# Fiscal Balancing Act

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June 2014

*This report was prepared for the Peter G. Peterson Foundation. The statements made and the views expressed are solely those of the authors.*

## Introduction – Fiscal Balance is a Plan, Not a Ledger

The term “fiscal balance” brings to mind accounting ledgers, matching up debits and credits, revenue and expenses—the full apparatus of fiscal hawks and the dismal science. But modern fiscal policy requires a more nuanced and dynamic view of balance. In particular, short- and long-run considerations are both in play, the needs of different generations must be taken into account along with distributional concerns within each generation, and financial constraints matched up over time with priorities for investments that further social goals including growth, mobility, and stability.

A strong and stable economy with sustained job creation and broadly shared growth ultimately requires a foundation of fiscal responsibility. Moreover, expansionary fiscal policy including the ability of the U.S. government to run fiscal deficits provides for a powerful macroeconomic tool with which to counter business cycle downturns and offset the negative impacts of financial sector problems. Utilizing this tool, however, requires the capacity to undertake a debt-financed fiscal expansion–to fund increased spending or tax relief by borrowing from markets. And this in turn depends on the trust of market participants that the U.S. government ultimately will achieve fiscal sustainability.

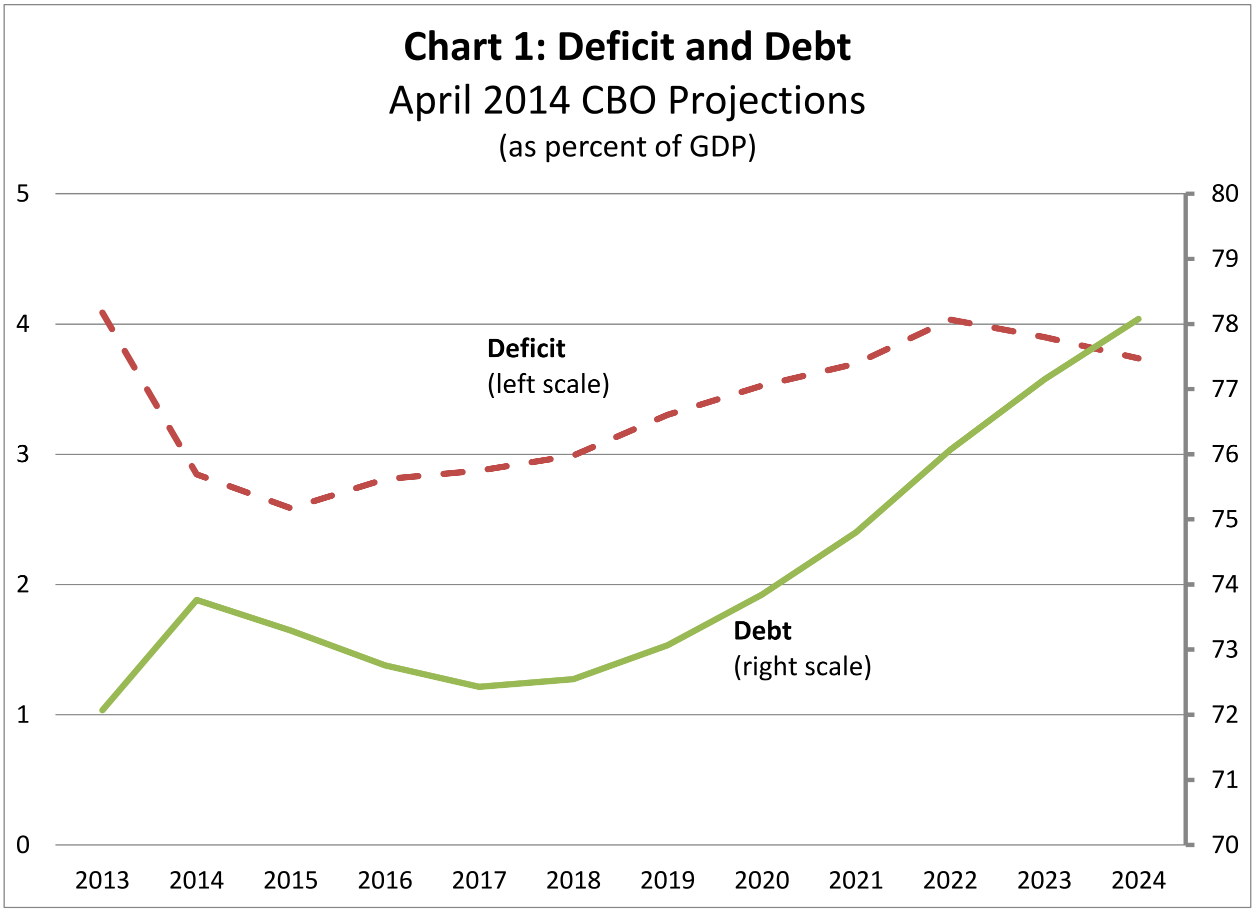
The U.S. fiscal position has improved in recent years, but long-term sustainability has not been assured, as budget deficits are still forecast to widen without future changes in government spending or taxes. A fiscal adjustment involving changes in revenues or expenditures is thus necessary, both to provide a stable foundation for growth and to ensure that the capacity exists for countercyclical fiscal policy.

