

FISCAL POLICY IN THE UNITED STATES: STILL IN NEED OF A STRATEGY

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Introduction

The fiscal position of the United States has begun to stabilize after substantial deterioration in recent years. Estimates of the federal deficit for fiscal year 2013 have been revised down appreciably, and the trajectory of projected deficits has been lowered some. But the recent improvement, while genuinely positive news, is coming only after cumulative deficits have driven federal debt relative to GDP to levels reached only once before in the history of country. Mounting debt has resulted from a confluence of factors, some that were easily forecastable and others that were largely unforeseen. The emerging demographic pressures on the federal budget arising from the aging of the US population have been well known and anticipated for years. Other factors could not have been anticipated, such as the expenditures associated with the military engagements that occurred in the wake of 11 September 2001. Taken together, these factors had already made the fiscal condition of the US economy more tenuous even before the financial crisis got under way. But of course, the crisis and its aftermath added significantly to deficits and debt, both

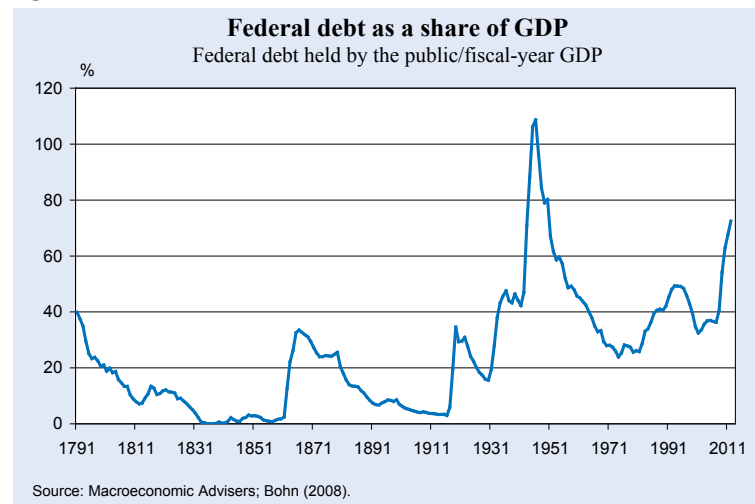
¹ Peterson Institute for International Economics. The views expressed in this paper are those of the author and do not necessarily reflect the views of the Peterson Institute for International Economics or other members of its staff.

through cyclical declines in revenues and increases in spending, and through the direct use of fiscal policy to provide stimulus to a slumping economy. The combination of these forces has resulted in a sharp jump in the ratio federal debt held by the public to nominal GDP – from 36 percent on the eve of the financial crisis in 2006 to about 73 percent last year (Figure 1). Some stabilization of this ratio is expected over the next several years. But without further actions, debt to GDP will be on an upward trajectory from its already elevated levels by the end of this decade.

As a consequence, adjustments in policies will be necessary to place deficits and debt on more sustainable paths. The good news is that those adjustments, if undertaken steadily over time, will not entail the type of extremely painful transitions now being experienced by a number of countries in Europe. The bad news is that our political system has not yet exhibited the will or sense of urgency to address the longer-term sources of pressure on the federal deficit. Putting in place now a plan to gradually rectify our longer-term fiscal imbalances would serve several mutually reinforcing objectives, which are: to raise the productive potential of the US economy; to avoid inflicting more painful adjustments on households and businesses in the



Figure 1



future; and to limit the risk that, at some point, the fiscal position of the United States reaches a tipping point that could lead to greater economic and financial instabilities.

Over the last couple of years, actions have been taken to curtail federal spending and boost revenues. And, those actions have been larger than is commonly appreciated. But those actions do not yet amount to a strategy for dealing with fiscal sustainability in the United States. Indeed, one could argue that the approach that has been followed to date is clearly suboptimal; we have been imposing considerable restraint in the near term on an economy that continues to recover sluggishly, while we have failed to put in place policies that will achieve sustainability over the longer term.

