U.S. Fiscal Topography: Cliffs & Abysses

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Wicker Chair Event
What is the “Fiscal Cliff”?

- Congress has left a few things dangling
- And created for itself—and us!—a sticky wicket

Option 1. Plunge over the cliff: in the next decade

\[
\begin{align*}
\text{Spending Cuts} &= \$1.3 \text{ trillion} \\
\text{Tax Hikes} &= \$5.5 \text{ trillion}
\end{align*}
\]

Option 2. Extend current laws: in the next decade

\[
\begin{align*}
\text{Accumulated deficits} &= \$7.5 \text{ trillion higher} \\
\text{Debt-GDP ratio} &= \text{from 70\% to 88\%}
\end{align*}
\]

- Congress’ “dilemma” shares much with Homer’s
  … both are myths
Congress’ False Choice
Deficit: Actual & Projected

Actual

Projected

Baseline: The Cliff
Congress' Scylla

Alternative: Dodging the Cliff
Congress' Charybdis

Percent of GDP

Debt: Actual & Projected

Baseline: The Cliff
Congress' Scylla

Alternative: Dodging the Cliff
Congress' Charybdis
Tax Increases: 2013

Alternative Minimum Tax $125 B
Expiration of Bush Tax Cuts $110 B
Expiration of Payroll Tax Cut $90 B
Other Taxes $30 B
New Health Care Taxes $25 B

What is the “Fiscal Cliff”? 
What is the “Fiscal Cliff”? 

Spending Cuts: 2013

- BCA Sequester: $65 B
- Expiration of Expanded Unemployment Benefits: $25 B
- Lower Medicare Payments to Doctors: $10 B
What is the “Fiscal Cliff”? 

- Expiration of Bush Tax Cuts, $340 B
- Alternative Minimum Tax, $225 B
- Expiration of Payroll Tax Cut, $120 B
- Other Taxes, $60 B
- New Health Care Taxes, $50 B
What is the “Fiscal Cliff”??
Tax Increases: 2013–2022

Expiration of Bush Tax Cuts $2.8 T
Alternative Minimum Tax $1.7 T
Expiration of Payroll Tax Cut $120 B
Other Taxes $455 B
New Health Care Taxes $420 B

What is the “Fiscal Cliff”? 
Spending Cuts: 2013–2022

BCA Sequester $980 B
Expiration of Expanded Unemployment Benefits $30 B
Lower Medicare Payments to Doctors $270 B
Net Interest $1.2 T

What is the “Fiscal Cliff”?
Potential Effects of the Cliff

- Macroeconomists summarize the impacts of fiscal policy through “multipliers”
  - If government spending or taxes change by $1, how much does GDP change, now & in future?

- To justify the $787 billion stimulus package in 2009, Romer & Bernstein created “estimates” of tax & spending multipliers

- They translated those multipliers into a predicted path for unemployment
Output Multipliers for Permanent Expansions

Quarters

Spending Increase

Tax Cut
The table shows that we expect the plan to more than meet the goal of creating or saving 3 million jobs by 2010Q4. There are two important points to note, however: First, the likely scale of employment loss is extremely large. The U.S. economy has already lost nearly 2.6 million jobs since the business cycle peak in December 2007. In the absence of stimulus, the economy could lose another 3 to 4 million more. Thus, we are working to counter a potential total job loss of at least 5 million. As Figure 1 shows, even with the large prototypical package, the unemployment rate in 2010Q4 is predicted to be approximately 7.0%, which is well below the approximately 8.8% that would result in the absence of a plan.
Unemployment Rate: Actual & Romer-Bernstein

Actual Unemployment Rate

Romer-Bernstein Prediction
Predicting Fiscal Effects is Hard

- Evidently, Romer-Bernstein’s predictions lacked accuracy
- Using similar methodology, CBO has predicted effects of the cliff
- CBO’s estimates are old-school
  - fiscal effects don’t occur until fiscal variables change
  - estimates maintain an assumption about monetary policy that is at odds with actual Fed behavior
- Like Romer-Bernstein, CBO estimates come from traditional Keynesian hydraulics
Unemployment Rate: Actual & Projected

