

The Cost of Crisis-Driven Fiscal Policy

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EXECUTIVE SUMMARY

Current fiscal policy is unsustainable and large, prospective deficits and debt, driven by “mandatory” spending on social benefits for the aging population and insufficient revenues, pose an eventual threat to the U.S. economy. Yet partisan divided government has failed to address this long-run problem sensibly, instead encouraging policy that is short-sighted, arbitrary, and driven by calendar-based crises. These policies have:

- Saddled a still-struggling economy with the “fiscal drag” of a contraction in discretionary spending.
- Created general uncertainty about fiscal policy that, through its impact on financial markets, has undermined economic growth.
- Forced the first prolonged shutdown of the federal government since the first term of the Clinton Administration.
- Failed to raise the federal debt ceiling in a timely manner, conjuring the specter of a sovereign default, with all its financial and economic fallout.

Results developed here suggest that the recent fiscal drag, in combination with heightened fiscal uncertainty, has slowed the annualized rate of growth in the nation’s Gross Domestic Product by as much as 1 percentage point since 2010. And while the government shutdown is, for now, more economic inconvenience than catastrophe, the consequences stemming from the failure to increase the debt ceiling could cause the next recession, even if the U.S. does not default on its debt.

Current Fiscal Policy is Unsustainable

In its recent report on the long-term budget the Congressional Budget Office (CBO) projects that under current law, the federal deficit, after dropping to 2.1% percent of the Gross Domestic Product (GDP) by fiscal year (FY) 2015, will climb steadily to 6.4% percent by FY 2038. In this scenario, the federal debt will reach 100% of GDP within 25 years—a level not seen since World War II—and will continue to rise thereafter.¹ Under less optimistic assumptions CBO projects that debt could climb to 190% of GDP over the same period. Driving both projections is a mismatch between revenues and outlays. In coming decades, outlays climb because of rapid increases in “mandatory spending” for Social Security and healthcare, which reflect an aging population and the rising relative price of healthcare. In contrast, CBO projects that under current law “discretionary spending”—outlays budgeted through the appropriations process primarily to fund operations of the civilian government and the US military—will fall from 8% of GDP in FY 2012 to 5.3% by FY 2023, the lowest level in half a century. Hence, the nation’s fundamental fiscal problem is not the immediate size of government, but rather unfunded promises of future entitlements.

The Deleterious Effect of Deficits

Economists agree that failure to shrink prospective deficits and debt will bestow significant economic consequences and risks on future generations. Federal deficits drive up interest rates, “crowding out” private investment. If government borrowing supports consumption (e.g., through Social Security and major health programs) rather than public investment, the nation’s overall capital stock declines, undermining our standard of living. The process is slow but the eventual impact is large.² In addition, accumulating debt raises the risk of a fiscal crisis. No one can say when this might occur but, unlike crowding out, a debt crisis could develop unexpectedly once debt reached high levels.

High deficits and debt also undermine the efficacy of macroeconomic policies and reduce policymakers’ flexibility to respond to unexpected events. For example, in a recession, it would be harder to provide fiscal stimulus if deficits and debt already were high. Furthermore, fiscal stimulus might be less effective then. Additional deficit spending could be seen as pushing the nation closer to crisis, thereby forcing up interest rates and undercutting the effects of the stimulus. With fiscal policy hamstrung, the burden of counter-cyclical policy is thrust on the Federal Open Market Committee (FOMC) but, particularly in a low interest-rate environment, the FOMC may be unable (or unwilling) to provide additional monetary stimulus.³

¹ The Congressional Budget Office, *The 2013 Long-Term Budget Outlook* (September 2013).

² Eventually, when yields on Treasury debt rise persistently above the economy’s underlying growth, the process can become explosive.

³ The FOMC has a “dual mandate” of sustaining “maximum” employment while maintaining “price stability”. At times, the near-term inconsistency of these sometimes-competing objectives can be addressed through coordination with fiscal policy—provided fiscal policy is not rendered inoperative by high deficits and debt. In addition, the FOMC cannot reduce the short-term interest rate below the “zero bound”. Hence, in a low-rate environment, the Fed must turn to unconventional policies to provide monetary stimulus. One such policy is “forward guidance,” essentially a promise to keep short-term interest rates lower for longer. The other is

Principles of Sensible Policy

In addressing our fiscal imbalance policymakers should be guided by a few sensible principles that transcend the details of any particular solution. First, policy should address the real problem—the mismatch between revenues and the promises made through our entitlement programs—in a credible manner. To be credible, a proposed solution must seem realistic, entail shared sacrifice, and include an enforcement mechanism not easily overturned by future political regimes. Second, fiscal adjustment should begin early enough to avoid a crises-driven response later on. It will be less painful to discipline ourselves politically today than be disciplined by global financial markets tomorrow. Third, while deficit-reduction eventually raises living standards, initially it can reduce economic growth and raise unemployment. Only later does the resulting decline in interest rates, perhaps accelerated by easier monetary policy, stimulate interest-sensitive spending enough to restore the economy to full employment at a higher standard of living.⁴ Fourth, given the trade-off between short and long-run effects, fiscal adjustment should be gradual and predictable in order to reduce near-term “fiscal drag” while minimizing the adverse impact of policy uncertainty on near-term economic growth. Fifth, in principle, the FOMC can mitigate or even offset entirely the effect of any fiscal drag. However, monetary policy affects the economy with a lag. Hence, to offset near-term fiscal drag, not only must the FOMC be able to cut interest rates, it must do so in advance of the fiscal contraction. Sixth, the fiscal adjustment should be “back-loaded” to occur when the economy is closer to full employment and interest rates closer to normal. At that point, the economy can more easily absorb fiscal drag and the FOMC can more effectively respond by lowering interest rates in advance of the fiscal adjustment.

Recent Insensible Policy

Unfortunately, polarized government has fostered a systemic refusal—or inability—to legislate sensible long-run policies to address U.S. fiscal imbalances. While there is disagreement over the terms of the inter-temporal trade-off implied by the requisite fiscal contraction, the political battle centers on the distributive role of government in society. Intransigence over that issue, combined with the annual need to appropriate funding for defense and other discretionary federal programs while avoiding sovereign default, has driven Congress and the Administration to adopt short-sighted, sometimes seemingly arbitrary policies. The number of temporary tax provision set to expire at the end of each year has risen dramatically over the past two decades. Too frequently Congress has failed to pass annual budget resolutions on time that set overall levels of spending within which priorities are then negotiated; and too often lawmakers rely on a series of “continuing resolutions” (CRs) to fund parts of

“quantitative easing”, the purchase of long-dated Treasury and mortgage-backed securities in an effort to reduce long-term interest rates directly. While these unconventional policies can be effective, they also carry risks that may discourage their further use, even in the face of a large fiscal contraction. For example, the recent back-up in long-term yields shows how difficult it might be to “exit” smoothly from the current state of monetary accommodation. In addition, despite today’s low inflation rate, some economists remain concerned about the potential inflationary consequences of quantitative easing.

