

# Economic Outlook

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## Deficit Reduction: Fiscal Drag or Addition through Subtraction?

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Given the attention paid to what could go wrong with “fiscal cliff” negotiations in Washington, corporate asset prices may not adequately reflect all that could “go right” over the course of the next 12 months. Deficit reduction need not result in a smaller economy or a slower rate of economic growth. If Congress enacts a credible and comprehensive deficit reduction package that aids business planning, establishes certainty regarding future tax rates, and significantly reduces the probability of a fiscal crisis, deficit reduction could actually provide the “stimulus” the economy need over the near-to-medium term. Rather than plunging the economy into recession, the fiscal cliff could ultimately produce a measurably larger economy in five-to-seven years’ time than would have been the case absent policy action.

### The Fiscal Cliff and Deficit Reduction

The “fiscal cliff” is the moniker used to describe the \$607 billion of automatic deficit reduction scheduled to take effect January 1, 2013 absent legislative action. It is widely believed that the U.S. economy would very likely contract in 2013 if the fiscal cliff’s tax increases and spending cuts were allowed to take effect in full. The arithmetic is simple: as of September 2012, U.S. personal savings stood at \$395 billion (annual rate), roughly equal to the tax increase portion of the fiscal cliff.<sup>1</sup> Even if households responded to the fiscal cliff by reducing savings to zero (i.e. spending every dollar earned), total spending would still contract. The Congressional Budget Office (CBO) estimates that the fiscal cliff would cause the U.S. economy to contract at a 3% annual rate in the first half of 2013.<sup>2</sup>

It seems more likely than not that Congress and the President reach some agreement – even one finalized after January 1 – to extend some current policies but allow others to expire. For example, if the 2% payroll tax reduction expires, the Affordable Care Act’s tax increases on high-income taxpayers take effect, and the scheduled \$65 billion in reduced federal outlays from “sequestration” are allowed to take effect or reallocated to other spending categories, total fiscal tightening would exceed 1% of GDP even if the current tax rates on ordinary income, capital gains, and dividend income were extended in full.<sup>3</sup> One might conclude, therefore, that an agreement would result in a “fiscal drag” of about 1% to 1.5% of GDP in 2013 on an economy expected to grow at a rate close to 2%.

<sup>1</sup> Bureau of Economic Analysis, *Personal Income and Its Disposition*, October 29, 2012.

<sup>2</sup> CBO, “Economic Effects of Policies Contributing to Fiscal Tightening in 2013,” November 2012.

<sup>3</sup> CBO, “Economic Effects of Reducing the Fiscal Restraint That Is Scheduled to Occur in 2013,” May 2012.

## The Private Sector's Likely Response to Deficits

Thankfully, the economic impact of fiscal policy does not end with the total amount of money the government spends or collects from households and corporations. The ultimate impact of a fiscal policy change depends on the way households, business owners, and corporate managers adjust their own spending and investment plans in response. If elevated debt levels and large, persistent budget deficits are currently depressing private spending, a well-conceived deficit reduction package could actually induce changes in private spending and investment that more than offset the fiscal drag.

The macroeconomic effects of public deficits and debt depend on their size, their salience in the minds of the public, as well as public perceptions concerning the magnitude, timing, and incidence of necessary future fiscal policy changes. When debt levels are low and deficits appear temporary, tax cuts or increases in government purchases can stimulate private sector activity.<sup>4</sup> Conversely, when debt levels are high and appear to be unsustainable, deficits may lose their stimulative impact as households and business managers rationally anticipate future tax increases, spending cuts, or the possibility of a fiscal crisis and choose to defer spending.<sup>5</sup> Uncertainty about which specific industries are likely to bear these tax increases further complicates business planning and can lead to paralysis. Indeed, the reduction in private spending in this case could be so great that deficits could actually retard growth.<sup>6</sup>

