BROOKINGS

The Economic Crisis and the Fiscal Crisis: 2009 and Beyond

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(Based on work with Alan J. Auerbach)

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Think Back to Y2K

- The budget was in surplus (2.4% of GDP)
- CBO projected rising surpluses over the next 10 years ($5.6 trillion)
- Even over a 70-year horizon, things were ok (fiscal gap was approximately zero)

More on Y2K

- The big concern was that the US would pay off all redeemable public debt by the middle of the decade. (Honestly!)
  - Would make it hard to conduct monetary policy
  - Would eliminate “riskless” assets for investors
  - These concerns invoked by Greenspan as a major justification for the 2001 tax cuts.

Fast Forward to 2009

- Huge short-term deficits (but they aren't the real problem).
- Unsustainable medium-term deficit path, inherited from Bush, continued under Obama.
- Large and increasingly urgent long-term shortfalls.
  - Sounds like an oxymoron, but isn't

Increasingly urgent concerns about federal debt

- The Chinese have publicly questioned the security of Treasury debt.
- Credit markets see a non-zero probability of default on senior U.S. Treasury debt in the next five years
- Medicare trust fund to go bankrupt by 2017.

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Fiscal problems elsewhere, too

- Almost all States facing significant fiscal shortfalls
  - California in particular
- European countries as well
  - S&P recently warned of a possible downgrade of UK debt
  - UK's debt trajectory not significantly worse than the US

The Good News

- We have decisively vanquished any fears of paying off the public debt.
  - “Mission accomplished”

Outline

- The 2009 budget
  - Where we are
  - How we got here
- The 10-year outlook
  - Under the CBO baseline
  - Under Bush policy
  - Under Obama policy
- The long-term outlook
  - Alternative projections
  - How can we close the gap?
- Discussion

The 2009 Budget

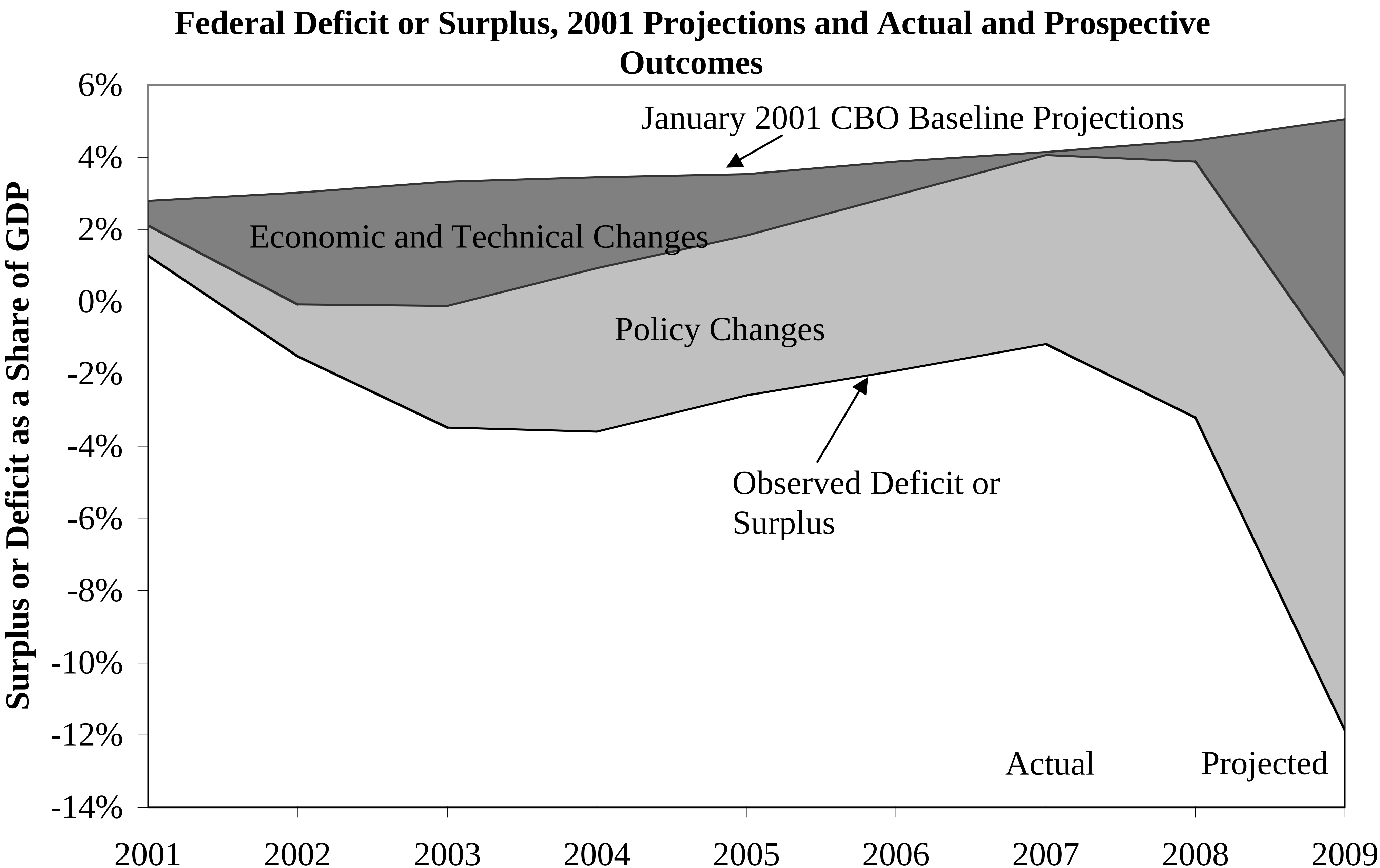
- Deficit = $1.7 trillion (11.9% of GDP) – Highest since WWII
- Spending (27.4% of GDP) – Highest since WWII
- Revenues (15.5% of GDP) – Lowest since 1950
- Public debt (54.8% of GDP) – Highest since 1955
- The figures would be even worse except that
  - Interest rates are extremely low.
  - The budget may not appropriately reflect fiscal aspects of several recent financial interventions.