While the need for gradual fiscal adjustment is well-recognized, the underlying objectives and constraints are more multifaceted than commonly discussed.

## Why is Adjustment Needed, but Difficult?

The motivation for undertaking fiscal adjustment remains the long-term U.S. fiscal imbalance, which in large part reflects the consequences of the aging of the population and the still-rising costs of health care.

Deficits under current law are forecast by the Congressional Budget Office (CBO, 2014) to remain below 4 percent over the next ten years (Chart 1, below), a gap that appears to pose little difficulty for the U.S. Treasury to finance. Debt held by the public as a share of GDP would remain essentially flat at around 73 percent for five years, and then rise only gradually to 78.1 percent of GDP by 2024. While this debt ratio is considerably above the debt of 35 percent of GDP at the end of 2007 before the financial crisis, there is little indication that it poses a near-term concern for fiscal stability or threatens a loss of confidence by market participants in Treasury securities. Still, the increased debt and expectation of normalized interest rates translates into increased costs of financing the federal debt, with net interest payments projected to rise from under 1.3 percent of GDP in 2013 and 2014 to above 3 percent of GDP by 2024. Again, though, there is no immediate and evident sign of a fiscal crunch.




Indeed, the U.S. fiscal outlook has improved over the past several years from legislative developments affecting both revenues and spending. The Budget Control Act of 2011 imposed caps on discretionary spending and resulted in the (perhaps unintended) implementation of spending cuts under the sequester mechanism. These were modified somewhat under the Bipartisan Budget Act of 2013 negotiated by Senator Patty Murray and Congressman Paul Ryan, but while retaining much of the spending restraint. On the revenue side, the American Taxpayer Relief Act of 2012 that averted the so-called fiscal cliff made permanent many of the tax policies put into place or extended from 2001 to 2010, but not all, resulting in increased revenues compared to the policy baseline under which all of the tax provisions had been extended.

Together, these spending and revenue changes made for a fiscal improvement of nearly $5 trillion over the decade from 2015 to 2024, as compared a forecast based on continuing the tax and spending policies in place in 2010 (Kogan and Chen, 2014). That is, under a reasonable set of economic assumptions and other policies kept in place, the sum of deficits over the 2015 to 2024 period is now estimated to come to just over $8 trillion rather than slightly more than $13 trillion projected before the 2011 Budget Control Act and the 2012 fiscal cliff deal. This is an adjustment of around two percent points of GDP over this horizon.