⁴ To be sure, this view is not universally held. Some economists build models that show an immediate improvement in GDP following a sharp fiscal contraction usually because the models assume—unrealistically, in our judgment—that households and business quickly expect lower future taxes and so feel free to spend enough extra to offset any fiscal drag. Furthermore, often these models assume no unemployment, or treat it as a choice.

government over short horizons. The approaching expiration of each resolution creates uncertainty about spending exacerbated by the recurring threat of a shutdown of government’s “non-essential” functions. The political rancor has encouraged use of the debt ceiling as a bargaining chip in fiscal negotiations. That politicians might purposely risk the full faith and credit of the U.S. government, once unthinkable, today seems possible.

This insensible process has produced four adverse policy outcomes without addressing the true long-run issue. First, discretionary spending as a share of GDP has contracted during a weak recovery when the Federal Reserve’s ability to offset fiscal drag through easier monetary policy has been limited.⁵ Second, uncertainty surrounding fiscal policy has increased while also becoming skewed towards the “downside” with the new risks posed by the specter of government shutdowns and sovereign default. Indeed, and third, political intransigence has now pushed us into the first such sustained shutdown since the Clinton Administration. And fourth, for the second time in two years Treasury debt is approaching its legal limit while elected officials trade political barbs. All this violates sensible principles of policymaking. But what can be said about the costs of these insensible near-term policies?

Near-Term Drag of the Recent Spending Squeeze

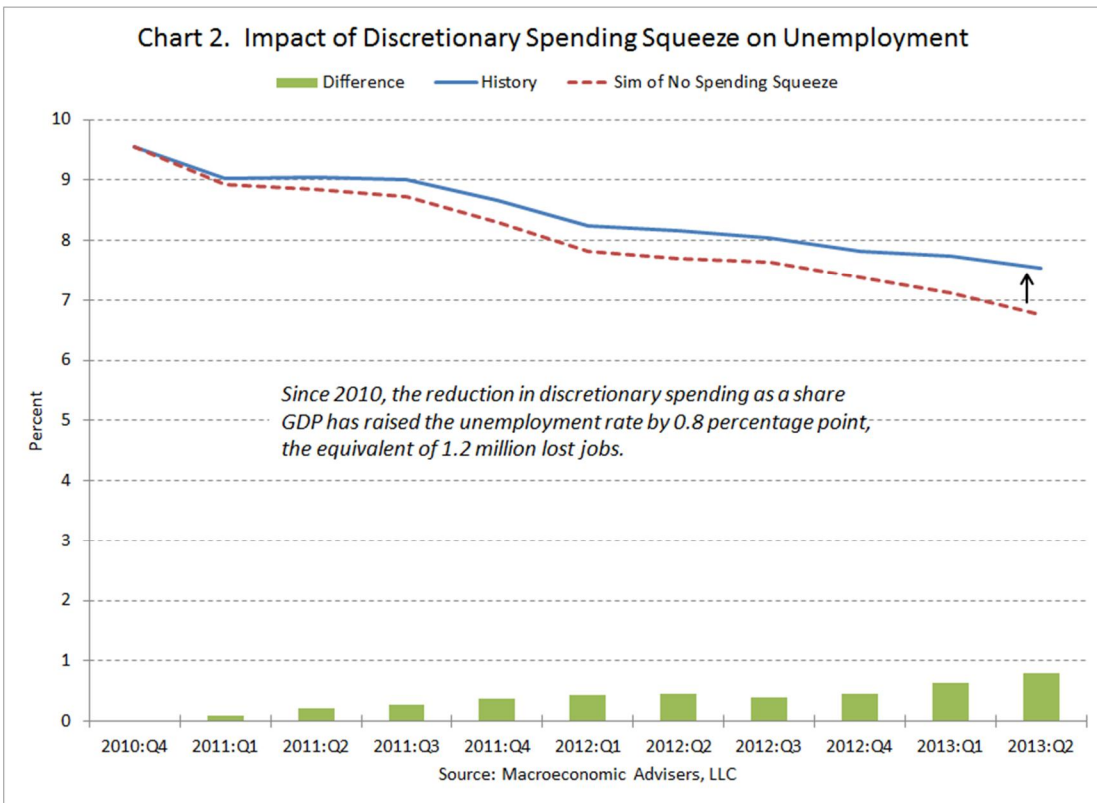
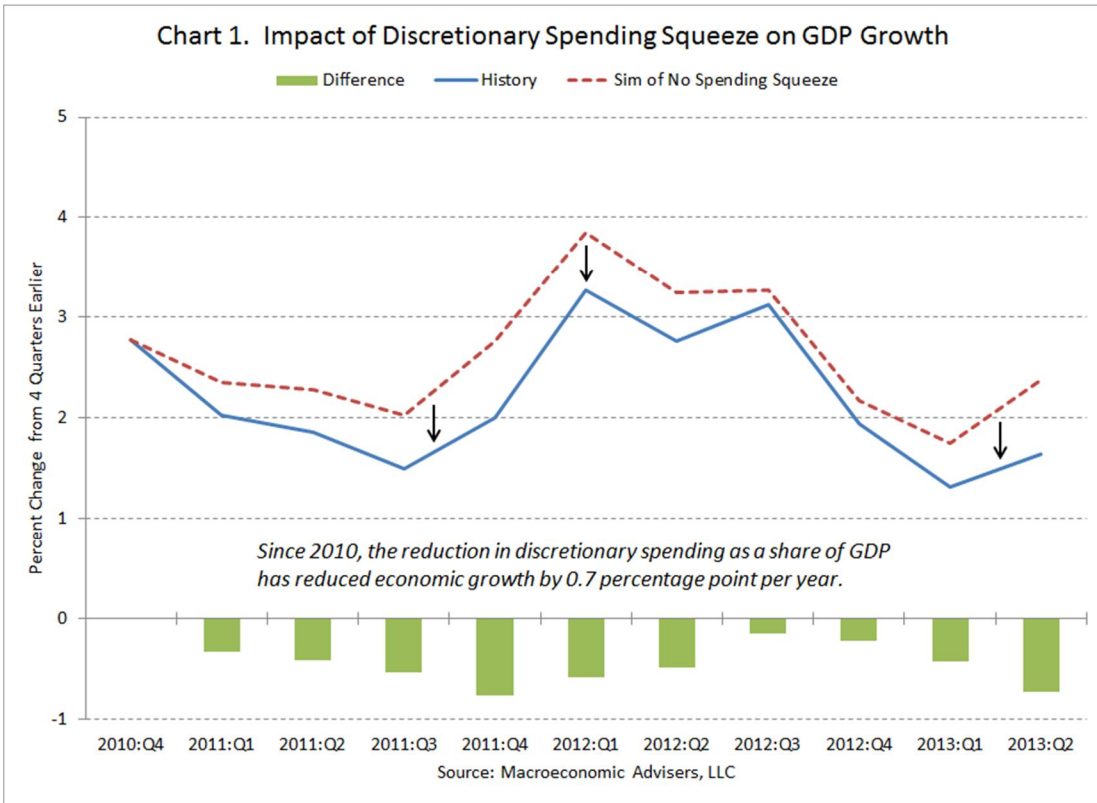
To assess the economic costs of the recent squeeze on discretionary spending we used our model of the U.S. economy to run a “counterfactual” simulation starting in 2011 but maintaining discretionary outlays at their 2010 share of GDP. The results are summarized in Charts 1 and 2. They suggest that the contraction of spending has trimmed annualized GDP growth by 0.7 percentage point since 2010 while raising the unemployment rate by 0.8 percentage point—the equivalent of 1.2 million lost jobs. This occurred when the economy was struggling to recover from the “Great Recession”. Many argued for a policy that would have delayed fiscal drag in favor of a back-loaded plan to reduce prospective deficits and debt more gradually.