Recent empirical work has largely embraced the view that deficits can slow growth once the public debt exceeds some threshold. The Bank for International Settlements (BIS) finds that once the public debt reaches 84% of GDP it begins to slow growth by 0.1% to 0.15% per year for every 10% increase in debt.<sup>7</sup> The BIS recommends that governments with debt levels above this threshold should “aim not only at stabilising [sic] their debt but also at reducing it to sufficiently low levels that do not retard growth.” Similarly, Reinhart, Reinhart, and Rogoff (2012) find that once the gross debt exceeds 90% of GDP, economic growth slows by about 1% per year.<sup>8</sup> This work follows a 2008 paper from the European Central Bank (ECB) that identifies a 90% of GDP threshold beyond which households tend to respond to fiscal deficits by building precautionary savings in the anticipation of future tax increases.<sup>9</sup> Importantly, these papers find evidence of slower growth even in cases where interest rates remain low and the government has no difficulty funding itself.

## Deficits in the Current U.S. Context

At the end of the 2012 fiscal year (September 30, 2012), the U.S. gross federal debt stood at \$16.1 trillion or 103% of GDP. After deducting intra-governmental holdings (largely debt issued to the Social Security and Medicare trust funds), the net federal debt stood at \$11.3 trillion, or 73% of GDP.<sup>10</sup> Current fiscal policies generated a deficit of \$1.1 trillion in the 2012 fiscal year (7.7% of GDP), of which about 65% (5 percentage points) represented the “structural” deficit, or the portion of the deficit attributable to policies rather than the

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<sup>4</sup> Ball and Makiw (1995), “What Do Budget Deficits Do?,” Federal Reserve Bank of Kansas City, Jackson Hole Symposium.

<sup>5</sup> The “households” referenced are primarily high net worth households who do not face liquidity constraints and can transfer consumption through time. Barro (1979), “On the Determination of the Public Debt,” *Journal of Political Economy*.

<sup>6</sup> Briotti (2005), “Economic Reactions to Public Finance Consolidation,” European Central Bank, October 2005. A permanent increase in spending financed by future distortionary taxes reduces permanent income and, therefore, consumption.

<sup>7</sup> Bank for International Settlements “The Real Effects of Debt,” September 2011.

<sup>8</sup> Reinhart, V., Reinhart, C. and Rogoff (2012), “Public Debt Overhangs: Advanced Economy Episodes Since 1800,” *Journal of Economic Perspectives*.

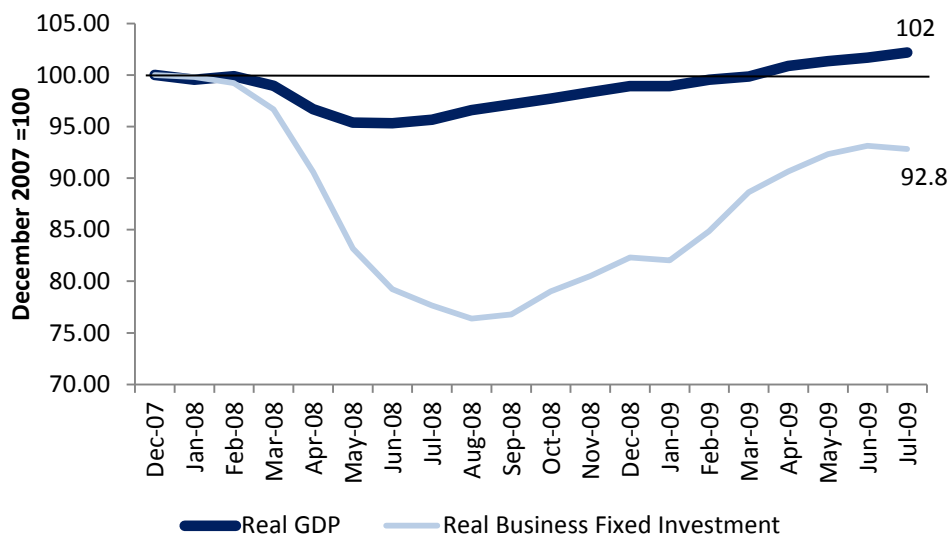
<sup>9</sup> Nickel and Vansteenkiste (2008), “Fiscal Policies, the Current Account, and Ricardian Equivalence,” European Central Bank, September 2008.