The result is roughly an additional decade with forecasts of moderate – and eminently manageable – levels of deficits and debt. Still, these developments brought breathing space but not a sustainable trajectory for the U.S. fiscal balance, as rising deficits and debt are still forecast to emerge in the future.

Under current law (that is, with the spending and tax changes noted above), deficits will exceed 5 percent of GDP from 2029 on, and reach 10 percent of GDP in 2065. U.S. debt is forecast to reach 100 percent of GDP in 2038 and breach 200 percent of GDP in 2076. While these figures for the far-off horizon are subject to considerable uncertainty, the implication is that the U.S. fiscal program now in place is not sustainable in the long run, even with the consolidation of the past several years.

Even in the near term, the fiscal adjustment to date is unsatisfactory in important respects. Notwithstanding the added flexibility in the 2013 Murray-Ryan budget agreement, the spending impacts of the sequester so far have been applied in a relatively mechanical fashion, with changes mainly affecting the discretionary part of the budget without establishing broader spending priorities relative to age- and health-related programs that appear elsewhere in the budget. Moreover, current laws involve spending restraint and tax changes that could prove challenging to implement in practice. For example, the implied restraint in defense spending could be unattainable in the face of renewed national security challenges, while measures to restrain health care costs could be revised to ensure that providers such as doctors and hospitals are willing to treat those receiving government-funded care. Similarly, taxes set to increase in the future under current law such as on high-cost health insurance policies might prove politically challenging to implement, while pressures will remain for other tax reductions large and small.

Even if all else goes well, without changes to planned revenues or expenditures, the costs of programs that largely serve seniors will inexorably crowd out other areas of the federal budget. Under current projections, the non-interest part of the federal budget available to fund items other than major health programs and Social Security is set to shrink to 7.5 percent of GDP by 2024 from an average of nearly 11 percent of GDP from 2003 to 2013.

The aging of the U.S. population will have economic impacts as well as fiscal ones. The demographic drag on the budget – the inverse of the demographic dividend received by the United States in the mid and late 20$^{th}$ century – occurs exactly as that same demographic inversion hits the workforce, reducing labor force participation and slowing productivity growth. Hence, the demands on the economy will be highest just as its capacity and its ability to generate fiscal resources is reduced. Moreover, research suggests that two factors that might alleviate this bind – technical productivity and capital investment – are also under-performing, further undermining prospects for private sector growth and budget sustainability.

**The Need to Set Priorities and Build Fiscal Capacity: How to Minimize the Costs and Risks of Fiscal Adjustment?**

This double-bind requires action on two broad fronts.

First, actions are needed to ensure fiscal sustainability over time (and not abruptly), whether through changes to revenues or expenditures or some combination. The precise set of measures is beyond the scope of this paper, but we believe there is a societal consensus that the burden of higher taxes and/or lower spending should be distributed in a progressive fashion. By this we mean that those with relatively high lifetime incomes would be most affected by the lower spending and/or higher taxes (indeed, one could make a case for increasing the share and effectiveness of government spending focused on those with the lowest lifetime incomes).

Second, fiscal adjustment should include creating room in the budget for activities that promote growth, mobility and stability. This set of priorities is grounded in good economic policy, since effective and well-targeted government programs contribute to prosperity by enhancing productivity and by creating an economic environment in which the private sector can thrive, while ensuring appropriate support for those most in need. Faster growth generates more resources for both the private and public sectors; mobility implies greater accessibility to economic success and incentive to invest; and a more stable and resilient economy provides greater opportunity for all.

While we do not specify the precise measures to be taken to ensure sustainability, changes in the fiscal commitment to seniors are likely required as part of an adjustment that also creates room for the public sector to make investments in productivity-enhancing activities. This reality reflects the salience of rising commitments to old-age transfer programs in driving the coming budgetary imbalances. Such changes must recognize that the size of this beneficiary group is growing and hence even with changes to the currently-promised benefits, the budget cost will grow. Moreover, fairness dictates a modulated approach, since current seniors and those approaching retirement rely on benefits already promised for their later years. Protecting the most vulnerable and those least able to adapt should be a further guiding principle of fiscal adjustment, with changes to the revenues or expenditures connected to the old-age transfer programs undertaken in a way that ensures that the burden of higher taxes and/or lower spending falls on those with relatively high lifetime incomes.