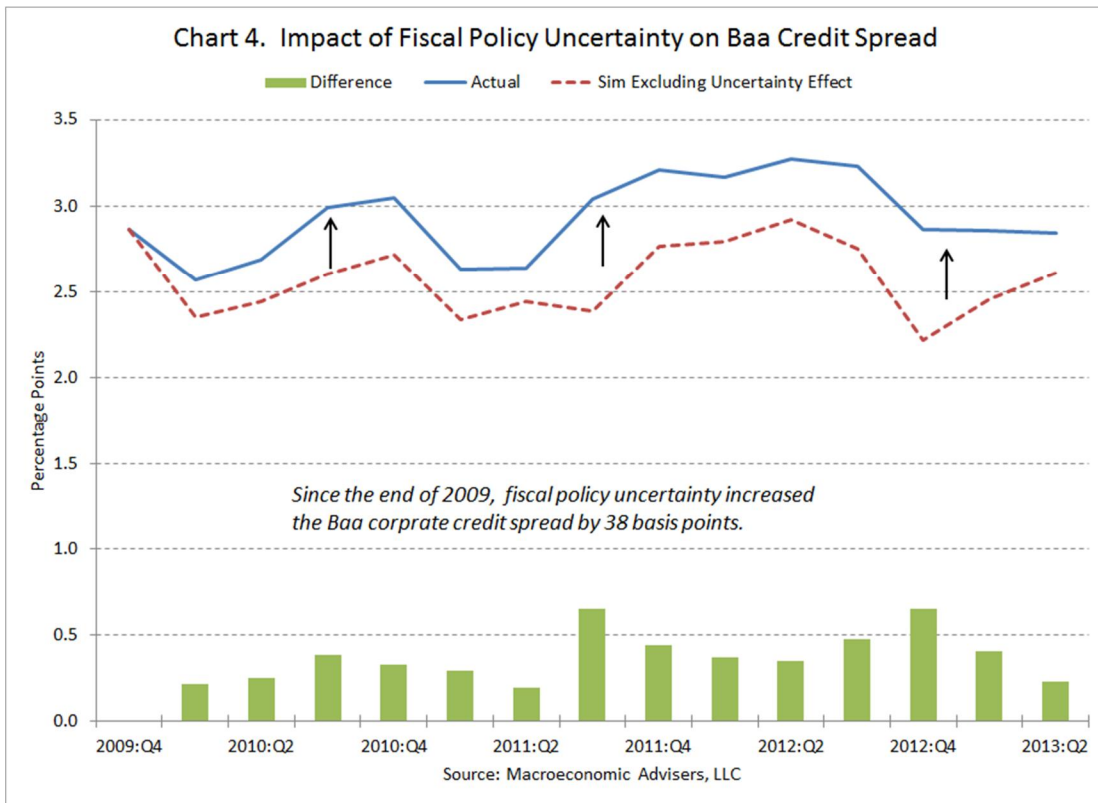
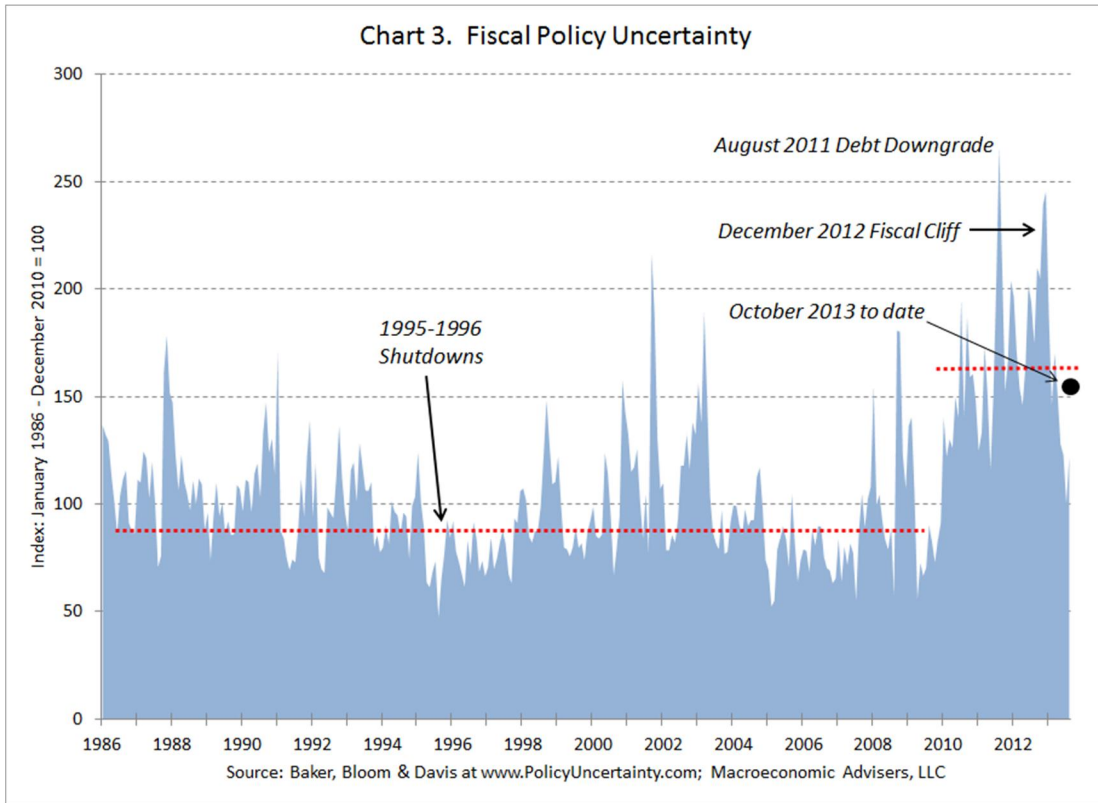
Fiscal Policy Uncertainty and Recent Economic Performance