In the second section, I discuss the actions that have been undertaken in the last several years to tackle our mounting fiscal difficulties and their consequences for recent macroeconomic developments. I lay out in the third section the longer-term outlook for US fiscal policy, including the key factors shaping that outlook. The macroeconomic consequences of alternative fiscal paths are discussed in the fourth section. Finally, in the fifth section, I discuss some of the principal risks surrounding action and inaction to address our fiscal challenges.

Recent actions to reduce the federal budget deficit

Because the political process in the United States has been so contentious and, at times, chaotic, it would be easy to lose sight of the fact that actions already have been taken in the past few years that have cumulated to a sizable amount of current and prospective deficit reduction. Indeed, a series of steps taken since early 2011 has reduced projected deficits over the next ten years by nearly a cumulative amount of 4 trillion US dollars, inclusive of interest savings. Nevertheless, these actions occurred not as the result of implementing a strategy of fiscal consolidation, but for the most part resulted from efforts to avoid politically induced ‘crises’.

In the summer of 2011, faced with the prospect of default on federal financial obligations when borrowing ran up against the debt ceiling, the Administration and Congressional leadership negotiated the Budget Control Act of 2011, which lowered the ten-year deficit nearly 1.1 trillion US dollars; this came on top of 775 billion US dollars of spending cuts enacted earlier that year. To avoid going over the fiscal cliff at the turn of this year, the Administration and Congress reached agreement on and passed the American Taxpayer Relief Act of 2012, which increased marginal tax rates on the wealthiest households and lowered the deficit by about 850 billion US dollars. And most recently, a sequester was triggered on 1 March 2013 that forced across-the-board cuts that lowered cumulative ten-year deficits by 1.1 trillion US dollars.

As a consequence of these actions, fiscal policy has swung quite sharply over the past few years from providing considerable support to the economic recovery to now imposing sizable restraint on activity (Figure 2). According to the estimates of the high-employment deficit from the Congressional Budget Office (CBO 2013c),² federal discretionary policy actions were adding considerable impetus to activity in 2009.³ However, policy actions have subsequently shifted toward restraint – increasingly so in 2012 and 2013. Recent actions, including the effect of the sequester are estimated to reduce growth by about 1-3/4 percentage points this

² The Congressional Budget Office provides economic analysis and budgetary cost estimates to the US Congress.

³ The CBO’s measure of the high-employment deficit (the deficit excluding the effects of the automatic stabilizers) is an imperfect measure of fiscal stimulus. For example, the 4 percent figure for 2009 overstates the size of the stimulus by including the spending associated with the financial rescue efforts, which probably did not directly boost aggregate demand.

Figure 2

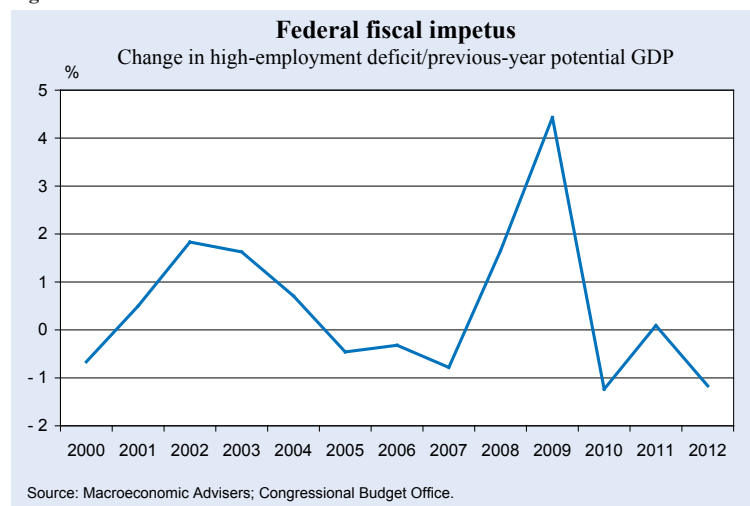
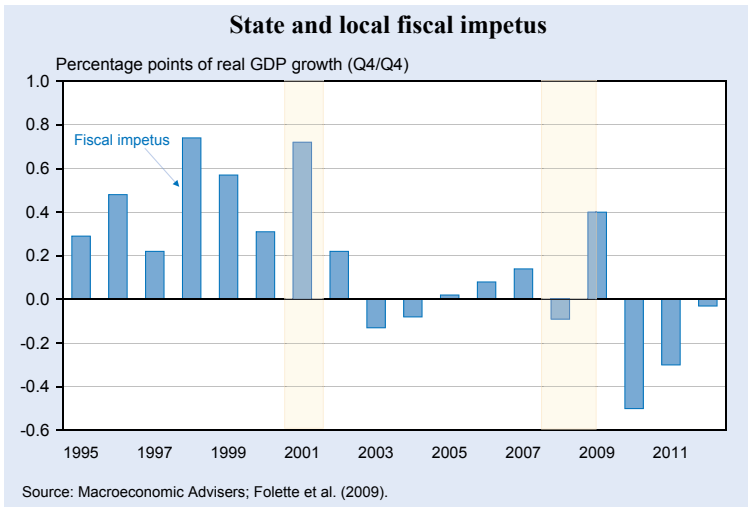