Any fiscal adjustment should be gradual, but with the economic recovery proceeding at a still-moderate pace, a strong case can be made for avoiding a fiscal retrenchment until growth and job creation has strengthened considerably into a self-sustaining expansion. While it would be convenient to assert that a fiscal contraction can itself be expansionary, the evidence does not support this idea. To be sure, a credible fiscal plan that ensures sustainability through gradual adjustment supports growth (as we propose also)–indeed, not ensuring fiscal sustainability ultimately would entail severe adverse economic consequences. But in the near term, fiscal withdrawal is well understood to be a drag on economic growth and must be undertaken deliberately, with fiscal policy stepping back as it becomes clear that sustained private sector growth has been established.

A gradual fiscal adjustment implemented in this way provides a foundation for economic growth and stability, creating an environment in which broadly-shared income gains and mobility are possible. However, the distribution and accessibility of gains should not be taken for granted. Indeed, the adjustment should ensure both that fiscal sustainability is achieved in a gradual fashion and that resources are available for growth-enhancing public uses. That is, reforms to programs such as Social Security and Medicare are important not just for addressing the long-term fiscal challenge, but also to make sure so that these programs, while a vital part of our society, do not inexorably crowd out from the budget the resources to support other priorities. These priorities include, for example, resources to hire pre-school teachers for universal early childhood education, to support human capital programs such as worker training, or to fund physical infrastructure development such as rebuilding America's roads and bridges. Such activities promote growth and are quintessentially the realm of the public sector, fulfilling the governmental role of supplying public goods that enhance private sector activity and overall economic growth. Moreover, public goods also help pave smoother pathways for the broad population to benefit from rising incomes and upward mobility.

Carrying out these public roles becomes increasingly difficult without fiscal adjustment. Indeed, creating appropriate fiscal space is important both to support growth and to address distributional concerns. An economy with strong growth strengthens demand for labor, supporting higher wages across the income distribution and promoting a work environment that makes possible social mobility. An effective public sector must be part of a successful economy, and a deliberate discussion about public priorities, rather than mechanical spending rules, contributes to that success. Similarly, mechanisms to ensure that taxpayer resources are spent wisely are also part of that success. Governmental spending per se is not the objective, but rather the outcomes brought about by effective public programs.

A focused fiscal adjustment is thus not only a budget issue; it is an issue of long-term productivity and growth. Revenue is eventually limited by practical, political, and social considerations, and wherever we think those limits lie, they do eventually require setting priorities. Currently, priorities are essentially set by historical mandates and budget rules, not deliberately by policy. Moreover, these historically driven costs would eventually impinge on the ability of the federal government to pay for basic research, for essential public health activities, to support affordable housing and early childhood education for needy families, to invest in infrastructure, and so on.

**Ensuring Room for Countercyclical Fiscal Policy**

Deliberate choices are also needed to ensure that there is fiscal room available for counter-cyclical policy in the face of a future economic slowdown.

Recent research emphasizes that fiscal policy can and should play an important role in countercyclical macroeconomic policy (in contrast to the view of a decade ago in which monetary policy was dominant over the business cycle). This resurgence in focus on fiscal policy follows naturally from experience during the financial crisis–see Romer (2012) and Romer and Romer (2014). For example, when monetary policy has already pushed interest rates to historically low levels, recent research emphasizes the greater effectiveness of fiscal stimulus. Empirical work on this point tends to find an especially large fiscal multiplier during the crisis, likely because the economy has operated below capacity. See, for example, Broda and Parker (2014), Chodorow-Reich et al (2012), Christiano, Eichenbaum, and Rebelo (2011), Nakamura and Steinsson (2014), Parker, Souleles, Johnson, and McClelland (2013), Romer and Romer (2010), and Wilson (2012).