To assess the effects of recent fiscal policy uncertainty on the economy, we created a measure of that uncertainty by modifying the “Economic Policy Uncertainty Index” developed by Baker, Bloom and Davis.⁶ Their “main” uncertainty index has four components: (a) news mentions of economic policy uncertainty; (b) the value of tax provisions expiring within two years; (c) forecasters’ disagreement about government spending one year ahead; (d) forecasters’ disagreement about inflation one year ahead. This last component reflects uncertainty about monetary policy so we expunged it to form an aggregate index better reflecting fiscal policy uncertainty alone. We also removed a cyclical component from the index because recessions foster debates about possible fiscal responses, the uncertainty over which is the result of a weak economy, not the cause of it.

⁵ CBO project that discretionary spending will fall from 7.3% of GDP in 2014, down more than 2 percentage points from 9.4% in 2010.

⁶ Scott R. Baker, Nicholas Bloom, and Steven J. Davis, “Measuring Economic Policy Uncertainty” (May 19, 2013),





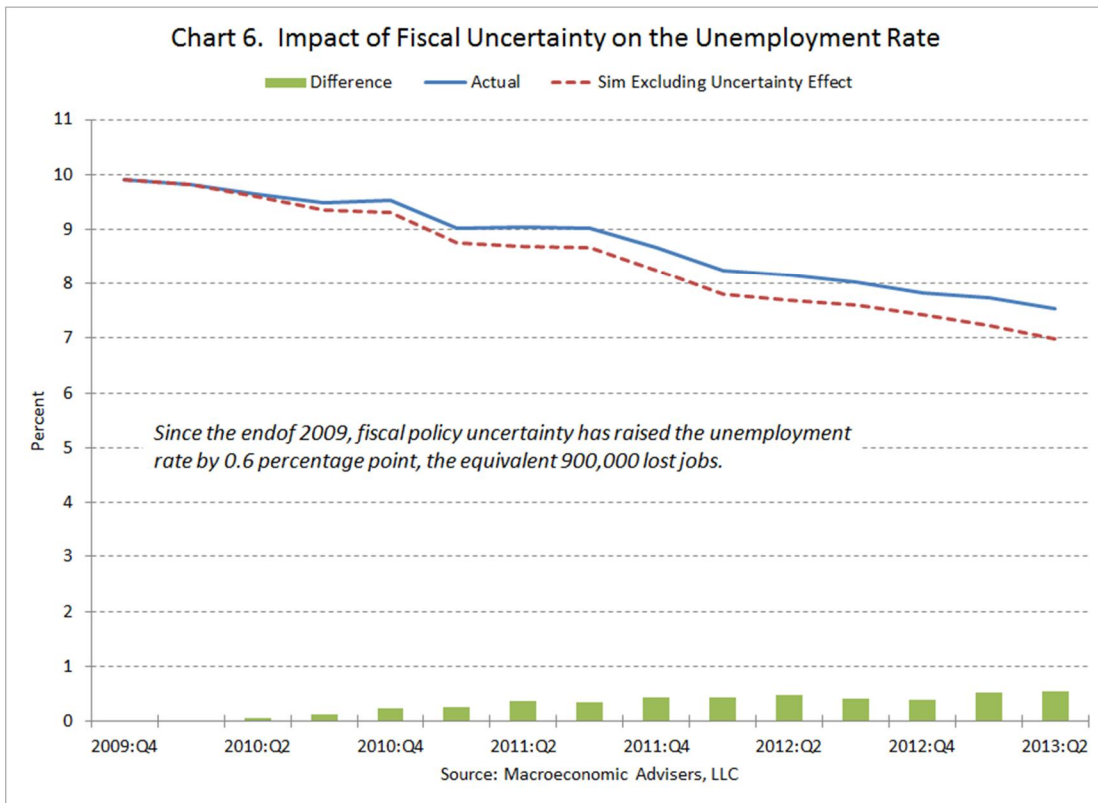
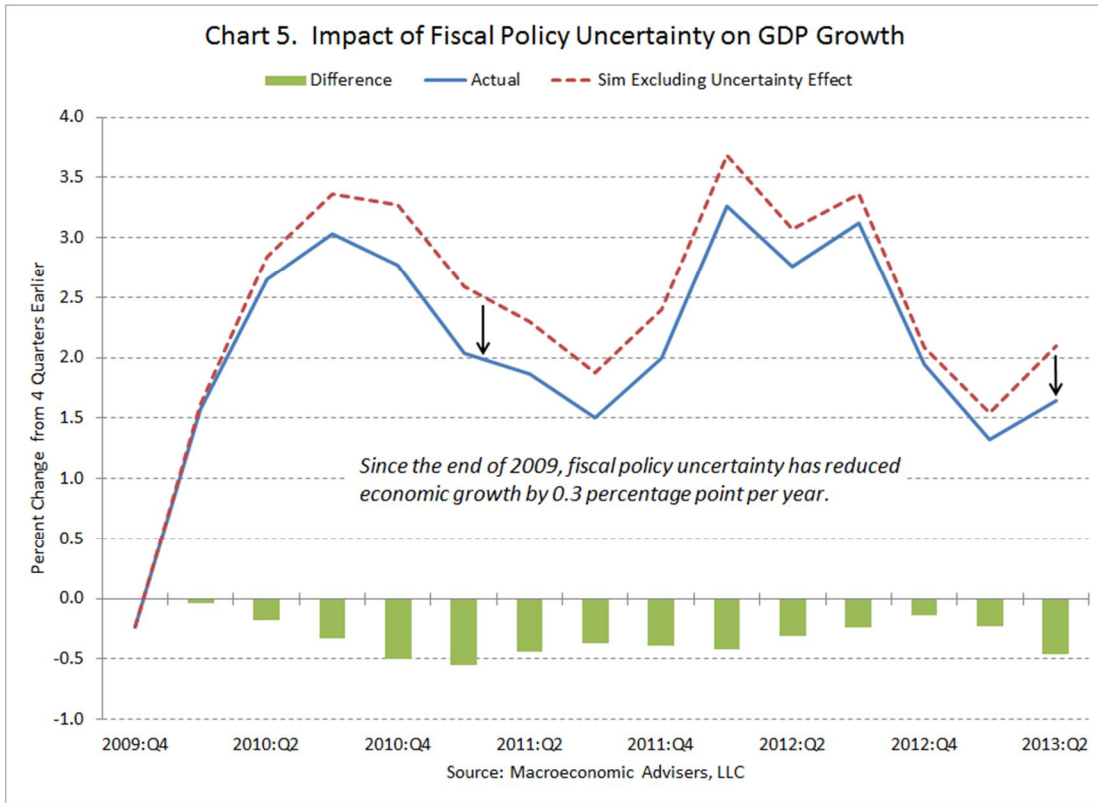


Chart 3 shows the resulting index. From 1986 through 2009 it averaged 98 but following the Great Recession it moved persistently higher to an average of 166. Much of that bulge reflected the looming expiration of the “Bush tax cuts”, but it was punctuated by two large spikes. The first occurred in the summer of 2011 during the confrontation between the Obama Administration and House Republicans as a CR wound down and Treasury debt approached its limit. The second was in late 2012 as the U.S. approached the “fiscal cliff” with its “triple threat” of a huge tax increase, the “sequestration” dictated by the Budget Control Act of 2011, and other spending cuts.