<sup>10</sup> CBO, “Update to the Economic and Budget Outlook: Fiscal Years 2012 to 2022,” August 2012.

(depressed) economy.<sup>11</sup> The International Monetary Fund (IMF) estimates that to reduce gross federal debt to 60% of GDP by 2020 would require annual budget surpluses averaging 2% of GDP (\$310 billion in 2012), which would require more than a 9% of GDP swing in the fiscal balance (\$1.4 trillion). When the effects of age-related spending on Medicare and Social Security are taken into account, the required fiscal adjustment by 2030 is 50% larger.<sup>12</sup>

Households, business owners, and corporate managers may not know the precise size of the required fiscal adjustment, but they are undoubtedly aware that trillions of dollars of tax increases and spending cuts are on the horizon. The problem is that these tax increases or spending cuts are not likely to be assigned *pro rata*. Until Congress acts it will not be clear which households, businesses, or industries are going to bear them specifically. This uncertainty makes planning impossible, which increases the marginal value of cash, encourages businesses to defer investment to preserve optionality, and leads to more liquid and conservative portfolios.<sup>13</sup>

**Figure 1: Real GDP and Real Business Investment Scaled to December 2007<sup>14</sup>**



These hypothesized effects are evident in the data. While U.S. household spending and overall GDP has returned to and exceeded the previous business cycle peak (December 2007), real business fixed investment remains 7.2% below its level of five years ago (Figure 1). Investment has been so weak that U.S. industrial productive capacity has actually contracted over the past three years, as depreciation has exceeded gross investment in plant and equipment.<sup>15</sup> Rather than reinvest cash flow into new productive capacity, business managers have opted instead to build cash reserves, with the ratio of cash-to-fixed assets on nonfinancial businesses’ balance sheets growing by 20%

**[N]onfinancial businesses held more than \$2.5 trillion in cash and cash-equivalents, which amounts to “excess” cash of more than \$400 billion**

<sup>11</sup> CBO, “The Effect of Automatic Stabilizers on the Federal Budget,” April 2011.

<sup>12</sup> IMF Fiscal Monitor, October 2012.

<sup>13</sup> The negative impact of deficits on business confidence and investment has been recognized since at least Myrdal (1939), *Fiscal Policy in the Business Cycle*, *American Economic Review*. Feldstein (1984) demonstrates that the differential impact of deficits on different sectors of the economy could be contractionary, but the channel is the interest rates. See Feldstein (1984), “Can an Increased Budget Deficit Be Contractionary?” NBER Working Paper 1434.

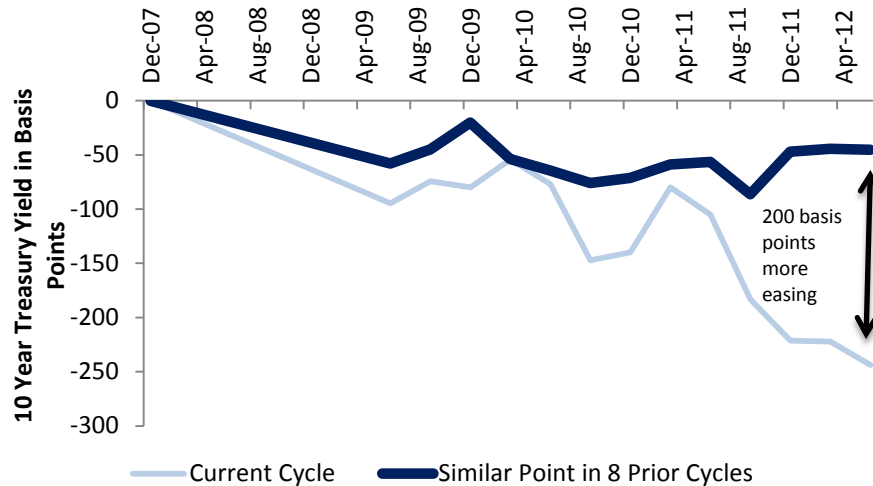
<sup>14</sup> Bureau of Economic Analysis.

