Economic Outlook

January 31, 2013

- Having successfully navigated the tax portion of the "fiscal cliff," Congress now faces a "fiscal cul-de-sac" where elected officials go round-and-round without making progress on additional deficit reduction.
- The greatest near-term political risk is that Congress will use upcoming deadlines in an attempt to force action on the deficit that stands little chance of success.
- Focus on the short-term political dynamics can obscure the very real costs associated with a failure to reach a long-run agreement in 2013.

The Fiscal Cul-de-Sac

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Fundamental disagreement concerning the size, timing, and composition of deficit reduction is likely to leave U.S. fiscal policy in a state of paralysis over the near-to-medium term. Rather than a "fiscal cliff," Washington must now grapple with a "fiscal cul-de-sac," where elected officials go round-and-round without making progress. A number of upcoming legislative deadlines provide Congress with an opportunity to try and dislodge the stalemate, despite the long odds of success. The fervor with which these opportunities are pursued is likely to be a key source of political risk in 2013-2014 that could potentially erode business and consumer confidence and generate volatility in financial markets. Yet, focus on the near-term political risks obscures the very real long-run fiscal problems facing the country. It is far from obvious that the country would be better off if deficit concerns were simply put aside for the time being.

Near-Term Legislative Outlook

In early January, President Obama signed the "American Taxpayer Relief Act Of 2012," which resolved the tax-related portion of the fiscal cliff through permanent extensions of most existing individual tax rates and tax increases on higher-income Americans. The legislation is expected to reduce deficits by nearly $700 billion, on a cumulative basis, over 10 years.[1] The law also postponed implementation of the $110 billion in spending cuts mandated by the Budget Control Act of 2011 (aka "sequester"). Following enactment, attention turned immediately to a potential fight over the statutory debt limit, which is expected to disrupt Treasury cash management by early March.[2] Congress responded by passing a bill to "suspend" the debt ceiling through May 18 to provide each chamber with time to pass a budget resolution. Despite its preference for a long-run extension, the Obama Administration offered its formal support for the bill.[3]

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[1] Congressional Budget Office, "The 'Fiscal Cliff' Deal," January 4, 2013.
[2] U.S. Treasury, Secretary Geithner Sends Debt Limit Letter to Congress, January 14, 2013.
[3] See "Statement of Administration Policy, H.R. 325 – Temporary Suspension of Debt Ceiling."

The calm following passage of the fiscal cliff and debt limit legislation is likely to be short-lived. On March 1, the mandated $86 billion in spending cuts are scheduled to take effect; on March 27, the continuing resolution that funds the government is set to expire; April 15 is the deadline for a Congressional budget resolution, as established by the Budget Act of 1974; and May 18 is the date the Treasury Department will once again have to rely on "extraordinary measures" to manage cash balances and avoid a technical default or late payment. While these calendar dates could optimistically be viewed as potential catalysts for a comprehensive deficit reduction package, they are better analogized to landmines. The parties appear to have fundamental differences on the likely shape and size of future deficit reduction, and have not successfully packaged tax increases for spending restraint thus far. When compromises have been made, they have generally *increased* the deficit, as Democrats and Republicans have traded less revenue for more spending. The political calendar is likely to generate considerable "rollover risk," as the continued operation of the government is likely to depend on Congress' ability to repeatedly enact a series of short-term extensions to appropriations and the debt ceiling.

Sources of Disagreement

It appears unlikely that Congress will agree to a long-term deficit reduction package because of profound disagreement on three key issues: (1) the optimal size of the deficit reduction package; (2) the timing of the spending cuts and the tax increases the package would contain; and (3) the composition of the package, with particular focus on the relative balance between additional spending cuts and revenues.

(1) The Optimal Size of Fiscal Consolidation

There is no unanimity on the threshold question of whether Congress should pursue deficit reduction at all. To many, concerns about "debt overhang" seem entirely misplaced given the Treasury's ability to borrow at sharply negative real interest rates.[4] Last year, net interest expense amounted to just 1.5% of GDP, 0.5% of GDP less than in 2000 when the federal government was running a large surplus.[5] Most "austerity" packages are motivated by rising borrowing costs that raise solvency concerns or threaten the sovereign's ability to access funding markets. With no evidence that the bond market is clamoring for action, deficit reduction could actually prove counterproductive if it reduces aggregate demand in an economy already operating well below capacity.

