Challenges for fiscal policy in the US

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I will touch on two topics relevant for US fiscal policy: stubbornly high unemployment and the long-run debt issue. Addressing these issues should incorporate concern as well for the quality of spending and taxing. While raising the debt limit has great importance and has the potential to impact other issues (for better and worse), I will not address it as anything written now will be out of date by the time it reaches readers.

I. Unemployment

The Fed has very little left with which to address this problem and it has announced that, other than by holding on to its portfolio, it will not do much. And I think that, by and large, it can't do very much. So if the US is to address its stubbornly high unemployment, we want more fiscal stimulus. In the eyes of many, including Marty Feldstein and Paul Krugman, the first fiscal stimulus bill was too small.

In judging the size of the fiscal stimulus, it is necessary to consider a counterfactual – what would have happened with a different size bill (perhaps zero). That we still have high unemployment does not say anything about whether it would have been even higher without the fiscal stimulus. Many analysts with macro models estimate that it would have been much higher. Similarly, the fact that the Obama administration was overoptimistic about what would occur after the stimulus also does not answer the questions of whether it helped and whether a larger stimulus would have helped more.

It seems to me that we need more fiscal stimulus, and certainly not an overall reduction in stimulus, as may happen when the previous stimulus phases out and is threatened by some proposed short-run spending cuts to address the long-run debt problem. Of course, some spending can be cut back and some taxes increased along with other actions that are more than fully offsetting from a stimulus perspective. In considering the mix of actions, it is appropriate to pay attention to both macro and micro dimensions – how much stimulus occurs with different policies relative to the direct increase in deficit and how valuable is the increase in consumption and/or investment that is accomplished as a consequence of the stimulus. The US has an enormous backlog of infrastructure needs. If an investment will be made eventually anyway, it is cheaper to do it at a time when you're drawing in part from idle resources and when you will get a multiplier of some kind.

An increased stimulus can make a critical start on addressing high unemployment, but it can't deal with the problem alone, because some of the increased unemployment is structural. As we've had a sudden large increase in unemployment, the bulk of it is not structural – the quality of matching of workers and jobs just does not deteriorate that quickly for structural reasons. First, an unusually large fraction of the unemployed is long-duration unemployed. It is well documented that it's hard for them to come back to work, so down the road this is a problem. There are some estimates of the current size of this impact that I think make very little sense. Looking just at individual job finding, some estimates are essentially built on the assumption that employment equals labour supply, so that when you get an

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extension of unemployment benefits, this calculates out as less labour supply. But when you have a very high ratio of unemployed to vacancies across all industries, and you reduce the willingness of a fraction to take jobs, that may have little effect on the availability of the unemployed to fill the jobs. Thus, it's not clear that benefit extension is a significant short-run issue, but in a longer run it is.

Second, we overbuilt both residential construction and commercial construction. That will affect further construction for an extended period. This calls for some reallocation of labour, at least on a temporary basis, which affects the efficiency of the labour market. Third, small businesses are growing more slowly compared to large businesses than traditionally. I think part of that is that lending by small banks has been tightened a lot. Large firms are sitting on a lot of money and can tap the bond market directly, but small firms are heavily reliant on banks. Moreover, a lot of small business startups rely on accumulated wealth as well as borrowing. For many potential entrepreneurs, their wealth is mostly housing, and much of that is gone. So while we do have a significant scope for an aggregate-demand increase to reduce unemployment, I think we should approach it somewhat cautiously, not relying on it exclusively or excessively.

II. Long-term debt

Carmen Reinhart showed us the history of the debt-to-GDP ratio in the US in the last century, a pattern that broke down in the late 1970s. Until then, the ratio rose sharply in wars and depressions, and trended down afterwards. Had Carmen included the 19th century in her chart, we would have seen the same pattern after the Revolutionary War, the Civil War, and some of the depressions. So there was a big break starting in the late 1970s. The 1980s and 1990s saw several legislative attempts to address the size of the debt, legislation that did not work in the 1980s but did in the 1990s. So a key issue in projecting the future of US debt is the kind of politics the US will have.