<sup>15</sup> Federal Reserve Board of Governors, G. 17.

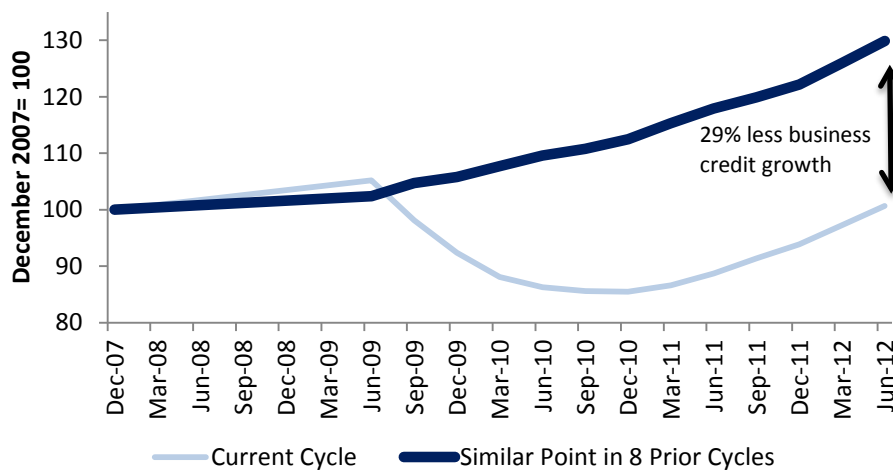
since 2007.<sup>16</sup> As of June 2012, nonfinancial businesses held more than \$2.5 trillion in cash and cash-equivalents, which amounts to “excess” cash of more than \$400 billion when measured relative to 2007 cash-to-fixed asset ratios.

Depressed corporate investment activity is even more curious given record low borrowing costs. Real interest rates remain negative up to 20 years, with five year Treasury inflation-protected securities (TIPS) yielding -1.36%. As shown in Figures 2 and 3, monetary policy has been extraordinarily ineffective, with cumulative easing 200 basis points greater than the average of prior business cycles but commercial and industrial (C&I) credit growth still lagging prior cycles by 29%, on average.

**Figure 2: Monetary Policy Easing, Current Recovery Relative to Average of Eight Previous Cycles<sup>17</sup>**



**Figure 3: Business Credit Growth, Current Recovery Relative to the Average of Eight Previous Cycles<sup>18</sup>**



<sup>16</sup> Federal Reserve Board of Governors, B.102, Flow of Funds.

<sup>17</sup> IMF Global Financial Stability Report, October 2012.

<sup>18</sup> IMF Global Financial Stability Report, October 2012.

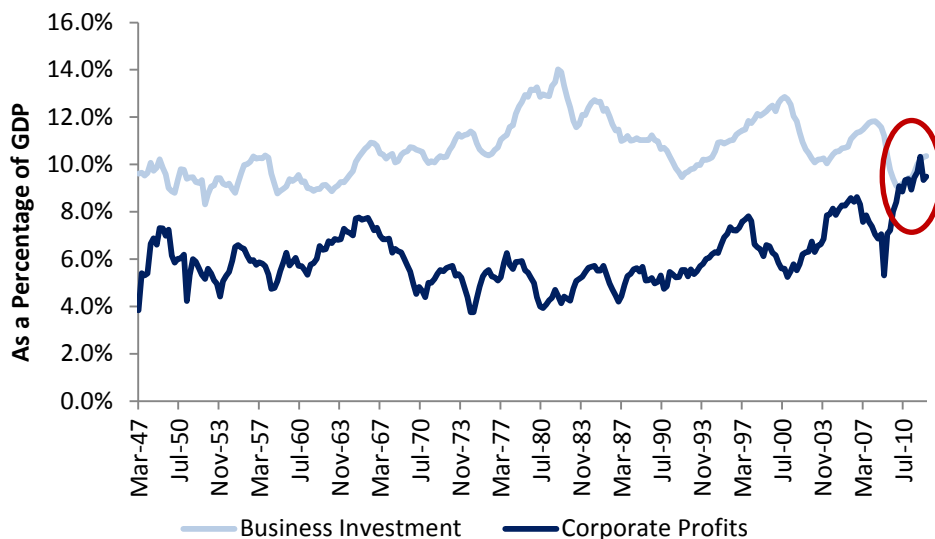
## Is Expansionary Fiscal Consolidation Possible?