While opponents of *any* deficit reduction are in a distinct minority, many observers argue for relatively modest additional adjustments. With continued economic growth, the additional revenue from high earners contained in the fiscal cliff deal, the expiration of the 2010-2011 payroll tax holiday, new Affordable Car Act surtaxes, and $1.2 trillion in cumulative spending cuts from the Budget Control Act, the federal deficit could fall to 3% of GDP by 2015 – a level consistent with a stabilization of debt-to-income ratios at close to 80% of GDP.[6] The Center on Budget and Policy Priorities (CBPP) argues that a relatively modest $1.2 trillion of additional deficit reduction (over ten years) is all that is required to stabilize debt ratios at current levels of 73% of GDP by 2022 (the end of the 10-year forecast window).[7]

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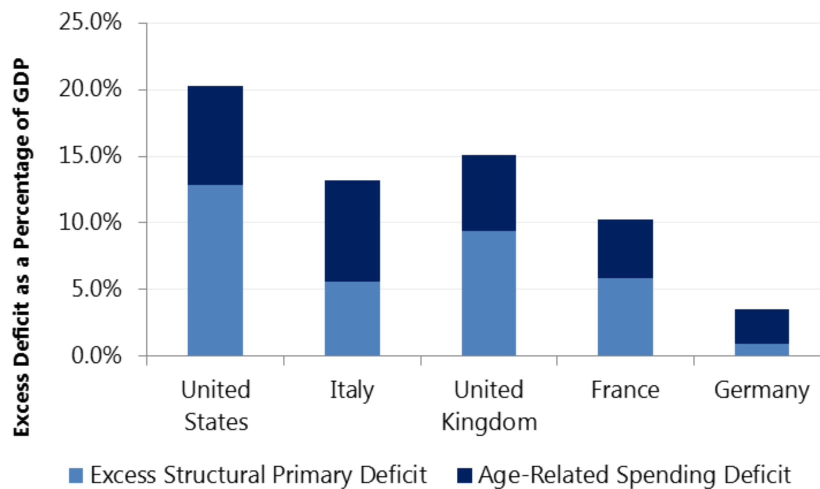
[4] C.f. Krugman, P. (2013), "The Dwindling Deficit," *New York Times*.
[5] Congressional Budget Office, Historical Budget Data, January 2012.
[6] Calculated from CBO, August 2012 Baseline.
[7] Kogan, R. (2013), "To Stabilize the Debt, Policymakers Should Seek Another $1.4 Trillion in Deficit Savings," Center on Budget and Policy Priorities. The $1.2 trillion is in reference to policy changes to the primary balance (net of interest costs).

Those seeking substantially larger deficit reduction highlight two deficiencies in these arguments. First, interest rates are unlikely to serve as a reliable signal for fiscal policy in the context of the Fed's open market operations. Between 2008 and the second quarter of 2011, the Fed acquired $1.14 trillion, or one-third, of the $3.37 billion in net new debt issued by the Treasury Department.[8] Thereafter, the Fed launched the Maturity Extension Program (MEP), which consumed nearly 60% of the net increase in Treasury notes and bonds during its operation and caused the 10-year Treasury yield to fall from an average of 3% in July 2011 to 1.72% in December 2012.[9] Today, the Fed routinely buys twice as much debt in a given week as the Treasury used to issue in 2008, which has led the Fed's balance sheet to expand at an annual rate in excess of $1 trillion. Under these circumstances, it is not reasonable to expect Treasury yields to provide unbiased information concerning the optimal debt accumulation path for the economy.

Figure 1: Primary Balance Adjustment Necessary to Reduce 2030 Debt to 60% of GDP [10]



Second, since entitlement costs grow faster than the economy, the shorter the time horizon for debt stabilization, the smaller the necessary fiscal adjustment. Policies necessary to stabilize debt ratios at current levels by 2022, for example, would be grossly inadequate to stabilize debt ratios by 2030. [11] Future debt not only burdens future generations; the recent empirical literature makes it clear that excess debt slows growth rates, even in situations where real interest rates remain low.[12] If policymakers took this threat seriously and aimed to stabilize long-run debt ratios at levels closer to 60% of GDP – the prudential threshold established by the Maastricht Treaty that established the euro – they would find that the cumulative deficit reduction required to reach this target is actually much greater in the U.S. than in any advanced economy other than Japan (**Figure 1**). The U.S. runs a structural primary deficit that is three-times larger than those in the five largest European economies and faces retiree health and pension cost growth that is four-times as large, on average.[13] The more favorable demographics in the U.S. are more than offset by more generous retiree benefit schedules.