Although uncertainty might directly discourage households from spending and businesses from hiring and investing, we’ve found little evidence of such a direct link. Fiscal policy uncertainty *is*, however, inversely correlated with stock prices and positively correlated with private “credit spreads”. Hence, by undermining wealth and raising private borrowing costs, fiscal policy uncertainty can indirectly undermine household spending as well as business hiring and investment.

To ascertain how much fiscal policy uncertainty degraded recent economic performance through this indirect channel we again used our model of the U.S. economy to run a “counterfactual” simulation starting in 2010 but assuming fiscal policy uncertainty remained at its pre-2010 average. The results are summarized in Charts 4 through 6. According to our estimates, uncertainty raised the Baa corporate bond spread over this period by 38 basis points⁷, lowered GDP growth by 0.3 percentage point per year and raised the unemployment rate in 2013 by 0.6 percentage point—the equivalent of 900,000 lost jobs. Because GDP growth averaged just 2.1% since 2009, fiscal policy uncertainty alone reduced growth by about 12%.

The Cost of Shutdown

Non-essential functions of government were closed beginning Tuesday October 1 when the Senate rejected efforts by House Republicans to tie funding of the federal government to the *defunding* of “Obamacare”. History has shown that a shutdown, if relatively brief, is an economic inconvenience not a catastrophe. The last significant shutdown occurred in 1995-96, when Congress, led by Speaker of the House Newt Gingrich, played a game of budgetary chicken with President Clinton that ultimately closed the federal government for the better part of a month. During that episode there were actually two separate shutdowns. The first lasted five days, from November 14 to November 19. It affected roughly 258,000 civilian defense employees and 489,000 nondefense workers. The number of civilian workers affected (747,000) was 36% of the roughly 2.1 million federal civilian employees (excluding postal workers). The second shutdown lasted 21 days, from December 16 to January 6. It affected roughly 284,000 nondefense employees, or 14% of the total.⁸ Together, then, these shutdowns covered almost 4 weeks. In August of 1996 the CBO estimated that those shutdowns subtracted only 0.5 percentage point from GDP growth during the fourth quarter of 1995.⁹ Calibrating those events to today’s economy, we estimate that a two-week shutdown would directly trim about 0.3 percentage point from

⁷ A basis point is one one-hundredth of one percent; hence 38 basis points are 0.38 of a full percentage point.

⁸ Between the first and second shutdowns, an appropriations bill was passed covering the Department of Defense.

⁹ Congressional Budget Office, *The Economic and Budget Outlook: An Update* (August 1996), Chapter 1, page 2.

fourth quarter growth, mainly by interrupting the flow of services produced by federal employees.¹⁰ Knock-on effects into the private sector would be small for a shutdown this brief, especially as Congress already has passed motions to ensure furloughed workers receive back pay.

Hitting Debt Ceiling and Temporarily, Technically Defaulting

The experience of 2011 suggests that even flirting with default is far worse than shuttering the federal government. On August 2, 2011, the President enacted the Budget Control Act of 2011 that lifted the debt ceiling, forestalling a crisis. Yet shortly afterwards S&P announced the first-ever downgrade of Treasury debt, pinning its decision on poor governance. Credit spreads and the equity risk premium immediately jumped, as did the implied volatility of stock prices. The repercussions were evident in financial markets for months afterwards. GDP growth, which was 3.2% during the second quarter of the year, slumped to 1.3% in the third quarter before the rebounding in the fourth. Not all these effects can be ascribed to fiscal uncertainty since an episode of the Eurozone sovereign debt crisis blossomed simultaneously. Yet the timing of events two years ago leaves little doubt there is looming risk presented in our current tack towards the debt ceiling.

Technically the U.S. hit that ceiling in May, but since then the Treasury Department has resorted to “extraordinary measures” to meet its financial obligations.¹¹ These measures will be exhausted around October 17, leaving the Treasury with only \$30 billion in cash and any new tax receipts to pay bills coming due.¹² Projections are that the debt ceiling will become truly binding by the end of the month. What would happen then? The Administration has ruled out as illegal or inappropriate unconventional strategies for financing continued government operations.¹³ Given the criticality of avoiding a debt default, the Treasury likely would continue to pay interest and, operationally, separate these payments from the nearly 100 million others made monthly. That action would be possible because interest is paid through a separate “FedWire” system. However, other “primary” spending would have to be cut substantially so that the Treasury could continue servicing the debt.¹⁴ By failing to pay employees and contractors on time the U.S. might breach legal contracts. By failing to pay benefits such as Social Security, it would breach longstanding social compacts. While such failures would be less pernicious than a debt default—and more easily cured—their unprecedented nature would undermine confidence in government, rattling financial markets around the world.

¹⁰ See “Showdown over a Shutdown: The GDP Effects of a Brief Federal Shutdown”, *Macroeconomic Advisers’ Macro Focus* (Volume 8, Number 7), September 25, 2013.

¹¹ For example, the Treasury temporarily delayed re-investing federal retirement funds in Treasury debt. This reduced the federal debt held by these funds, creating room under the debt ceiling to sell additional securities to the public. The cash from the sales was then used to pay the federal government’s financial obligations.

¹² Recent reports on the budget talks ongoing in Washington suggest the parties might agree to a three-week extension of the debt to buy time for negotiating a larger budget compromise. That would avert a crisis this month but there seems little likelihood of reaching agreement on the long-run fiscal issues so quickly. Hence, in all likelihood we’d soon be facing the debt ceiling again while having generated yet another round of damaging fiscal policy uncertainty.

¹³ These include invoking the 14th Amendment of the Constitution to keep borrowing, fire-selling Treasury assets, minting platinum coins, and issuing IOUs.

¹⁴ Primary spending excludes interest on the debt.