If businesses can find so few profitable investments to fund at near-zero borrowing costs does that mean the expected return on new equipment, corporate acquisitions, or inventory is effectively zero? No. Instead, business investment is being depressed by the combination of uncertainty regarding current fiscal policy and the fear of excess capacity. While businesses can respond to low interest rates by buying additional plant and equipment, they cannot easily sell this added capacity in the future if demand turns out to be weaker than anticipated.<sup>19</sup> For this reason, it is generally more costly to reduce unwanted capacity in a weak economy than it is to buy additional capacity in a strong economy. This asymmetry increases the hurdle rate that prospective investments must yield in order to be profitably undertaken.<sup>20</sup> The greater the uncertainty and more risk averse the business manager, the higher the hurdle.

If fiscal cliff discussions were to result in a comprehensive and credible deficit reduction package, hurdle rates would fall and investment would likely increase. The potential investment growth would not only offset the negative cash flow effects of tax increases, but could also result in substantially faster growth over the medium term.

As shown in Figure 4, Q1-2010 marked the first time in history that corporate profits exceeded business fixed investment.<sup>21</sup> Unlike prior cycles where an increase in corporate profits led to faster investment growth as cash was reinvested in plant and equipment, business investment has increased very modestly since 2009 even as corporate profits have nearly doubled as a percentage of GDP. *Were businesses simply to reinvest cash flow at historic rates, fixed investment would add nearly 4% to GDP (\$695 billion) by the end of 2016 and more than offset the fiscal drag from reduced disposable personal income.*<sup>22</sup>

**Figure 4: Business Fixed Investment and Corporate Profits as a Share of GDP<sup>23</sup>**



<sup>19</sup> Zhang (2005), "The Value Premium," *The Journal of Finance*.

<sup>20</sup> Abel and Eberly (1999), "The Effects of irreversibility and Uncertainty on Capital Accumulation," *Journal of Monetary Economics*.

<sup>21</sup> The corporate profits series dates back to 1947.

<sup>22</sup> This assumes profit margins remain constant.

<sup>23</sup> Bureau of Economic Analysis.

On the household side, uncertainty about future tax rates motivates higher desired savings and more liquid portfolios to pay expected future taxes.<sup>24</sup> While removal of uncertainty should not impact the spending decisions of liquidity-constrained households (i.e. those households for whom desired spending exceeds disposable income), greater clarity could induce higher-income households to spend more of their disposable income and shift more of their wealth out of cash and government bonds and into productive assets (stocks, corporate bonds, etc.). If tax increases come through tax reform that reduces economic distortions introduced by the current tax code and lowers marginal rates, the positive economic impact could be even greater.

## Conclusion

Monetary policy has done all that it can to boost the economy. Further action to stimulate growth will have to occur through fiscal policy. High debt levels and large deficits have likely caused households and business managers to anticipate tax increases and spending cuts and defer spending accordingly. Until Congress acts, it will not be clear which specific businesses, industries, or households will bear these costs. This uncertainty further depresses current spending and investment. A comprehensive, credible, and well-designed deficit reduction strategy that makes these costs certain could not only moderate the cash flow impact of deficit reduction, but actually accelerate U.S. growth over the medium term. Such a package would boost confidence in the nation's fiscal future and federal government, yielding unquantifiable benefits to growth and employment.

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<sup>24</sup> Chan (1983), "Uncertainty and the Neutrality of Government Financing Policy," *Journal of Monetary Economics*.