Alan Auerbach showed us the Congressional Budget Office baseline, which is focused on current law and does not reflect that Congress regularly undoes some parts of current law, including the sunsets of some tax reductions.[2] For example, the lapsing of all of the Bush tax cuts would raise a great deal of money. But that is not expected to happen. The Alternative Minimum Tax is projected to affect a rising fraction of the public, but again, that is not expected to happen as annual fixes are expected. Another example is that Congress regularly votes for some harsh cutbacks in Medicare payments to providers, and then delays them, putting them in place to start later on.[3] Alan also showed us the debt projection under a more realistic policy-as-usual projection, showing a much more serious problem. Eventually, continuation of this policy as usual would become unsustainable. It is not clear when "eventually" would occur, but absent a debt-limit triggered response, I don't think that continuing policy as usual will trigger a large bond market reaction for an extended period. If the debt trend does continue with no apparent change in politics, then at some time, the bond market will respond based on the debt level and the political forecasts at the time. The stock market may well react sooner than the bond market does.

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[2] An exception to this approach is the scoring convention for Social Security. By law Social Security can not borrow and can only pay benefits from accumulated and present revenues. Yet the CBO projection includes benefits without the limitation this imposes.

[3] In contrast, the Social Security payroll tax had future tax rate increases on the books from the beginning until 1990. While these increases were sometimes delayed, they were never cancelled.

While we can hope the US will simply go back to policies resembling the earlier, longstanding policy of trend reductions in debt/GDP, that hope seems extraordinarily weak. Thus there are proposals for legislation that attempt to alter this pattern as part of the discussion of increasing the federal debt limit.

Ideally, in the near term, the US would put into place something that will impact the debt significantly, something that moves in slowly so as not to worsen unemployment (or even better lowers it), something that handles the commitment issue, something that is not likely to be done and then undone, and something that does not have bad effects. Restoring actuarial balance to Social Security has the potential to be a perfect contribution to the debt problem.

Social Security is money in and money out. Everybody who looks at it understands how it works. We have good estimates of the behavioural responses to changes of its parameters. Everyone agrees that we have a Social Security problem, even if we didn't have a debt or overall deficit problem. The system's trust fund is scheduled to run out of money in 2036 according to the latest projection. Of course the payroll tax revenue will continue to flow in, so that benefits would need to be cut by a quarter, not to zero. And, everyone agrees that when you fix Social Security, you need to phase it in slowly.[4] If we fix Social Security, we are very unlikely to undo it.[5] So it's the perfect thing to do. It has a significant effect on debt held by the public in the long run, it has no significant tightening effect on the economy in the short run, and it has little or no commitment problem. [6] If it is a well designed reform it also passes the test of good spending and revenue increases and so is worth having.

There is the possibility that this might be a (relatively) good time to try to fix Social Security. Fixing Social Security involves raising taxes and/or lowering benefits, both of which are very hard to do before Social Security faces an imminent crisis. That this might be a good time to fix Social Security comes from heightened concern about the long-run debt held by the public and a relatively good ability to address one of the two major issues in trying to reform Social Security. The harder issue is what mix to have between additional revenues and decreased spending. To get the 1983 Social Security reform, President Reagan and Speaker of the House Tip O'Neill agreed it would be 50/50, and set a committee to work that out. Congress stayed fairly close to balance, but not right on it. Part of the change was to introduce taxation of benefits, which hadn't been there before, with the revenue going back to Social Security. The Republicans claimed that that was a reduction in benefits, and they negotiated well and got more than 50% on the benefit side. The Democrats claimed that was taxation, so they got more than 50% on the revenue side. So, everyone was sort-of happy. Finding an acceptable mix remains a serious problem and we need to find a mechanism for addressing it.

The second issue that has held up reform since 2000 is whether to use existing payroll tax revenues for individual accounts. I assume that this idea is now mostly dead, because one of the essential consequences of diverting payroll tax revenues from the trust fund, which holds public debt, to individual accounts with diversified portfolios is an increase in the debt held by the public. Instead of the payroll tax revenues flowing into the trust fund for purchase of government debt, some revenue goes to purchase stocks and corporate bonds, resulting in

[4] Although one exception is the proposal to lower the cost of living adjustment, which would presumably kick in rather quickly and which I think would be bad Social Security policy.

