Fiscal Resiliency in a Deeply Uncertain World

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Key point

The era of low interest rates is teaching us the wrong lesson:

- It is not that rates will necessarily stay this low forever (how most of the fiscal debate is now being framed)
- It is instead that we are very bad at predicting the future -- a fact that goes well beyond how poorly we anticipated the era of persistent low rates
- We therefore need a new fiscal paradigm to reflect deep uncertainty, not just a shift in the parameters to reflect the current era of low rates
- Major take-away: we are cognizant of how often economic and budget projections are wrong.
    - Rather than being surprised once again in the future when reality intrudes on a confidently made prediction, that thought should be incorporated in the design of our fiscal policies in the first place.

What does that mean?

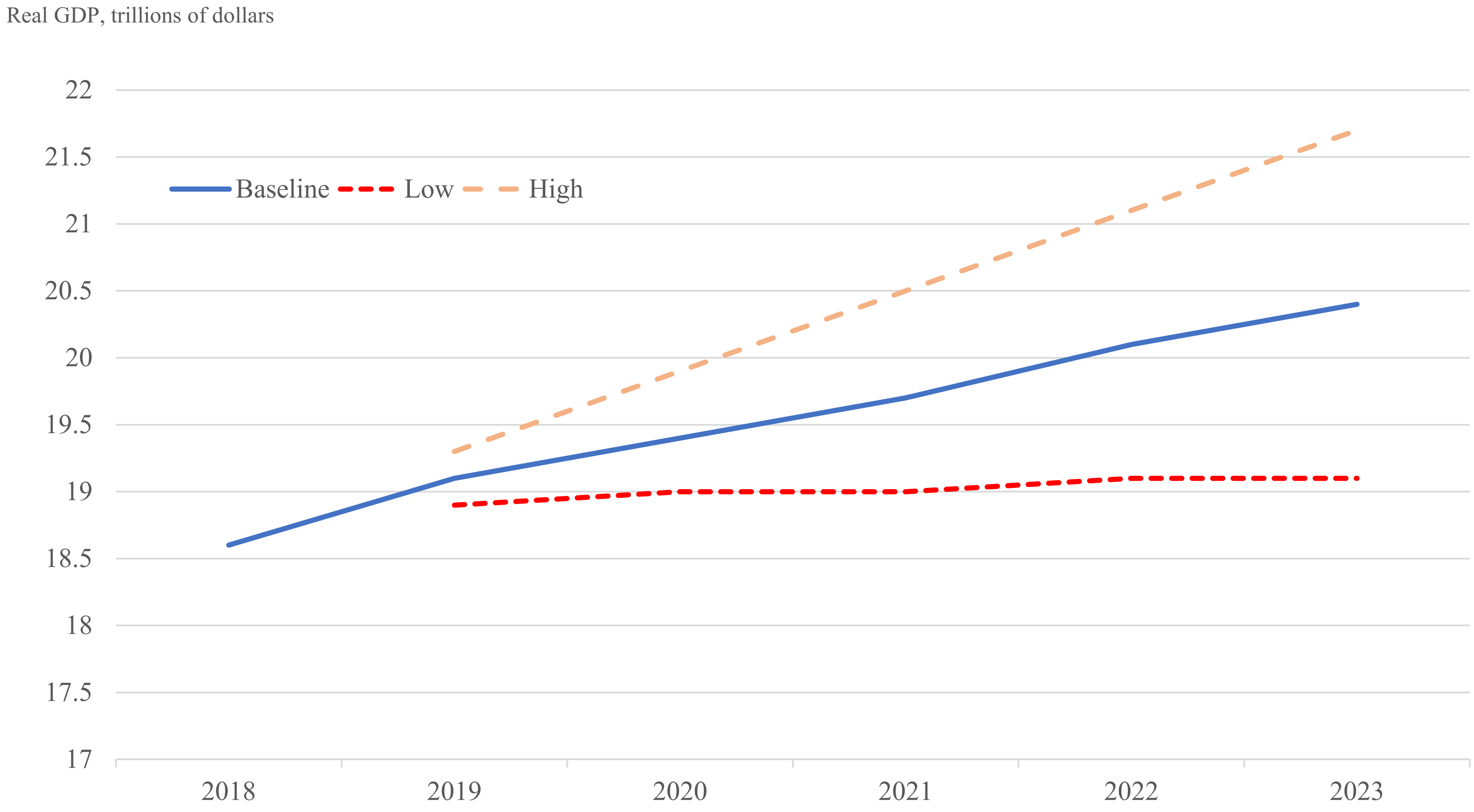
- Do not rely on arbitrary top-down fiscal anchors – like the deficit or debt (or even net interest) as a share of the economy
- Instead reserve full discretion for policy-makers to adjust, without being constrained by arbitrary top-down anchors
- <u>But</u> have the budget respond more automatically to short-term economic conditions and long-term drivers within each major entitlement program, to ease the decision-making burden embodied in discretion
- The result is what we call “semiautonomous discretion.” (We are open to better names.)
- The underlying idea is akin to assisted driving: retain full autonomy for the driver but make the process more focused