Figure 3



being squeezed hard by a decline in property tax revenues, slumping sales tax receipts, and declining incomes. As state and local governments have dealt with their budgetary problems and as the overall economic recovery has improved their fiscal condition, these governments have exerted a diminishing drag on activity. In 2012, fiscal actions of state and local governments were about a neutral influence on growth, and they are likely to be a roughly neutral influence this year as well.

year relative to what would have occurred otherwise. In the absence of this fiscal restraint, the United States would have likely experienced a more robust upturn in activity, with growth in real GDP likely running close to 4 percent this year.

The policies of the federal government are not the complete fiscal story. Actions taken by state and local governments in response to the economic fallout from the financial crisis have also shaped macroeconomic developments in the United States in the past several years. In general, state and local governments have limited ability to pursue counter-cyclical policies because of balanced-budget rules and other restrictions. However, during this cycle, a sizable slug of federal fiscal stimulus came in the form of grants to state and local governments. And these governments appear to have used those funds to maintain or increase spending, and thereby provide support to aggregate demand (Figure 3). Federal grants allowed state and local governments to implement stimulative policies in 2009 (Follette, Kusko and Lutz 2009). However, by 2010, these governments were taking actions that, on net, exerted a drag on aggregate activity.⁴ The impetus to growth from federal grants was waning, and their budgets were

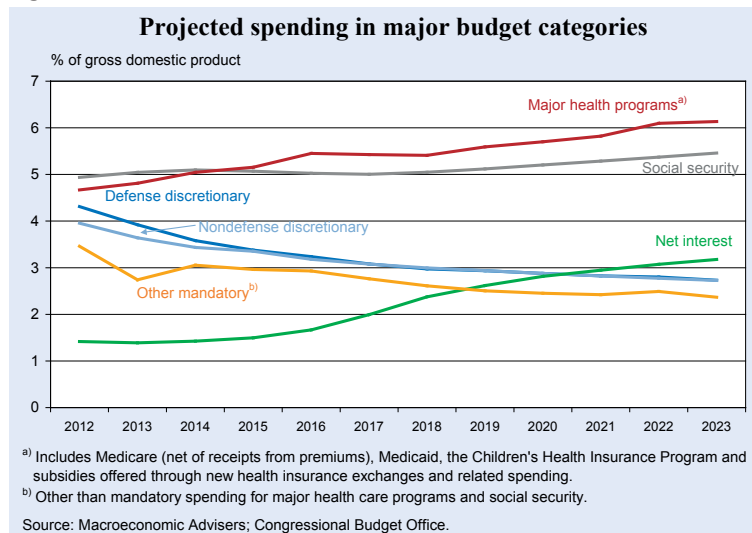
⁴ Because the Follette *et al.* (2009) measure includes the effects of actions by state and local governments that were facilitated by increased federal grants, one cannot simply add this measure to measures of federal fiscal stimulus like the one shown in Figure 2.

The longer-term outlook for US fiscal policy

Under the assumption that the fiscal actions taken in the past few years will remain in place, the Congressional Budget Office projects that deficits will decline over the next few years (CBO 2013d). After peaking at nearly 76 percent in 2014, federal debt to GDP is expected to recede to between 75 and 71 percent for the remainder of the decade. But by early next decade, the debt ratio resumes a steady upward climb. In brief, the deficit-reduction measures undertaken to date will result in only a pause in an otherwise upward trend.