How did we get here?

"How did you go bankrupt?" Bill asked.

"Two ways," Mike said. "Gradually and then suddenly."

--Ernest Hemingway, *The Sun Also Rises*



Source: CBO (2009b), CBO (2001). Authors' calculations.

Federal Deficit or Surplus: 2001 Projections and Actual and Prospective Outcomes

	2001	2008	2009
CBO 2001 Baseline Projection (% of GDP)	2.8	4.5	5.1
Actual Surplus or Deficit	1.3	-3.2	-11.9
Difference	-1.5	-7.7	-16.9
Policy Changes	-0.8	-7.1	-9.8
Economic and Technical Changes	-0.7	-0.6	-7.1

The 10-Year Outlook: Apres Bush, Le Deluge

- The CBO Baseline
- The Adjusted Baseline (“Bush Policy Extended”)
- The Administration’s Budget

CBO baseline

- Mechanical projection of current law.
- Assumes that almost all tax provisions expire as scheduled
  - 2001 and 2003 tax cuts
  - "Regular" expiring tax provisions
  - AMT patches.
- Assumes that discretionary spending will stay constant in real terms

Adjusted baseline ("Bush Policy")

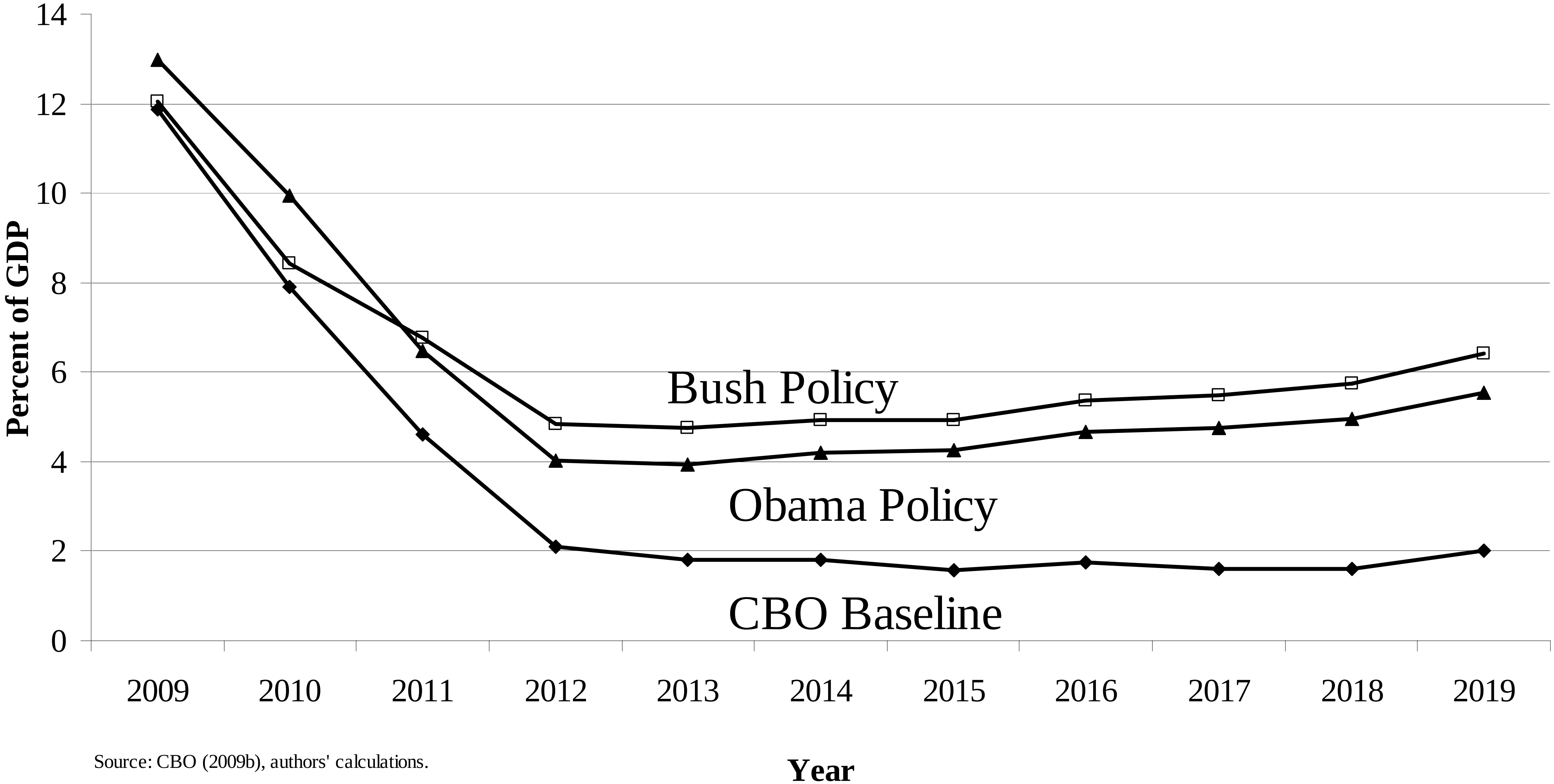
- Start with the CBO baseline
- Extend all expiring tax provisions
- Allow DS to grow with inflation and population
- Include stimulus package

- Not exactly Bush policy, but the stimulus expires in 2011.

Obama Policy

- As proposed in the Administration's budget and analyzed by the CBO.

Alternative Deficit Projections, 2009-2019



Source: CBO (2009b), authors' calculations.

10-Year Summary

- CBO: Deficit falls to 2% (of GDP) by 2012, and remains level through 2019.
- Bush policy: Deficit falls to 5% of GDP in 2012, then rises to 6.4% by 2019.
- Obama Policy: Deficit falls to 4% in 2012, then rises to 5.5% in 2019.
- Bush and Obama: Deficits averaging $1 trillion per year for 2009-2019, more than that later.