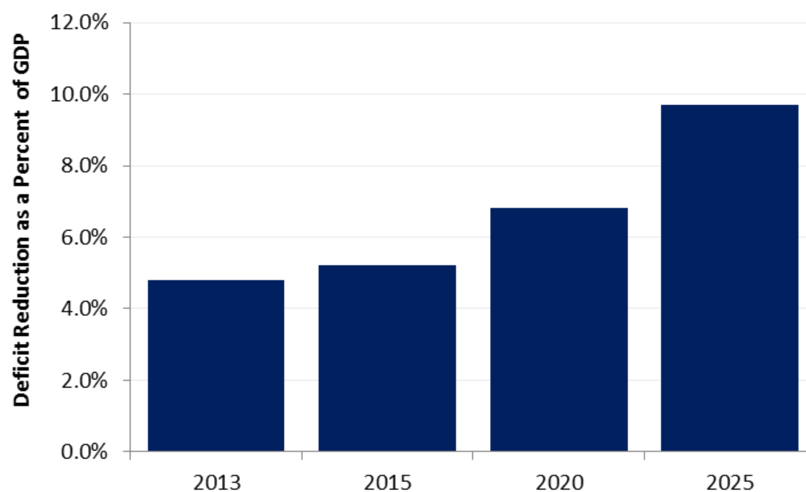
[8] Federal Reserve, Flow of Funds, L. 209.
[9] Treasury Department, Quarterly Data Release, Office of Debt Management.
[10] International Monetary Fund, *Fiscal Monitor*, October 2012.
[11] Congressional Budget Office, Long-Run Budget Outlook.
[12] Reinhart, V., Reinhart, C. and Rogoff, K. (2012), "Public Debt Overhangs: Advanced Economy Episodes Since 1800," *Journal of Economic Perspectives*.
[13] The structural primary deficit is the budget deficit net of interest expense and adjusted for the current state of the economy relative to full employment.

(2) Timing of Tax Increases and Spending Cuts

The U.S. economy continues to operate well below capacity. Despite payroll employment gains that have averaged 150,000 per month for the past year and an unemployment rate that has declined for the past three years, the employment-to-population ratio remains stuck near a 30-year low of 58.5%, which is still below its September 2009 level.[14] Even if one believes fiscal consolidation is required over the medium-to-long term, it is reasonable to think deficit reduction should be delayed as long as possible. Excessive fiscal tightening could push an already weak economy back into recession and reverse the labor market gains witnessed since 2010.[15]

The benefits of a large, but delayed, fiscal consolidation are obvious and this position has attracted many adherents, including Fed Chairman Bernanke.[16] However, there are two obvious problems. The first is credibility. Scheduled tax increases or spending cuts, like diets, can always be postponed. Indeed, much of the long-run budget problem in the U.S. is a function of this tendency to postpone painful adjustments through "short-term" extensions to current spending programs and expiration dates for tax rates (the "fiscal cliff" is the most obvious example). It may be challenging to craft a delayed deficit reduction in a manner that breeds confidence that this pattern will not be repeated.

Figure 2: Immediate Deficit Reduction Required to Stabilize Long-Run U.S. Debt Ratio[17]



Second, delay increases the present value of the ultimate fiscal adjustment. As shown in **Figure 2**, if consolidation begins this year, the cost of stabilizing debt ratios over the next 25 years is equal to 4.8% of GDP ($770 billion per year). If consolidation is postponed until the end of the decade, the cost increases 41% to 6.8% of GDP ($1.17 trillion per year in 2012 dollars). The earlier fiscal consolidation starts, the less dramatic the policy changes need to be. This is especially significant for changes to Social Security and Medicare. If cuts to benefit schedules are to be made, they should be done as soon as possible so future retirees can recalibrate work and savings plans in response to reduced expectations of public support.

Finally, just as there is no unanimity on the question of whether deficit reduction is needed, it is also not clear that the economy would suffer as grievously from near-term deficit reduction as is commonly feared. Well-devised fiscal consolidation increases business and consumer confidence and fixed private investment,