As can be seen (Figure 4), the principal drivers of the adverse trends are the major entitlement programs of the United States – Medicare, Medicaid, and Social

Figure 4



^{a)} Includes Medicare (net of receipts from premiums), Medicaid, the Children's Health Insurance Program and subsidies offered through new health insurance exchanges and related spending.

^{b)} Other than mandatory spending for major health care programs and social security.

Security. By contrast, with the notable exception of interest payments on the debt, the other major areas of federal spending are projected to shrink in relation to the size of the economy. Defense outlays fall from about 4- $\frac{1}{2}$ percent of GDP to just 2- $\frac{3}{4}$ percent in 2023 – nearly 2 percentage points below their average over the past 40 years. Likewise, nondefense discretionary outlays – a broad category that encompasses spending on education, infrastructure, R&D, and many other basic functions of government – are projected to fall from about 4 percent of GDP to 2- $\frac{3}{4}$ percent in 2023, also well below their 40-year average of about 4 percent.

Two questions are raised by these projections of discretionary spending: are these reductions feasible, and are they advisable? As for feasibility, the issue will be whether the magnitude of recent cuts will eventually result in declines in services that the public finds unacceptable. Already some greater flexibility to reappropriate the cuts implemented under the sequester has been provided in response to public pressure. Although the most likely outcome is that restraint of the magnitude embedded in the sequester will be maintained, that expectation is far from a certainty.

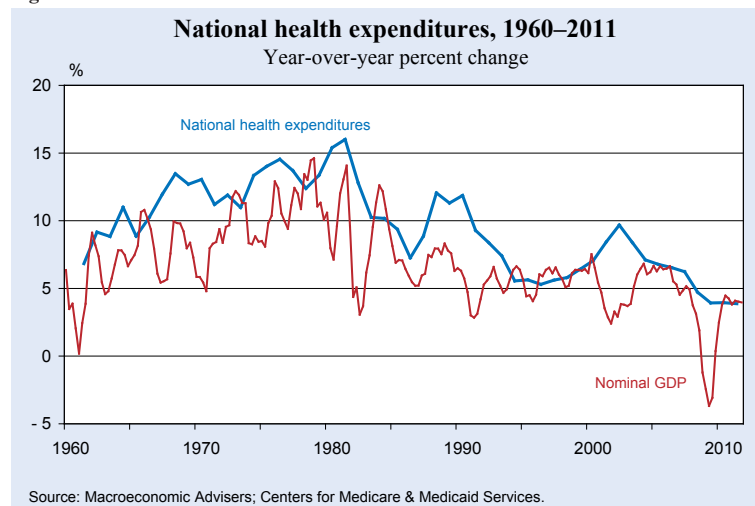
As for advisability, these reductions, at least in their current form, risk cutting some spending that is likely to have high social returns, the implementation of which could ultimately lower the economy's long-term potential output. Spending on infrastructure, education, and scientific research are prominent examples. Moreover, the cuts to defense spending in their current form could hurt military readiness and the ability of the United States to respond to unforeseen challenges.

The longer-term pressures on the federal budget are driven principally by the major retirement and health programs. Social Security outlays are expected to rise from about 5 percent of GDP this year to about 5- $\frac{1}{2}$ percent in ten year's time. The increases associated with Social Security primarily reflect the aging of the baby-boom generation and the resulting demographic bulge in retirements that is just now getting under way.

The projected increases are more dramatic for the federal health care programs, which increase as a share of the economy from a bit below 5 percent in 2013 to about 6- $\frac{1}{4}$ percent in 2023. Once again, demographics are at work. Over the next 10 years, the proportion of the population of the United States that is over 65 years of age will increase by a third. The aging of the population will inevitably generate greater demands for health care, especially through the Medicare program. But the growth in health expenditures is driven by more than demographics. Indeed, the United States faces a broader health expenditure problem, of which federal programs are only one element. Over long periods of time, health expenditures in the United States have grown more rapidly than the overall economy. The interaction of technological advances in medical care, a health delivery system that relies heavily on a fee-for-service model and insurance that largely disconnects medical decision makers from the marginal costs associated with the services being demanded are important factors in the rising cost curve of medical spending. Much has been made of late in the United States of a recent slowing in health expenditures to about the rate of growth of nominal incomes (Figure 5). However, we have experienced other periods when the growth of national health expenditures and nominal GDP converged for a time. Both experience and prudence suggests that it would be wise to gather further evidence before assuming the recent better behavior of health spending will persist.