Obama Policy in 2019

- The (full employment) deficit = 5.5% of GDP
  – Highest FE deficit since WWII except for 2009
- Public debt = 82% of GDP (and rising)
  – Highest level since 1948 (when it was falling)
- Spending will exceed 24% of GDP
  – Highest level since WWII except for 2009
  – Net interest will be 3.8% of GDP, highest level ever (and larger than Defense or NDDS in 2019)
- Revenues will fall below 19% of GDP

Economic Assumptions

- Budget figures depend critically on the economy. So far, however, the economy has performed worse than projected.

- Global, financially-induced recessions tend to run for a long time.
  - Reinhart/Rogoff document big revenue declines after financial crises.

Political Assumptions

- The political assumptions built into the budget forecast border on heroic.
  - The stimulus package expires as scheduled
  - By 2019, NDDS falls to its lowest share of GDP since before 1962.
  - Difficult cuts in health care occur.
  - A new cap and trade system is enacted with all permits auctioned.
  - PAYGO is installed (and honored!) for a decade.

PAYGO

- Even if installed and honored, PAYGO is of limited use.
  - All of the projections in this paper implicitly assume that PAYGO (as proposed by Obama) is installed and honored. This does not prevent massive long-term deficits.
- PAYGO does not apply to built-in growth of entitlements
  - So it misses the real problem.
  - It allows existing wasteful programs to continue unabated, while only imposing constraints on new initiatives.
- As proposed by Obama, PAYGO is even worse.
  - Exempts the Bush tax cuts, big AMT changes, and Medicare provider payments.
  - This is fiscally irresponsible: $3 trillion in giveaways over the decade. Yet, from 2001-6, even a Republican Congress, facing a much better fiscal outlook than now, refused to make the tax cuts permanent.
  - This is an intrusion of budget policy into determination of specific tax and spending proposals. (And BTW if intruding anyway, why do so to advance the Bush agenda rather than the Obama agenda?)