If the debt ceiling remained binding for long it would force an unprecedented large and rapid fiscal contraction on the economy. Furthermore, given the unpredictable nature of tax revenues, the Treasury could, despite its best efforts to juggle federal finances, still find itself strapped for cash with an interest payment coming due. Before then financial uncertainty would spike, likely compelling a hasty political resolution of the impasse. Nevertheless, the uncertainty unleashed by crossing this fiscal threshold, however briefly, might undermine economic performance for several years.¹⁵

Scenario 1: Heightened Risk Aversion

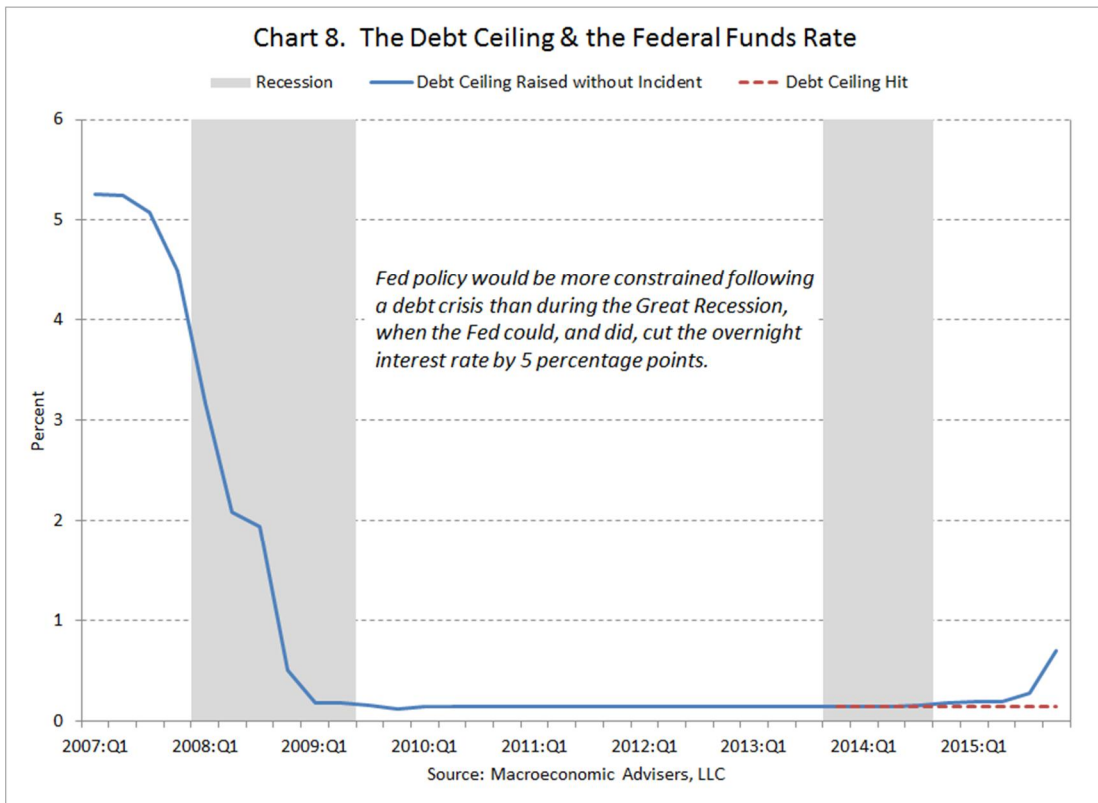
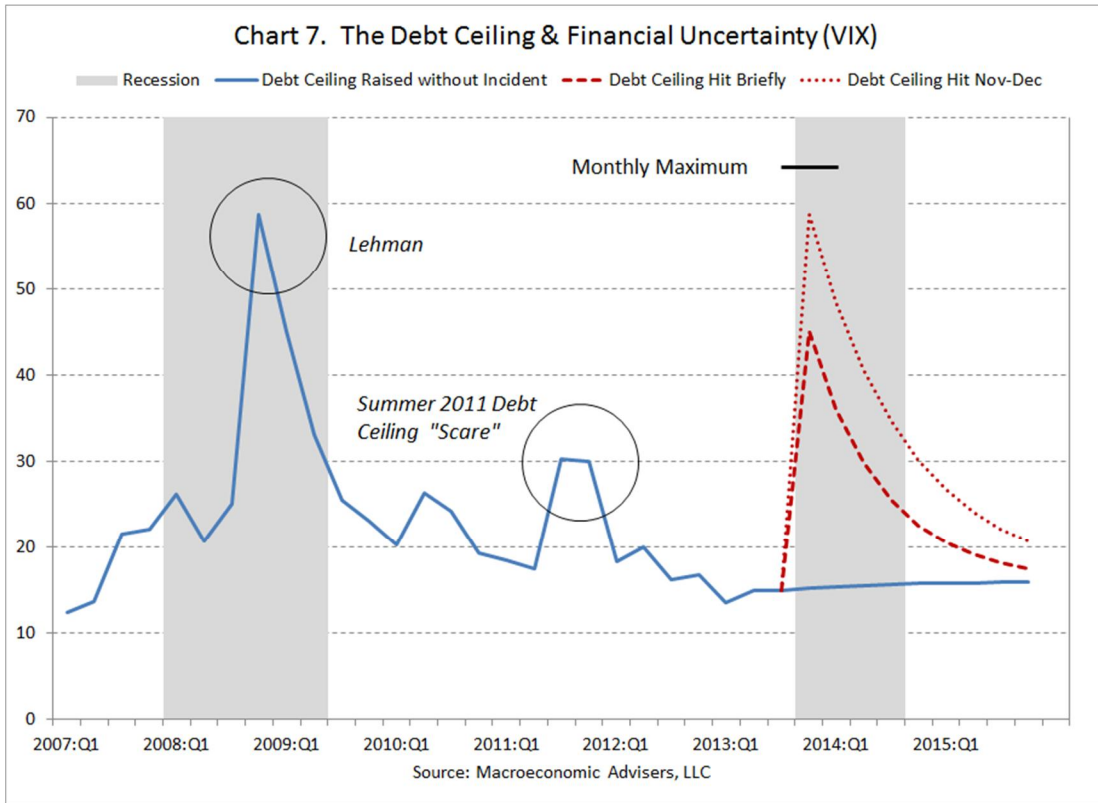
We consider two scenarios in which the debt ceiling is hit briefly in mid-to-late October. In the first, the Treasury prioritizes spending to make the interest payments due on October 31 and November 15.¹⁶ However, Social Security and Medicare payments due on October 23 and November 1 appear threatened, as do military, veterans and civil service benefits also due November 1.¹⁷ Financial conditions deteriorate sharply, forcing a quick resolution of the political impasse that avoids a fiscal contraction. Markets, however, are slow to recover. Consequently, both the U.S and the global economy weaken.