Just as retirement-related programs are among the main long-term drivers of federal fiscal challenges,

Figure 5



much the same is the case for the long-term budgetary pressures on state and local governments. These governments have made pension promises to their workers that are only partially funded, and the funding position of these pensions has deteriorated in recent years. Estimates of the funding ratios of the pension plans of state and local governments have been made by the Center for Retirement Research (CRR) (Munnell, Aubry, Hurwitz, Medenica and Quinby 2012). These calculations (Figure 6) reveal that in 2011 (the most recently available data) only about 75 percent of the outstanding liabilities were currently funded. That figure is down from about 87 percent in 2007, just as the crisis commenced. And the problem is arguably larger than these conventional calculations suggest. Because the retirement benefits of these workers are protected in most cases by state law, there is relatively little uncertainty surrounding these liabilities. As such, standard finance theory would suggest that these liabilities should be discounted using a risk-free rate, rather than a discount factor that uses the average returns on pension assets – the conventional approach. When the CRR repeats its calculations using a risk free discount factor, the aggregate funding ratio is only about 50 percent of future liabilities of state and local pensions.

In some cases, state and local governments are negotiating ‘voluntary’ adjustments in these pension programs with workers and retirees. But these actions alone do not seem likely resolve the looming problems. Deep cuts in other areas of state and local spending or sizable increases in taxes or both may ultimately be required to fund the pension promises that already have been made.

The macroeconomic consequences of alternative fiscal paths

The baseline forecast presented by the CBO in February remains a useful point of departure for considering the implications of alternative approaches to dealing with the longer-term fiscal imbalances in the United States (CBO 2013a). And, there is some favorable news in that baseline (the dashed line in Figure 7(1)). The fiscal actions taken to date, combined with a forecast that the US economy will continue to gradually recover, result in a stabilization of federal debt to GNP through late in this decade.⁵ However, as noted above, this stabilization represents just a temporary pause in a more persistent uptrend that is driven by the influences of the major entitlement programs discussed in the previous section.

Any serious backsliding from the deficit reduction actions of the past few years could quickly place the fiscal condition of the United States in a more precarious position. For example, if actions were taken that cumulated to a 2 trillion US dollar increase in deficits over the next ten years, debt to GNP would breach the 80 percent level by the end of the decade and be headed quickly to 90 percent.

If, on the other hand, the Administration and Congress could agree to further actions to reduce the size of the deficit over the next decade, the nation’s fiscal position could be returned long-term sustainability. The CBO (2013b) estimates that an additional 2 trillion US dollars in deficit reducing actions would place the debt-to-GNP ratio on a gradually declining path to below

70 percent by the end of this decade. An even more aggressive attack on deficits that resulted in 4 trillion US dollars of additional reductions over the next ten years would place the debt-to-GNP ratio on a more appreciable downtrend – dropping to below 60 percent by early next decade.

⁵ Gross national product (GNP) is a measure of the income earned by domestic factors of production wherever they are located, while gross domestic product (GDP) is a measure of output produced domestically. For assessing the ability of an economy to service its debt, a measure representing the income produced by domestic factors of production (GNP) is arguably a more relevant measure than domestic product (GDP).

