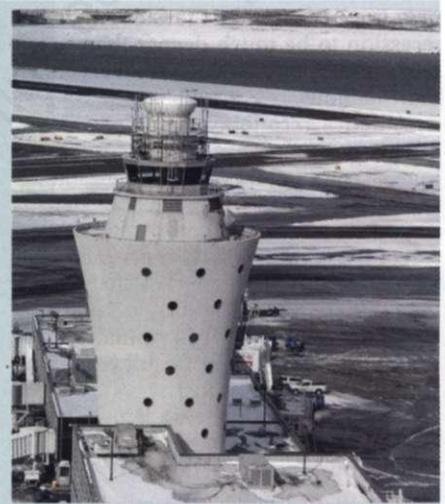
NEW YORK

A worked example of the effects of congressional stupidity

AFTER he had signed the debt-ceiling deal, Barack Obama mentioned "another Washington-inflicted wound on America". He was speaking about the impasse over funding for the Federal Aviation Administration (FAA), which manages air safety and air-traffic control. Congressmen could not resolve a petty disagreement over the extension of the agency's operating-authority bill, which expired on July 22nd. As a result, the agency has partly shut down, and 4,000 employees have been sent home. Air-traffic controllers are still on the job, as they are paid from a different source. But scores of FAA construction and research projects have been halted, affecting at least 70,000 workers. "Members of Congress should not get on a plane to fly home for vacation without passing an FAA bill and putting thousands of people back to work," said Ray LaHood, the transport secretary. His words were drowned in the rush for the doors.

The FAA's long-term funding bill expired in 2007. Since then Congress has passed, with little fuss, 20 stopgap bills, each lasting a few months. This time round, politicians could not agree on seemingly minor provisions. House Republicans passed a bill that cut \$16.5m in federal subsidies for passengers at a dozen remote rural airports, something the Senate Democrats oppose. They also oppose a measure that would make it more difficult for airline workers to unionise. Because of this impasse over \$16.5m a year, the government is losing \$30m a day in uncollected federal taxes on airline tickets.

A long shutdown could cost taxpayers more than \$1 billion by next month. And passengers are not even enjoying a tax holiday at the airport, as most airlines have raised fares by an equal 7.5% (though Delta and US Airways are promising, shamefaced, to refund the money to customers). Jamie Baker of JPMorgan



LaGuardia's old tower, now partly down

estimates that the daily benefit to the airline industry could approach \$25m.

For laid-off workers, the picture is less rosy. They are unlikely to get back to work before September. That worries Luca Toscano of Paul J. Scariano, a contractor on a \$6m stalled demolition project at LaGuardia airport. He estimates that 70 jobs may be at risk there. A new tower was opened in January; the old one is being dismantled to improve sightlines. Two storeys have been removed, and an abandoned digger now sits on top of the partly dismantled tower. More than 200 stop-work orders have been issued across the country, suspending \$10.5 billion-worth of projects in the middle of the building season.

Meanwhile, 40 FAA airport safety inspectors are working without pay. They are flying from airport to airport, checking runways and monitoring airfields. What is more, they are travelling on their own dime, hoping they will be reimbursed when the shutdown ends. If only a similar unselfishness prevailed on Capitol Hill.