[5] The US got a pretty good fix out of the 1983 reform of Social Security. If you run 50 years off a piece of legislation without having to make significant changes, you've done a pretty good piece of legislation, even if it didn't run the 75 years it was aiming for.

[6] For example, the reform proposed in my book with Peter Orszag would have reduced debt held by the public by 25% of GDP by 45 years after enactment.

more debt that gets sold to the public.[7] Some proposals have had massive implied increases.[8] I think that add-on voluntary individual accounts could be something that everyone could be comfortable with.

Could we get an agreement on a split between revenue increases and benefit cuts? That is looking particularly hard with the kind of politics we have seen around raising the debt limit. One possibility is to set up a commission, similar to the Base Closing Commission, whose report (with a sufficient majority) would receive special congressional rules requiring an up-or-down vote and not allowing a filibuster. The instructions to the committee would first have them separate out the contribution to restoring actuarial balance chosen by the commission from coverage expansion (any increase in the taxable maximum or coverage of state and local workers). Since coverage expansion increases both revenues and benefits, it is not really part of distinguishing between actions that directly increase revenues or reduce benefits. The remaining deficit would be covered by increases in revenue and decreases in benefit expenditures, with a requirement that the commission hit a required balance of the latter two. Unlike changes in spending and revenues that have many parts, the public could fairly readily understand what it would mean to refuse any revenue increases or to refuse any benefit cuts. Neither position is viable for a plan to rescue Social Security from its projected imbalance. And polls have shown the public wants a balanced Social Security reform, suggesting that there would be sufficient pressure on Congress to reach a legislated balance.

In contrast to fixing Social Security, addressing healthcare costs, the elephant in the room, has none of these traits. We don't understand how to make it work better. We do understand how to shift costs from the government to the private sector, but we not only have a healthcare problem for the federal budget, we have a healthcare problem for state and local budgets, we have a healthcare problem for Americans. We have a system that doesn't work well and learning how to fix it is going to take experimentation, evaluation, and repeated corrections. And we have a repeated history of undoing previous legislation.

The idea that anyone today knows the right level of spending on Medicare 10 years from now is silly. Maybe we will learn how to lower costs while improving quality and should spend much less. Or maybe there will be valuable but expensive scientific breakthroughs or some terrible new disease and we should spend an even larger fraction of GDP. Medicare legislation is an annual affair because we have limited understanding of the effects of changing rules and changing spending. These considerations make Medicare a poor candidate for including distant spending patterns as part of addressing today the future debt problem, even though Medicare is one of the big spending items today, and projected to get even larger.

While a future Congress could correct today's faulty choice of future spending by new legislation, that process is subject to the familiar checks and balances that can make it hard to get legislation passed unless both parties see room for improvement from the default spending level. With only spending on Medicare in the legislation, one party or the other may make it hard to change the level of spending when good policy calls for more or for less. For a default to lead to good outcomes, it would help for the default to contain elements neither party likes. If neither party likes the default, there will be an incentive to legislate around it, to make explicit choices on spending and taxes, rather than letting the default kick in. And if

[7] For example, the proposal from the Bush administration would have added 19% to the debt-to-GDP ratio by 2050.

[8] For example, the proposal by Congressman Ryan and then-Senator Sununu would have added more than 90% to the debt-to-GDP ratio by 2050.

both parties are going to dislike the default, it probably needs to work on the tax side and the spending side simultaneously.

As part of dealing with the long-run debt problem, I think it's important to realise that the US has some programmes that work very well and ought to be expanded, and some programmes that don't work very well and ought to be contracted or closed. So anything that ends up with across-the-board percentage cuts is not going to do well at addressing the inefficiencies in spending. Similarly, if we just raise all of the marginal tax rates and don't make changes to the tax code, we won't resolve the inefficiencies in the tax structure.

By itself, of course, a second round of stimulus would add to long-term debt issues, so one would hope that we would get a package, something that would address long-term debt issues in ways that are not significantly contractionary in the short run, at the same time that something expansionary is done in the short run.