Figure 6

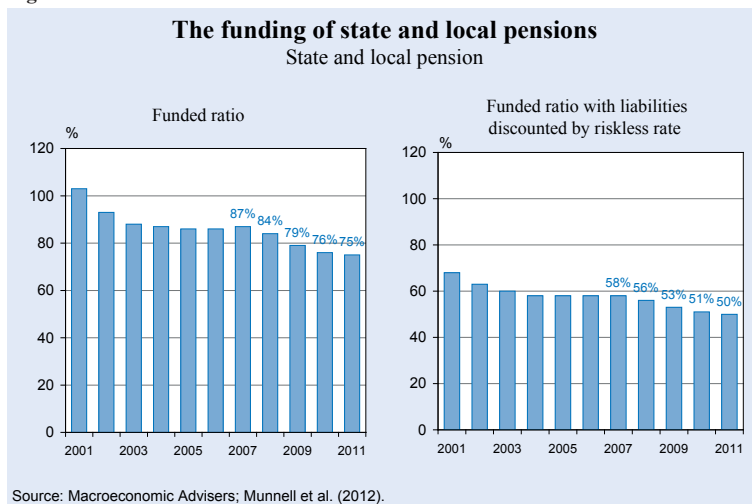
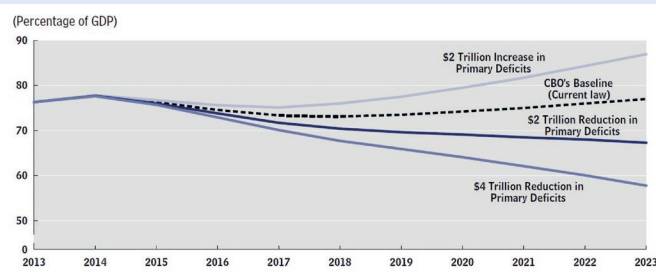


Figure 7

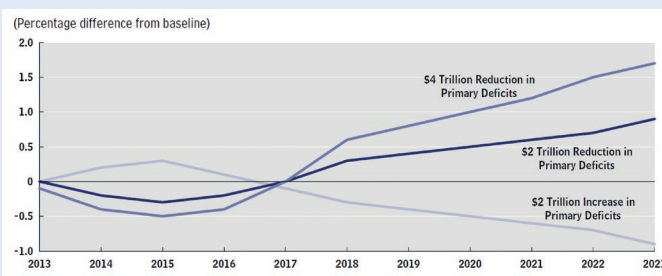
Macroeconomic effects of budgetary paths

(1) Debt held by the public under current law and the illustrative paths, including economic effects, fiscal years 2013 to 2023



Note: The primary deficit equals revenues minus noninterest spending.

(2) Effects of illustrative paths on real GNP, relative to projections under current law, calendar years 2013 to 2023



Notes: The primary deficit equals revenues minus noninterest spending. Figures reflect the percentage difference in the annual levels between a path's effects and the outcomes under CBO's baseline, which incorporates the assumption that current laws generally remain unchanged.

Source: Macroeconomic Advisers; Congressional Budget Office.

The macroeconomic consequences of these alternatives are large (Figure 7(2)). Deficit-increasing actions might result in a short-term boost to output relative to baseline, but at a cost of a permanently lower level of output in the future; 2 trillion US dollars of deficit-increasing actions lowers estimated output by nearly 1 percentage point relative to baseline in ten years. Conversely, taking immediate actions to bring down the deficit will result in some weakening of the economy in the near term, but with the benefit of lifting the level of output permanently over the longer haul. Deficit-reducing actions amounting to 2 trillion US dollars over the next ten years would boost the level of real output by about 1 percentage point by the end of that horizon; obviously, 4 trillion US dollars of deficit reduction would lift the level of output commensurately more. Of course, the timing of the tradeoff between lower output from fiscal restraint in the near term and higher output in the longer term is one that policymakers can take action to influence – an issue to which I will return shortly.

The macroeconomic mechanisms by which lower deficits and debt eventually lead to a higher level of real output are familiar ones. Increased national saving is accompanied by a lower trajectory of real interest rates. This, in turn, boosts capital spending, productivity and, with it, the level of income. Obviously, higher deficits and debt crowd out investment, lower productivity, and reduce incomes in the long run.

The risks ahead

Failure to address the longer-term fiscal imbalances in a timely manner poses financial and economic risks to the United States. Current policies are unsustainable in the long run, and thus adjustments will be required at some point. But the circumstances that prompt those adjustments could matter a great deal in determining their economic consequences.