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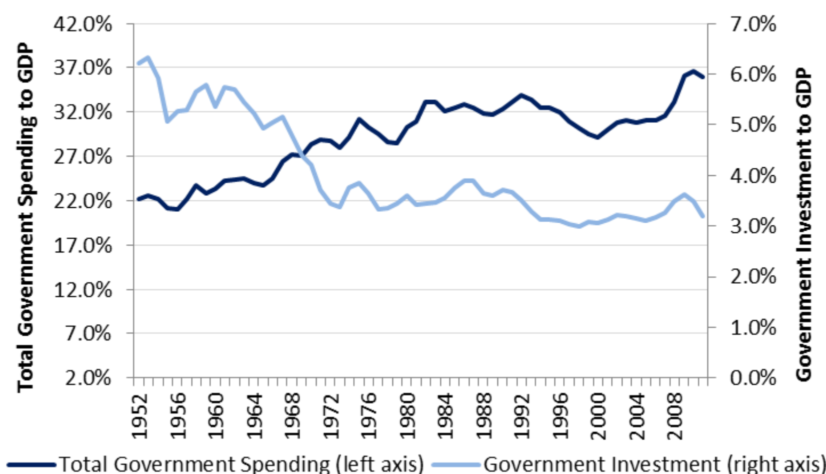
[14] Bureau of Labor Statistics Database, January 2013.
[15] IMF, World Economic Outlook Update, January 2013.
[16] Bernanke, B. (2012), "The Economic Recovery and Economic Policy."
[17] Congressional Budget Office, Long-Run Outlook, January 2012.

which mitigate the short-run impact of reductions in disposable personal income and government purchases.[18] Excess holdings of corporate cash relative to fixed assets, declines in industrial production capacity, and all-time low rates of business fixed investment relative to profits are all evidence of a corporate sector unnerved by the uncertainty regarding the size, timing, and incidence of the inevitable tax increases and spending cuts.[19] Clarity about the magnitude and timing of the fiscal adjustment and specifics about which industries, households, and business forms will bear it is likely to increase the expected risk-adjusted returns on new investment.

(3) Composition of the Deficit Reduction Package

The biggest obstacle to closing the fiscal gap is determining the relative share that should be allocated between revenue increases and spending cuts. Many Republicans have ruled out any further revenue increases as part of deficit reduction.[20] President Obama's initial fiscal cliff offer included $1.6 trillion in additional revenues, or roughly $1 trillion more than was enacted (over 10 years).[21] Without significant incremental revenues, the President appears to be unwilling to consider structural changes to entitlements. It is difficult to see what event would cause the respective sides to reverse these positions, aside from a bond market selloff, sudden decline in the foreign exchange value of the dollar, or a real threat of default. Even another downgrade from the rating agencies is unlikely to be a catalyst given the way Treasury securities rallied in the "flight-to-safety" following the 2011 S&P downgrade.

Figure 3: Total Government Spending and Government Investment as a Share of GDP[22]



In many ways, the focus on composition of the deficit reduction is the most regrettable aspect of the current impasse. The obvious inefficiency of the current tax code seems to be a much greater concern than the precise proportion of GDP collected in tax revenue. Simulations suggest that replacing the existing tax code with a progressive consumption tax could boost long-run output by nearly 6%.[23] Should such proposals be avoided if they would cause federal revenue to drift above 20% of GDP? Government spending has shifted dramatically over the past sixty years from a focus on physical infrastructure to transfers. In 1952, gross public investment accounted for 28 cents of every dollar of government spending (6.2% of GDP relative to total spending of 22.2%). In 2011, the ratio fell to 9 cents, as investment fell to 3.2% of GDP even as total

[18] Alesina, A., Favero, C., and Giavazzi, F. (2012), "The Output Effect of Fiscal Consolidations," *NBER Working Paper No. 18336*.
[19] Thomas, J. (2012), "Deficit Reduction: Fiscal Drag or Addition through Subtraction?," *Economic Outlook*.
[20] C.f. "Ryan: No more revenue," *Politico*, January 27, 2013.
[21] Sperling, G. and Furman, J. (2012), "Limiting Tax Deductions: The Reality of the Math." The White House.
[22] Bureau of Economic Analysis, National Income and Product Accounts.
[23] Viard, A. and Carroll, R. (2012), *Progressive Consumption Taxation: The X-Tax Revisited*.

spending rose to 36% of GDP. As with the tax code, it should be possible to reorient spending in a way that reduces its overall level (relative to projections) but increases its societal and economic value.

Conclusion

Fundamental disagreement concerning the size, timing, and composition of deficit reduction has created a "fiscal cul-de-sac." Unlike the "fiscal cliff," which necessitated Congressional action to avoid a sudden and unwelcome fiscal tightening of 4% of GDP, the current circumstances require no further action beyond the routine passage of debt limit increases and appropriation bills. However, an unwillingness to enshrine the *status quo* into law will likely result in a series of short-term extensions that keep political risk at the forefront of investors' minds. In the long-run, much more is at stake in the deficit reduction debate than the noise generated by brinksmanship politics. Failure to enact substantial new deficit reduction in 2013 or 2014 will likely result in slower long-run growth rates and larger, more painful policy adjustment in the future.

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