Alternative: Dodging the Cliff Congress' Charybdis
Baseline: The Cliff Congress' Scylla
Keynesian hydraulics likely misstate effects of cliff by not accounting for

1. Role of policy uncertainty
2. Role of expectations
3. Role of monetary policy

Each of these can dramatically change predictions of how the cliff will affect the economy
Misstating Fiscal Effects I

1. Role of policy uncertainty
2. Role of expectations
3. Role of monetary policy

- A number of researchers are trying to quantify the impacts of policy uncertainty
- Baker-Bloom-Davis index of economic policy uncertainty includes
  - frequency of news references to policy uncertainty
  - number of federal taxes set to expire
  - forecaster disagreement over future inflation & government purchases
- I add a measure of political uncertainty
  - degree to which political parties are polarized
  - polarization has been on the rise for 20 years
Effects of Increase in Policy Uncertainty

Figure 8: Estimated Industrial Production after a Policy Uncertainty Shock

Industrial Production Impact (% deviation)

Notes:
This shows the impulse response function for Industrial Production and employment to an 11.2 unit increase in the policy-related uncertainty index, the increase from 2006 (the year before the current crisis) to 2011. The central (black) solid line is the mean estimate while the dashed (red) outer lines are the one-standard-error bands.

Estimated using a monthly Cholesky Vector Auto Regression (VAR) of the uncertainty index, log(S&P 500 index), federal reserve funds rate, log employment, log industrial production and time trend. Data from 1985 to 2011.

Employment Impact (millions)
1. Role of policy uncertainty
2. Role of expectations
3. Role of monetary policy

- The fiscal cliff is no surprise—an outgrowth of polarization
- We have had an inkling of this cliff since the 2001 Bush tax cuts came with a sunset provision
  - during the 2000s did anyone really believe that in 2011 tax rates would jump to their pre-2001 levels?
  - this was a political gimmick from the get-go
- Since the Budget Control Act was enacted in August 2011, people have put some probability on Congress continuing its dysfunctional ways
  - did anyone really believe the Super Committee would do anything super?
  - that was a political gimmick from the get-go
Research on *fiscal foresight*—which people certainly have about the cliff—suggests

1. Impacts of future fiscal changes can begin well before changes take place
2. Impacts can be perverse relative to standard predictions
3. Impacts are not correctly measured by conventional models

Example: well-anticipated income tax increase

1. negative wealth effects kick in immediately
2. increase labor supply, employment & output now
3. substitution effects kick in when tax hikes occur
4. decrease labor supply, employment & output in future

A depressing message: our anemic job growth may be *more* rapid than it would otherwise be
1. Role of policy uncertainty
2. Role of expectations
3. Role of monetary policy

- Fed has kept funds rate at Depression-era levels
- And has announced intention to keep it there for at least 3 more years
- If fiscal cliff creates lower expected inflation...
  - Fed policy translates into higher real interest rates
  - amplifies contractionary impacts of the cliff
Multiplier for Spending

Present Value Multiplier of Spending for Output

Average (solid) & 90% Probability Bands (dashed)

Assumes the "usual" policy: monetary policy aggressively targets inflation

Range of Multipliers from Conventional Macro Model Makes Obsolete Assumptions About Fed Behavior
Multiplier for Spending

Present Value Multiplier of Spending for Output

Average (solid) & 90% Probability Bands (dashed)

Assumes the "usual" policy: monetary policy aggressively targets inflation

Assumes current policy: monetary policy aggressively reacts to output or is at the zero lower bound for interest rates

Range of Multipliers from Conventional Macro Model
Makes Realistic Assumptions About Fed Behavior
Ready for a Shocker?