The possibility that long-term unemployment can lead individuals to lose their attachment to the labor force provides a further motivation for the use of countercyclical fiscal policy. The existence of such hysteresis effects in which cyclical unemployment turns into a long-lasting (or even permanent) detachment from the labor force argues for forceful action to prevent long-term damage to the economy from a deep downturn. This further motivates both holding off on fiscal restraint now, but then ensuring that an adjustment takes place so that the capacity is available for a fiscal expansion when needed in the future.

At some point, a sufficiently high level of debt would make it costly and difficult for the United States to undertake a debt-financed fiscal expansion in response to a business cycle slowdown. Truly countercyclical fiscal policy requires adjustment during the economic upswing. Given the demonstrated difficulty in adjusting fiscal policy to reflect the business cycle (reflecting both the technical and political difficulties inherent in such adjustments), policymakers should consider fiscal rules to automate countercyclical adjustment.

In effect, this approach would encompass automatic stabilizers which both roll on and roll off in a way that is sensitive to economic conditions. This already occurs to a degree with unemployment insurance, for example, and could be added for extended unemployment insurance benefits and for adjustments to the so-called FMAP formula by which the federal government shares the burden of Medicaid payments with states. This approach puts less political pressure on the cyclical component of fiscal policy and has proven effective during the financial crisis, when automatic stabilizers already in place provided countercyclical fiscal policy in an amount equivalent in size to the deliberate policy actions taken through the American Recovery and Reinvestment Act. (See CBO, 2013, for further analysis.) Moreover, such automatic stabilizers could be targeted at fiscal margins that are identified in advance as providing especially high impact, such as transfers to low-income households.

**But if Not Now, When? Breathing Room for Now, but Not Forever**

There is no simple threshold for the critical level of debt or deficits that poses a challenge to macroeconomic or financial stability. This is a vital area for further research. With long-term borrowing rates still low, the concern is not over immediate crowding out in which government borrowing deters private sector activities such as business investment. The potential danger instead is from the loss of fiscal room to maneuver in the future–a situation in which private sector concerns over sustainability make it costly to undertake a debt-financed fiscal expansion in the face of a cyclical downturn. The pace at which the transition from fiscal support to fiscal adjustment occurs depends on a number of factors.

As the economy recovers, cyclical fiscal support can be withdrawn. A natural time to implement tighter fiscal policy would be when monetary policy is no longer expansionary, and the interest rate target is no longer constrained by the zero lower bound – that is, when the interest rate the Fed targets is no longer near zero. The attraction of this timing is that it would mark a point at which monetary policy would be in a position if necessary to help offset the economic drag from the higher taxes and/or lower spending involved with the fiscal consolidation, or to react in the event of a further negative demand shock unrelated to the fiscal adjustment. That is, fiscal consolidation (or, deficit reduction) can begin when monetary policy is in a position to return to its normal place as the countercyclical policy of first resort. Removing fiscal support before monetary policy has moved off the zero lower bound leaves the U.S. economy exposed to external shocks without flexibility in its immediate macro policy instruments. In practice, ensuring that there is some room to maneuver in monetary policy before removing fiscal support means delaying the fiscal adjustment until the Federal Reserve's target for the federal funds rate has moved sufficiently higher that the Fed could implement a meaningful interest rate cut if needed.