Five-point plan

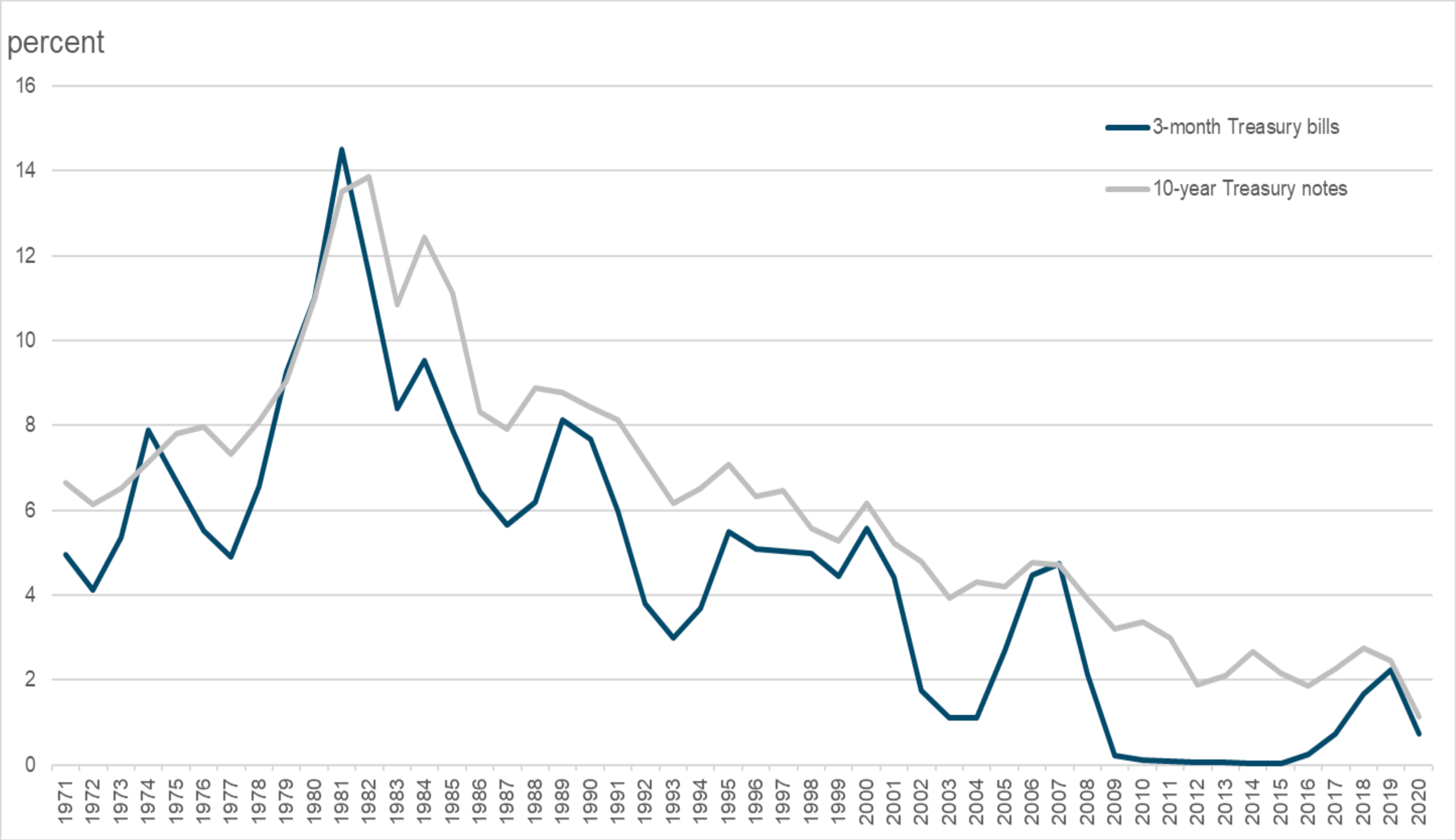
In addition to embracing substantial additional fiscal support for the economy in the short run, we sketch five elements to this new fiscal architecture:

- Stronger automatic stabilizers;
- A new infrastructure program that offsets the growing pro-cylicality of infrastructure spending;
- Extension of debt maturities;
- Indexation of long-term fiscal programs to their underlying drivers;
- More emphasis on residual fiscal discretion on top of these measures

Budget and Economic Uncertainty



Interest Rates



How Confident Should We Be About Low Rates Beyond the Near Term?