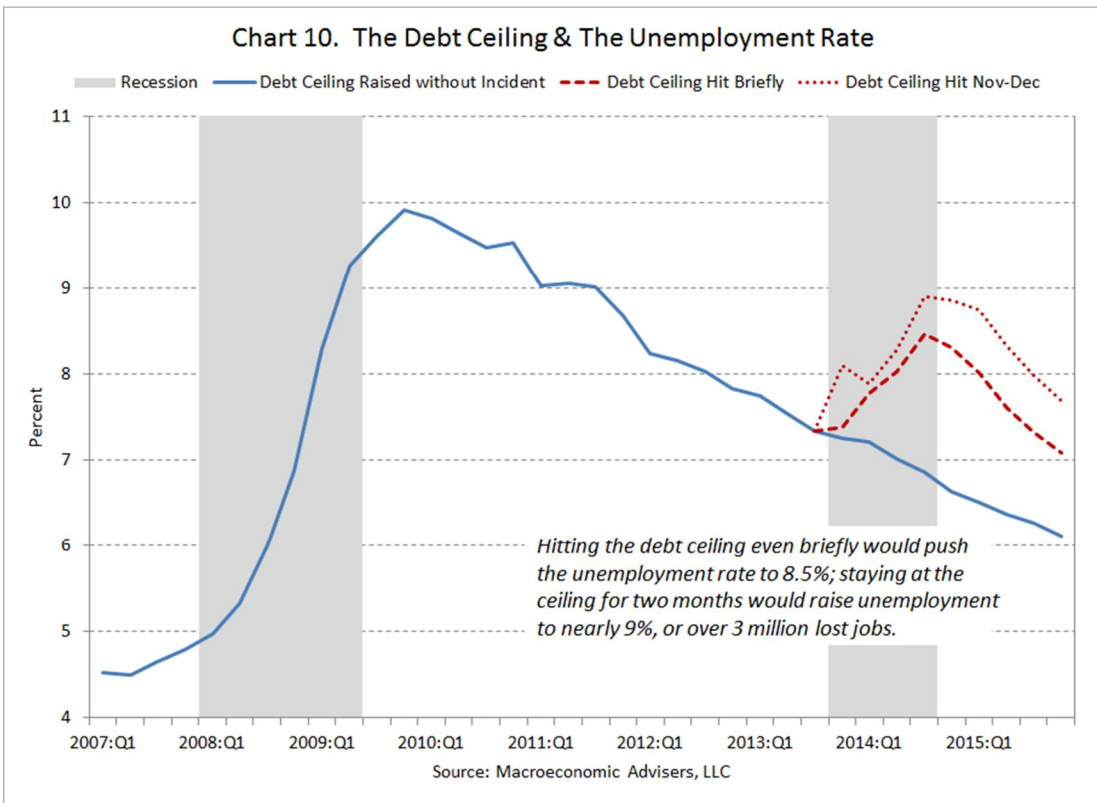
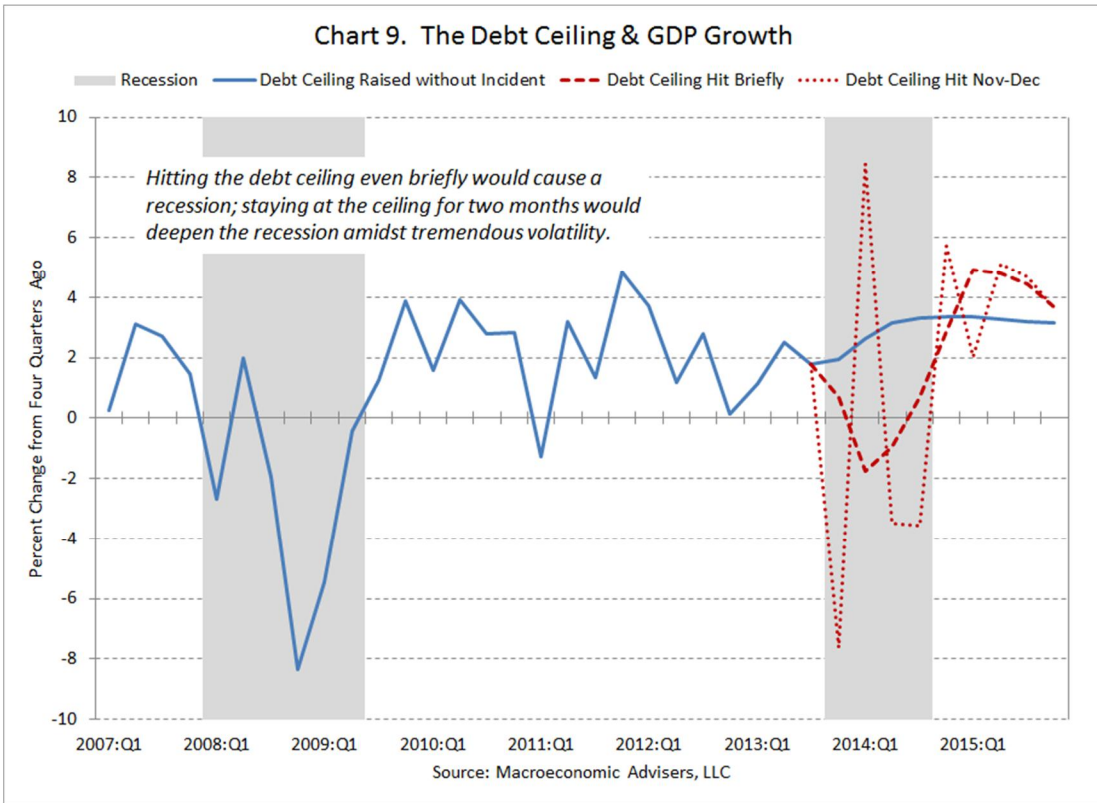
How large would the economic fallout from this be? Given the territory is uncharted, no one can say for certain. However, to calibrate the possibilities, we introduced into our model of the U.S. economy a large global financial shock starting in November, and compared the results to our “baseline” forecast in which the debt ceiling is assumed raised without incident. In our model the “VIX,” which reflects near-term volatility in stock prices and is described in the financial press as the “fear index,” serves as a general marker for uncertainty. In this scenario we assumed that in the fourth quarter of 2013 the “VIX” temporarily spikes to 45, a level intermediate between that observed during the 2011 brush with the debt ceiling and the peak hit when Lehman Brothers failed in 2008. Thereafter we let the VIX recover towards its long run average at a rate suggested by historical experience (Chart 7, red dashed line). The ripple effect of this shock raises all measures of risk aversion in our model: the equity risk premium, private credit spreads, and banks’ (un)willingness to lend. As investors eschew risk, financing costs rise, the prices of risk assets fall, and the economy slows. A mild recession ensues, exacerbated by the Federal Reserve’s inability to lower short-term interest rates (Chart 8). Growth in GDP turns briefly negative in 2014 before then starting to rebound (Chart 9, red dashed line). The unemployment rate rises to a peak of 8.5%, 1.6 percentage points above the baseline—the equivalent of 2.5 million lost jobs. Thereafter the unemployment rate does decline, but even two years later the unemployment rate is a still full percentage points above the baseline forecast—the equivalent of 1.6 million lost jobs (Chart 10, red dashed line).