- Multipliers also work in reverse
  - Major cuts in spending
  - Major increase in taxes
  - Fed policy of keeping interest rate at zero until mid-2015
- These point in one direction:

Declines in GDP & employment

- Europe is the poster child for this as the eurozone enters its second recession
Turning to the Abyss
We Are All Aging Rapidly

Dependency Ratio: Population 65 and above relative to ages 15-64

Blue: 1960
Red: 2005
Green: 2050
U.S. "Unfunded Liabilities"

The chart illustrates the unfunded liabilities of Social Security and Medicare and Medicaid as a percentage of GDP from 1962 to 2082. It shows a significant increase in the unfunded liabilities over time, with Medicare and Medicaid contributing more to the overall unfunded liabilities.
U.S. “Unfunded Liabilities”

- Social Security
- Medicare and Medicaid
- Other Federal Non-interest Spending

Percentage of GDP

- Other Federal Non-interest Spending
- Medicare and Medicaid
- Social Security

Federal Debt as a Share of the Economy: Actual and Projected 1790–2084
What Do Sensible People Think?

- These projections cannot happen
- Some assumptions underlying projections cannot hold
  1. economies will grow out of projected deficits
  2. governments will default outright on debt
  3. fiscal policies will adjust surpluses to stabilize debt
  4. paths of inflation will turn out different from assumed
  5. some combination of the four
- No one serious believes 1
- Europe makes clear how onerous is 2
- Most central bankers hope for 3
  - what are the prospects for significant fiscal reform?
KEEP GOVT OUT of MY MEDICARE

Dawn Teo
Europe Today—America Tomorrow?
Europe Today—America Tomorrow?

Sovereign Interest Rate Spreads Over German Bund

Basis Points

Greece

Italy

Spain

Portugal
More Than One Way to Default

- Portugal, Ireland, Italy, Greece & Spain do not control their monetary policy
  - can default only by outright refusing to pay

- United States controls its monetary policy

- Now and for the next several years, Fed intends to maintain high bond prices

- This primes the U.S. economy for fiscal inflation
  - U.S. treasuries are denominated in dollars
  - some treasuries have long maturities
  - increases in the price level devalue outstanding debt

- Debt expansions not backed by future tax increases must raise current & future inflation

- Permits the U.S. to default by devaluing debt
General Points About Inflation

- People value money because government accepts currency—and only currency—in payment of taxes
- Inflation arises when government prints more currency than it eventually absorbs in taxes
  - people try to get rid of currency & buy things
  - pushes up prices & wages
- Government can soak up currency by selling bonds
  - does this when it spends more (hands out currency) than it taxes (soaks up currency)
- Nominal bonds—like fiat currency—are promises to pay back more currency in future
- If government doesn’t soak up bonds with taxes... inflation
General Points About Inflation

- Just as money gets its value from taxes...
- Monetary policy gets its power from fiscal backing
- When fiscal backing is assured, MP operates as taught in textbooks
  - MP can control inflation
  - higher interest rates—open-market sale of bonds—reduce consumption & inflation
- But fiscal backing requires future taxes to rise to soak up bonds
- Otherwise, higher rates (tighter monetary policy)...
  - raises wealth, reduce value of bonds, increase aggregate demand & inflation
- Without fiscal backing, monetary policy can’t work
An American Policy Option

- As long as political polarization persists, prospects for policy progress are poor
- Likely impacts will far exceed any coming from the “fiscal cliff”
  1. Elected leaders’ unwillingness to act creates massive uncertainty
  2. Reasonable people will put some likelihood on
     - taxes rising in future
     - Social Security & Medicare payments being cut
     - inflation rising to stabilize debt
  3. As consumers & firms hedge against uncertainty, savings will rise & employment will fall
  4. Simultaneously, inflation will rise
  5. Postponing reforms enhances the deleterious impacts
  6. Absent credible reforms, prospects are for prolonged future stagflation