

# US economy is already on the edge – a prolonged government shutdown could send it tumbling over

John W. Diamond, Director of the Center for Public Finance at the Baker Institute, Rice University

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It's a long way down.

*IAISI/Moment via Getty Images*

The economic consequences of the current federal government shutdown hinge critically on how long it lasts. If it is resolved quickly, the costs will be small, but if it drags on, it could send the U.S. economy into a tailspin.

That's because the economy is already in a precarious state, with the labor market struggling, consumers losing confidence and uncertainty mounting.

As an economist who studies public finance, I closely follow how government policies affect the economy. Let me explain how a prolonged shutdown could affect the economy – and why it could be a tipping point to recession.

## Direct impacts from a government shutdown

The partial government shutdown began on Oct. 1, 2025, as Democrats and Republicans failed to reach a deal on funding some portion of the federal government. A partial shutdown means that some funding bills have been approved, entitlement spending continues since it does not rely on annual appropriations, and some workers are deemed necessary and stay on the job unpaid.

While most of the 20 shutdowns that occurred from 1976 through 2024 lasted only a few days to a week, there are signs the current one may not be resolved so quickly. The economy would definitely take a direct hit to gross domestic product from a lengthy shutdown, but it's the indirect impacts that could be more harmful.

The most recent shutdown, which extended over the 2018-2019 winter holidays and lasted 35 days, was the longest in U.S. history. After it ended, the Congressional Budget Office estimated the partial shutdown delayed approximately US\$18 billion in federal discretionary spending, which translated into an \$11 billion reduction in real GDP.

Most of that lost output was made up later once the shutdown ended, the CBO noted. It estimated that the permanent losses were about \$3 billion – a drop in the bucket for the \$30 trillion U.S. economy.



Many parks, such as Florida's Everglades National Park, were closed as a result of the shutdown.

*AP Photo/Rebecca Blackwell*

## **The indirect and more lasting impacts**

The full impact may depend to a large extent on the psychology of the average consumer.

Recent data suggests that consumer confidence is falling as the stagnation in the labor market becomes more clear. Business confidence has been mixed as the manufacturing index continues to indicate the sector is in contraction, while other business confidence measures indicate mixed expectations about the future.

If the shutdown drags on, the psychological effects may lead to a larger loss of confidence among consumers and businesses. Given that consumer spending accounts for 70% of economic activity, a fall in consumer confidence could signal a turning point in the economy.

These indirect effects are in addition to the direct impact of lost income for federal workers and those that operate on federal contracts, which leads to reductions in consumption and production.

The risk of significant government layoffs, beyond the usual furloughs, could deepen the economic damage. Extensive layoffs would shift the losses from a temporary delay to a more permanent loss of income and human capital, reducing aggregate demand and potentially increasing unemployment spillovers into the private sector.

In short, while shutdowns that end quickly tend to inflict modest, mostly recoverable losses, a protracted shutdown – especially one involving layoffs of a significant number of government workers – could inflict larger, lasting impacts on the economy.

## **US economy is already in distress**

This is all occurring as the U.S. labor market is flashing warnings.

Payrolls grew by only 22,000 in August, with July and June estimates revised down by 21,000. This follows payroll growth of only 73,000 in July, with May and June estimates revised down by 258,000. In addition, preliminary annual revisions to the employment data show the economy gained 911,000 fewer jobs in the previous year than had been reported.

Long-term unemployment is also rising, with 1.8 million people out of work for more than 27 weeks – nearly a quarter of the total number of unemployed individuals.

At the same time, AI adoption and cost-cutting could further reduce labor demand, while an aging workforce and lower immigration shrink labor supply. Fed Chair Jerome Powell refers to this as a “curious kind of balance” in the labor market.

In other words, the job market appears to have come to a screeching halt, making it difficult for recent graduates to find work. Recent graduate unemployment – that is, those who are 22 to 27 years old – is now 5.3% relative to the total unemployment rate of 4.3%.

The latest data from the ADP employment report, which measures only private company data, shows that the economy lost 32,000 jobs in September. That’s the biggest decline in 2½ years. While that’s worrying, economists like me usually wait for the official Bureau of Labor Statistics numbers to come out to confirm the accuracy of the payroll processing firm’s report.

The government data that was supposed to come out on Oct. 3 might have offered a possible counterpoint to the bad ADP news, but due to the shutdown BLS will not be releasing the report.

## **Problems Fed rate cuts can’t fix**

This will only increase the uncertainty surrounding the health of the U.S. economy. And it adds to the uncertainty created by on-again, off-again tariffs as well as the newly imposed tariffs on lumber, furniture and other goods.

Against this backdrop, the Fed is expected to lower interest rates at least two more times this year to stimulate consumer and business spending following its September quarter-point cut. This raises the risk of reigniting inflation, but the cooling labor market is a more immediate concern for the Fed.

While lower short-term rates may help at the margin, I believe they cannot resolve the deeper challenges, such as massive government deficits and debt, tight household budgets, a housing affordability crisis and a shrinking labor force.

The question now is not will the Fed cut rates, because it likely will, but whether that cut will help, particularly if the shutdown lasts weeks or more. Monetary policy alone cannot overcome the uncertainty created by tariffs, the lack of fiscal restraint, companies focused on cutting costs by replacing people with technology, the impact of the shutdown and the fears of consumers about the future.

Lower interest rates may buy time, but they won’t solve these structural problems facing the U.S. economy.

John W. Diamond does not work for, consult, own shares in or receive funding from any company or organization that would benefit from this article, and has disclosed no relevant affiliations beyond their academic appointment.

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