The alternative scenarios discussed in the previous section illustrate the consequences of adjustments made in advance of a crisis. In these scenarios, the risks are easily identifiable; less fiscal adjustment results in a lower capital stock, lower productivity, and lower incomes in the long run. Moreover, macro simulations such as these likely underestimate the costs of failing to make timely fiscal adjustments. If delay eventually forces larger adjustments in entitlement programs and taxation into a shorter time frame in the future, this will almost certainly cause more disruption to households and businesses. And, as we are witnessing in Europe now, waiting for a crisis to force adjustment is likely the most painful approach to addressing issues of fiscal sustainability.

Perhaps the risk of greatest consequence posed by the still precarious fiscal position of the United States is that a tipping point could eventually be reached. At some point, investors in US federal debt may come to doubt that actions will be taken to put the government on a sustainable fiscal path, at which time they could begin to demand increased risk

premia in compensation for holding Treasury securities. The higher resulting yields and accompanying increase in debt-service costs would then make the fiscal situation even more tenuous, and an unfavorable dynamic could be set in motion that precipitates a full-blown debt crisis. A recent paper by Greenlaw *et al.* (2013) estimates some simple equations that make sovereign debt yields a function of the stock of government debt and the level of current account deficits (relative to the size of the economy). They find effects that are significant, positive, nonlinear, and amplified by the interaction of debt with high current account deficits. Their work indicates that the CBO estimates shown in Figure 7(1) could be far too benign if unfavorable dynamics led rising sovereign yields to feed back into rising debt-servicing costs and deficits.

One does not need to fully embrace the modeling approach or precise estimates provided by Greenlaw *et al.* (2013) to acknowledge that the mechanisms they outline suggest that the risks for instability increase the longer fiscal imbalances are left unattended. Moreover, as is so readily apparent in some countries of Europe today, the economic pain associated with addressing fiscal problems is much greater once those instabilities have manifested themselves. The United States does not yet appear to be at that tipping point, but economists should be very humble about assuming that we will be able to anticipate with much prescience when that point will arrive.

Some concluding thoughts

Viewed from a macroeconomic perspective, the United States is pursuing a suboptimal approach to the mix and cyclical timing of its macroeconomic policies. We are experiencing the pain of implementing restrictive fiscal policies in the context of an economy struggling to gain some forward momentum, while failing to reap the potential benefits of putting in place a credible long-term strategy to re-establish fiscal sustainability. As a consequence, the economic expansion in the United States has been dependent upon highly accommodative monetary policies. Those policies appear to have provided much needed support to aggregate demand. But both the benefits and costs of unconventional monetary policy are more uncertain than those of con-

ventional monetary policy and are arguably more uncertain than the effects of fiscal policy.

An alternative approach is possible. Policy makers should work with a sense of urgency to put in place a credible strategy to address our longer-term fiscal imbalances. That sense of urgency is not driven by the view that we face an imminent threat to financial and economic stability from our fiscal imbalances; while imminent instability cannot be ruled out, I judge it to be a reasonably low probability event over the next several years. Rather a sense of urgency should be generated by the potential dividends such a strategy could pay and pay now. Implementing a credible strategy that relied on increasing restraint as the economy gains a firmer footing would likely result in an immediate easing of interest rates and of broader financial conditions. That easing of financial conditions could reinforce the accommodative thrust of monetary policy and perhaps even hasten its eventual re-normalization. Moreover, much as well-anchored inflation expectations have allowed the Federal Reserve to use monetary policy to aggressively counter the weakness in the economy, a credible long-term plan to address our budget imbalances would likely provide flexibility to dial back on some of the near-term restraint that is being imposed by fiscal policy at present. If that were possible, the probability of a more vigorous expansion in the United States would be improved.

The key elements of a longer-term strategy for fiscal balance are reasonably clear. Major federal entitlement programs must be reformed to curb their ever-increasing draw on national resources. At the same time, the aging of the population suggests that spending will need to be above historical norms, at least for a time, and thus increased revenues should be part of the fiscal solution. The current course of fiscal restraint is relying too heavily on cuts to discretionary spending, at least some of which have negative consequences for the economy's long-term growth potential and for national security. Considerable benefits would flow from adopting a coherent fiscal strategy for the United States.

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