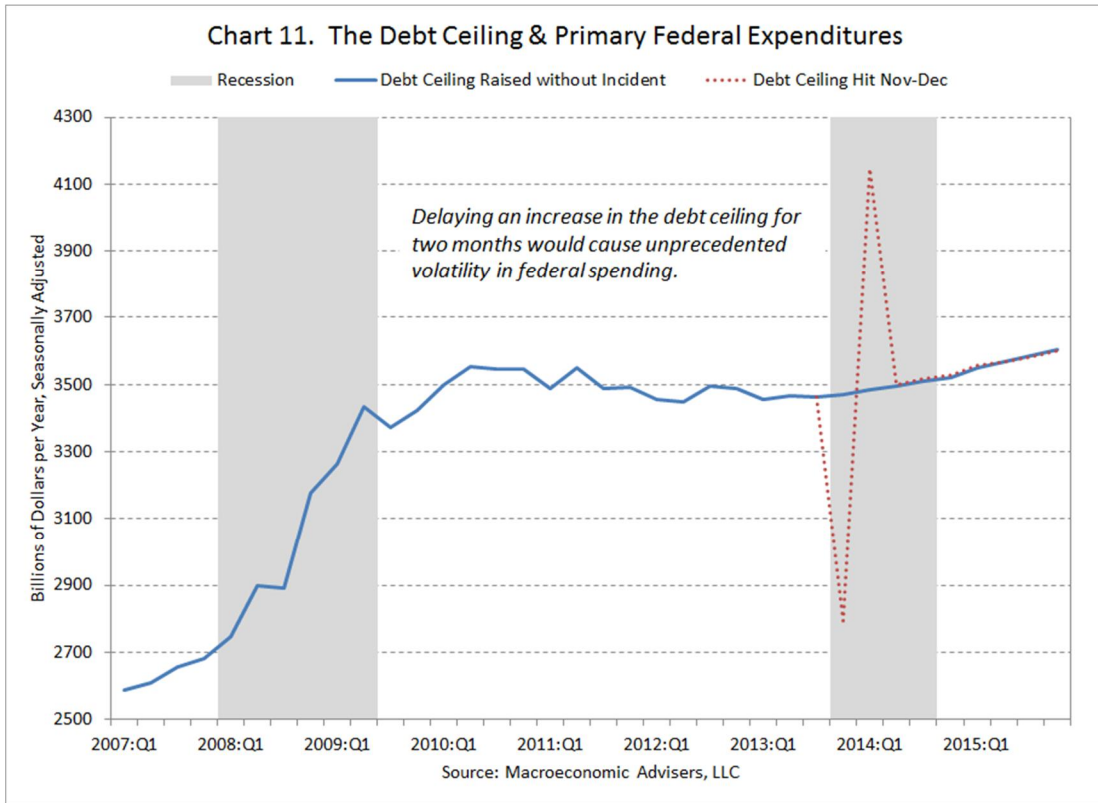
¹⁵ The effects could persist for several reasons. First, foreigners, who hold almost half the debt, might permanently re-allocate their investment portfolios away from Treasury securities. Second, as occurred in 2011, the major rating agencies might again downgrade Treasury debt. Third, there could be runs on money market funds, forcing a liquidity squeeze reminiscent of events in 2008. Fourth, because Treasuries universally serve as collateral, the threat of default could trigger margin calls that precipitate a deleveraging.

¹⁶ \$6 billion of interest comes due on October 31, and another \$29 billion on November 15.

¹⁷ Social Security payments of \$12 billion come due on October 23. On November 1, \$18 billion of Medicare payments come due, as do another \$25 billion of Social Security payments, and \$12 billion in military pay, retirement, and veterans benefits.







Scenario 2: Spending Volatility

As dysfunctional as the federal government now seems, it's hard to imagine that financial markets wouldn't quickly discipline politicians to end the impasse as assumed in the previous scenario. However, to illustrate the costs of not raising the debt ceiling, we assume in this second scenario that the political stalemate lasts two months. Again, interest payments are made on time, but in November and December primary spending is cut enough below tax receipts to balance the budget every day for two months. The necessary cuts in spending are amplified by the cyclical drop in tax revenues caused first by the heightened uncertainty and then exacerbated by the fiscal contraction itself.

To gauge the effects, we started with the previous simulation and then cut spending by the required amount in November and December, but assumed the cuts are reversed and the missed payments made up during the first three months of 2014. The resulting quarterly path of primary spending is shown in Chart 11 (red dotted line). Outlays fall roughly \$680 billion (at an annual rate) below the baseline path in the fourth quarter, then jump twice that much in the first quarter of next year during the catch up, before then falling sharply back to the baseline in the second quarter. The chart makes clear just how unprecedented such short-term volatility in federal spending would be.

To acknowledge that uncertainty would be both greater and more persistent in this scenario, we assume the VIX spikes to the same peak as in 2008 before recovering slower than suggested by historical regularities (Chart 7, red dotted line); other measures of risk aversion are sympathetically affected. The

additional uncertainty implies a longer and deeper recession than in the first scenario, but one also characterized by extreme volatility imparted by the wild swings in federal spending. Annualized GDP growth whipsaws between plus and minus 8% before the oscillations diminish (Chart 9, red dotted line). The unemployment rises unevenly to a peak of 8.9%, 2 full percentage points above the baseline forecast and the equivalent 3.1 million lost jobs. Two year later the unemployment rate is still 1.6 percentage points above the baseline—the equivalent of 2.5 million lost jobs (Chart 10, red dotted line.)

Summary and Conclusions

The results presented here suggest that fiscal drag, in combination with heightened fiscal uncertainty, has slowed the annualized rate of growth in the nation's Gross Domestic Product by as much as 1 percentage point since 2010. And while the government shutdown is, for now, more economic inconvenience overall than catastrophe, hitting the debt ceiling even briefly could cause the next recession, even if the U.S. does not default on its debt.

These estimates are uncertain—especially those describing the potential impacts of hitting the debt ceiling. Economic models derive their predictive power from past empirical regularities, and so they necessarily become less reliable when used to assess the ramifications of an unprecedented event. Furthermore, it is difficult to predict the full extent of the economic and financial instability that might accompany a heightened threat of default. Still, one can assert with confidence that the fiscal policies of the last several years have damaged our still-struggling economy. One can only hope that our policymakers will implement more sensible policies in the future but, in surveying today's political landscape, it is easier to be pessimistic than optimistic about the possibilities.