On the financing side, the United States enjoys a relative advantage from the immense liquidity available in the market for Treasury securities. Research suggests that investors have limited safe asset alternatives, since no other security market has the scale and security available in U.S. Treasuries (Gourinchas and Rey, 2007). Recent research examines the role of Treasuries in financial markets. This work emphasizes the special role played by Treasuries in providing a global, liquid safe asset, which can be used as safe collateral world-wide. In filling this role, Treasury securities have an "exorbitant privilege," benefitting the US government and taxpayers by keeping borrowing costs exceptionally low, even at long maturities. (Krishnamurthy and Vissing-Jorgenson, 2012) The extraordinary value of this privilege was both demonstrated and enhanced during the past several years. Global demand for safe securities and the relative paucity of safe issuers increased the value of U.S. Treasury debt despite domestic financial weakness and a higher debt to GDP ratio. This unusual benefit was also clearly evident during the debt-ceiling crisis of 2011, when S&P downgraded U.S. debt, and yet Treasury borrowing rates *fell* amid the ensuing turmoil in global financial markets. The privilege enjoyed by Treasury securities has allowed the United States to borrow more and at lower rates than might have been seen as possible before the crisis.

While this advantage has allowed for the provision of fiscal support to the U.S. economy at lower-than-expected cost, it should not be taken for granted. The ability of the United States to undertake a debt-funded fiscal expansion relies on the continued relative safety and liquidity of Treasury securities as perceived by global markets. Hence, the advantage should give some comfort–but at the same time caution, since fiscal adjustment eventually is needed to maintain the assurance that the global confidence of investors is well-founded. That is, the relative safety and liquidity of Treasuries must remain above reproach for such an advantage to persist.

While occurrences of the global safe asset are unusual, there are many cases in which sovereigns have lost the confidence of financial markets. The experience of other countries suggests that the debt threshold at which confidence is affected depends on country-specific factors. The United States has benefited from the ability to borrow cheaply and consistently even in financial crisis, and looks to maintain this ability with a debt to GDP ratio above 70 percent. Japan can borrow even with debt to GDP above 200 percent, but has the unusual situation of funding itself mainly with domestic saving.

More research is needed on the factors behind the cross-country differences, and then to bring that experience to bear on the U.S. fiscal adjustment. Historical risks to sovereign borrowing include a high debt burden, rising interest rates, inability to collect taxes, weak governing institutions, and inability to control credit growth. The policy implication for the United States remains that actions are necessary to address the fiscal imbalance over time to avoid a market-based concern about the level of debt–the point at which the interest rate response would be salient.

**Conclusion**

The budget deficit has declined to levels close to those seen historically, reflecting economic recovery as well as policy changes to both taxes and spending that have had the effect of rolling back cyclical support for the economy. Returning to a more familiar deficit-to-GDP ratio, however, should not provide too much comfort. First, the forward march of demographics will raise both the deficit and the productivity increases needed to sustain growth. Second, the composition of spending put into effect from the deficit-reducing measures does not reflect deliberately-set priorities to support economic growth and mobility. Third, larger deficits are still expected not far over the horizon. Their return will erode the fiscal room to maneuver that will be desirable during future downturns.

Harsh and immediate cuts are counterproductive, as they erode the economic foundation of fiscal balance. Indeed, fiscal contraction while monetary policy is still accommodative creates internally contradictory macroeconomic policy. Until the recovery is firmly established, fiscal policy should work in the same direction as monetary policy. Monetary support will naturally recede as economic growth picks up. With sustained private consumption and investment driving growth, the economy will be in a stronger position to absorb fiscal adjustment, and monetary policy, no longer constrained by the zero lower bound, will be able to react to external shocks.

The usefulness of fiscal policy over the business cycle goes along with the importance of fiscal sustainability in ensuring macroeconomic stability. A stable and sustainable fiscal position ensures both the ability to use expansionary policy when needed and the economic foundation on which to build a broad and accessible prosperity.

The falling deficit and low current borrowing costs provide room for the United States to get the adjustment right. The global financial crisis and recession have taught many lessons, including of the importance of countercyclical fiscal policy. Fiscal tools can be difficult to develop and implement in a careful and timely fashion, but these challenges reinforce the need to ensure that there is the capacity to use them when needed.

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