As one example, CBO links lower rates to many factors, including:

- Lower real output growth;
- Higher savings rates;
- Slowing labor force growth and an aging population;
- An increase in the capital share of income;
- Changes in the premium on risky relative to safe assets;
- Evolution of the debt-GDP ratio

"The agency's forecasts of interest rates over the medium and long terms are highly uncertain, in large part because forecasts of the underlying driving factors are uncertain."

Net interest as share of GDP

	2021	2025	2030
CBO baseline	**1.4**	**1.2**	**2.2**
With 25 basis point increase in rates per year	1.5	1.8	3.9
Difference relative to baseline	**0.1**	**0.7**	**1.8**
Note: Interest rate increase relative to baseline	0.25	1.25	2.5

False Attractions of Top-Down Fiscal Anchors

Problem 1: No clear threshold beyond which the budget becomes unsustainable

- threshold depends on investor perception, the state of financial markets, and other variables beyond purview of most fiscal models and which vary over time and across different environments
- also depends on political economy considerations, such as the degree of social willingness to accept higher taxes and/or lower spending to address fiscal instability. These also likely vary over time.

False Attractions of Top-Down Fiscal Anchors, continued

Problem 2: even if an unambiguous sustainability threshold could be defined, we have little insight into when the fiscal path would hit that threshold.

- 2/3 confidence interval around CBO's five-year-ahead deficit forecast: 4 percent of GDP
- For debt: 12 percent of GDP

False Attractions of Top-Down Fiscal Anchors, continued

- Aligned with skepticism in Blanchard, Leandro, and Zettelmeyer (2021)

- One example: 3 percent deficit target

  "Journalists found that the 3 percent limit was 'invented' by two low-rank young officials in the French Ministry of Finance in 1981. They were asked by Philipp Bilger, deputy of the budgetary department in the Ministry of Finance under Laurent Fabius, the then finance minister under the presidency of Francois Mitterand, to make a proposal for budget negotiations in order to limit the wishes of cabinet members. There was no economic rationale behind the number 3, as the inventors told the journalists. The French negotiators of the Maastricht Treaty used this number, specifically Jean-Claude Trichet, at the time Finance Minister; the Germans agreed."

Note: although we are not certain where any fiscal limit resides, we do not believe it makes sense to assume one does not exist.

Sketch of Five-Point Plan: Semiautonomous Discretion

Part 1: Bolster Auto Stabilizers

Fiscal stimulus has been quite effective in response to pandemic and to financial crisis, but the risk of ending prematurely looms large (as recent delays in enacting another round of support illustrated). Strengthening the automatic stabilizers would attenuate this risk.

Stabilizer expansion could include:

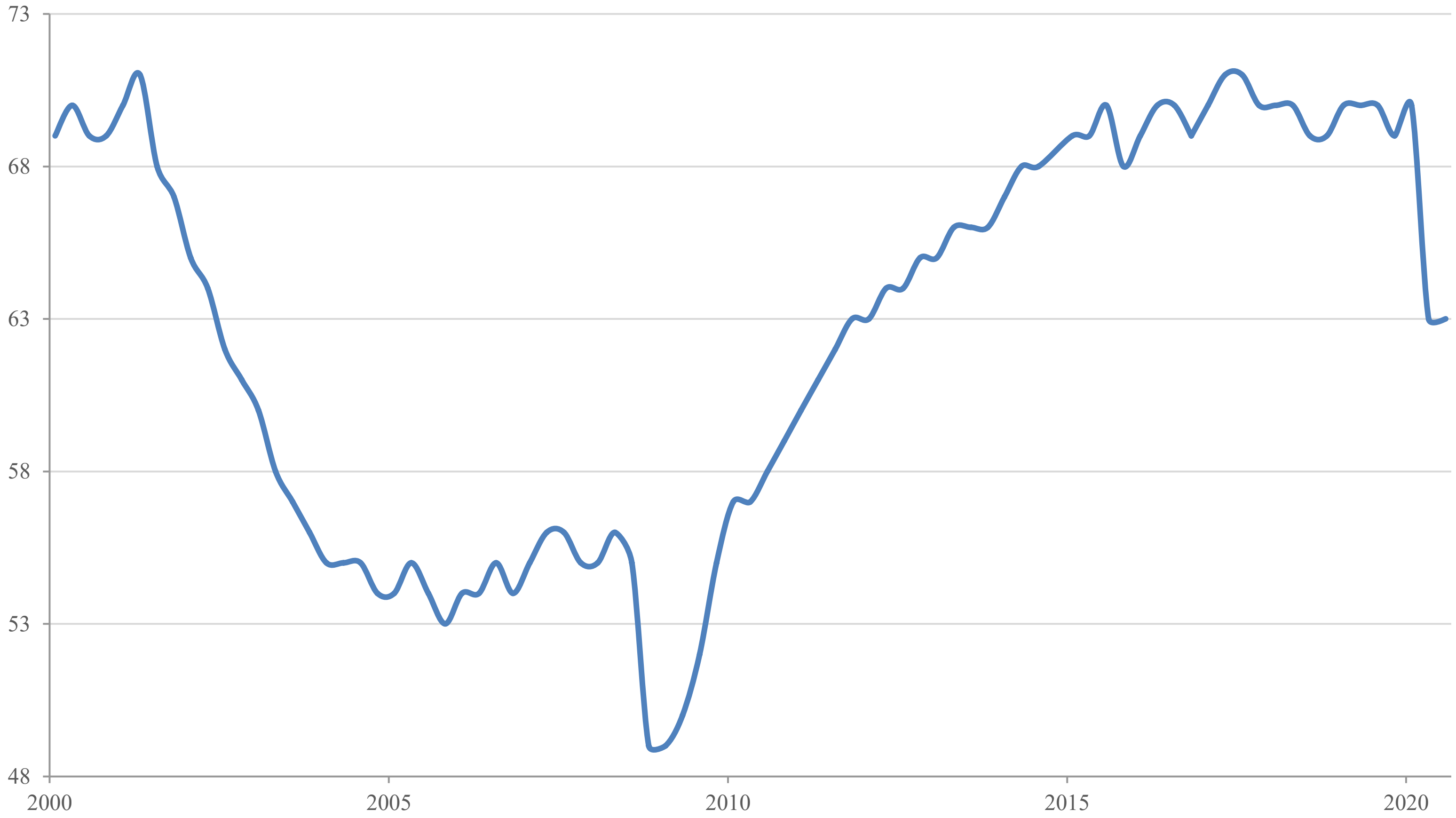
- direct cash rebates (Sahm 2019)
- unemployment insurance (Chodorow-Reich et al 2019)
- SNAP (Hoynes and Schanzenbach 2019)
- state and local fiscal aid (GAO 2011)

Part 2: New infrastructure program

- Haughwout (2019): "infrastructure investment varies positively with overall economic activity; in other words, investment disproportionately occurs when macroeconomic conditions are strong, and diminishes as the economy weakens…."
- New infrastructure program could expand during recessions and focus on projects that could be quickly completed (or substantially accelerated) during periods of economic weakness.
  - Example: new Federal grant program could match state and local government infrastructure spending. Match rate would increase when the economy weakened, providing more funding when it is most useful from a macroeconomic perspective, smoothing public investment through the business cycle. The match rate could also, as under Medicaid, vary inversely with per capita income in the state and could be tied to local economic conditions

Part 3: Lengthen debt maturities

Average Federal public debt maturity, months



Part 3: Lengthen debt maturities, continued

- Insurance against rate changes could be accomplished by extending Treasury maturities
  - Increase the issuance of longer-dated instruments (i.e., 10-, 20-, and 30-year)
  - Create new instruments (e.g., 50- or 100-year bonds or even a perpetuity)

- Extension of maturities mitigates risk of an interest rate increase on the existing stock of debt but would not eliminate all interest rate risk

- Like any insurance policy, maturity extension not a “free lunch”

Part 4: Indexation of key programs

Example: index Social Security to life expectancy (e.g., Diamond-Orszag 2006)

Motivations:

1. Intent of program (protect against individual mortality risk, not population-wide changes)
2. Tilt toward fiscal balance, with understanding that changes can be undone in future if necessary (asymmetry behind original intent of budget reconciliation rules)

Part 5: Discretion

- Even with more resilient budget that includes more adjustment features, policymakers will almost inevitably need to act
- This is “semi-autonomous discretion” we embrace
- Note: we currently have different views about how policymakers should act in late 2022 and thereafter, assuming economy recovers to full employment by then.

A personal note

New York Magazine, April 2011:

"Peter Orszag….saw laid before him two different paths: Stiglitzism and Rubinism. There were both intellectual and career-arc components to these. While both are liberal Democrats, Rubin was the consummate insider, whose philosophy was that the free markets, balanced budgets, and limited regulation would create a rising tide that would lift all boats (or at least make Wall Street not complain too much about Clinton's social programs). Stiglitz, the public intellectual, is as concerned with the boats as with the tide."