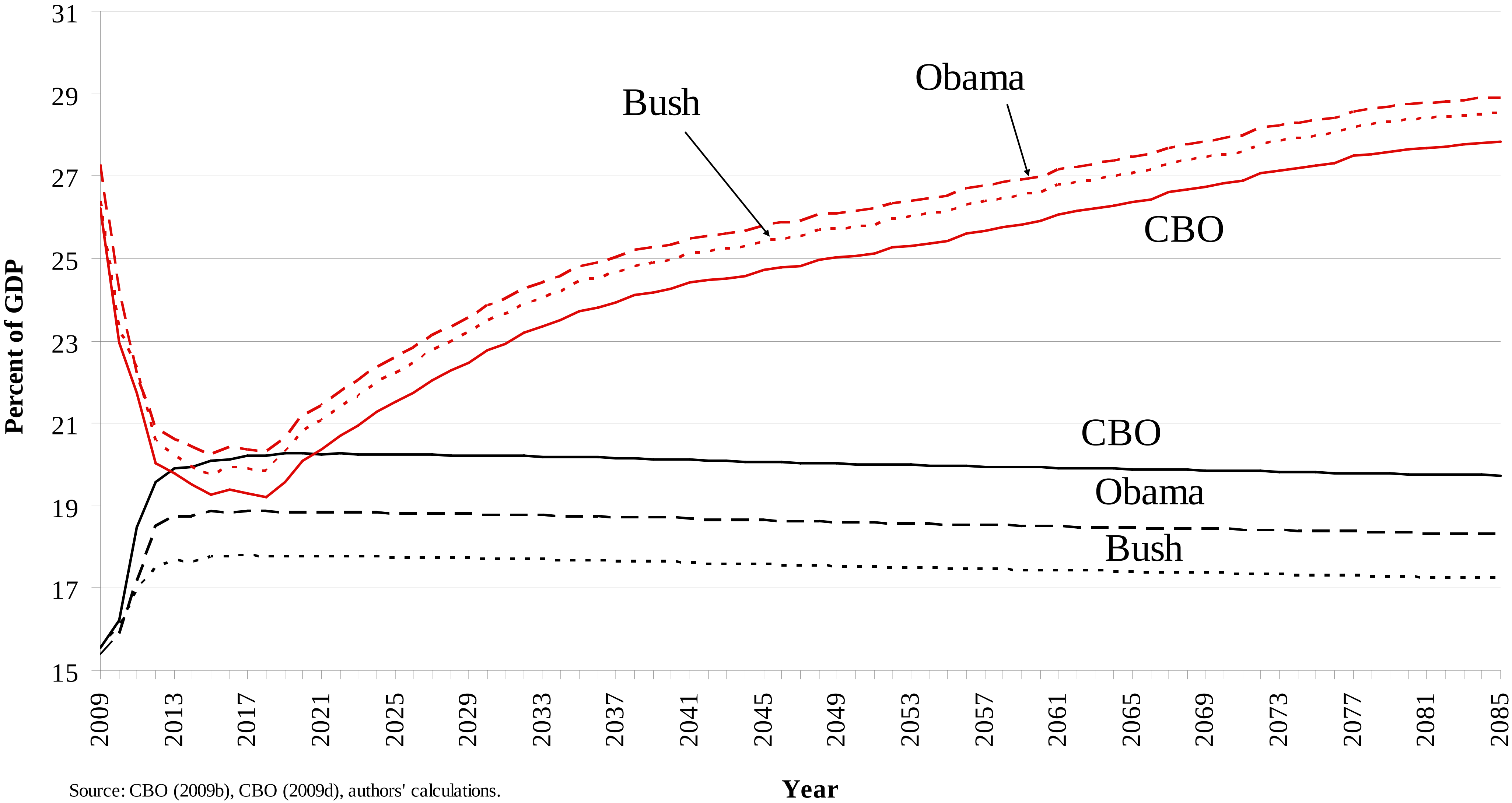
Long-term Outlook

- Defining the fiscal gap
  - As a share of GDP, the gap equals the size of the immediate and permanent tax increase or spending cut (or combination) that would keep the debt/GDP ratio at the same level in the long-term at is now.
  - In dollar terms, the gap is the present value of the difference between all expected future revenues and expected future non-interest spending.

Estimating the Fiscal Gap

- For the first 10 years, 3 scenarios
  - CBO baseline
  - Bush policy
  - Obama policy
- Beyond that
  - Long-term projections for SS, MM
  - Constant share of GDP for other revenues and spending
  - SS projections for interest rates and GDP

Revenues and Non-Interest Expenditures as a Percent of GDP



Source: CBO (2009b), CBO (2009d), authors' calculations.

Fiscal Gaps

Baseline:	Percent of GDP		Trillions of present-value dollars	
	Through 2085	**Permanent**	**Through 2085**	**Permanent**
CBO Baseline	4.4	6.2	33.7	90.3
Bush Policy	7.4	9.4	56.9	135.3
Obama Policy	**6.8**	**8.7**	**52.2**	**125.9**

Source: Authors' calculations

Note: Policies enacted during the Bush Administration raise the gap by 5 percentage points of GDP.

Closing the Gap

- Only four ways to close the gap
  - Tax increases
  - Spending cuts
  - Default on debt (a tax on bondholders)
  - Print money (an inflation tax)

What Would it Take?

- The long-term gap = 8.7% of GDP.
- A 15-20% VAT would eliminate the gap
- In 2009,
  - Income tax revenues = 7.2% of GDP
  - Corporate tax revenues = 1.2% of GDP
  - Payroll tax revenues = 6.3% of GDP
  - Defense spending = 5% of GDP
  - NDDS = 4.7% of GDP
  - Mandatory spending = 11% of GDP (in 2008)

Can health cuts close the gap?

- To eliminate the fiscal gap via health cuts, the growth rate of MM spending would have to fall by 3 percentage points immediately and for 75 years.
  - MM spending would have to <u>fall</u> relative to GDP starting now.

- If the health care spending growth rate fell by 1.5 pp for X years, the long-term gap would be Z% of GDP
  - X = 0, Z = 8.7 (Obama policy baseline, shown above)
  - X = 10, Z = 7.1 (Mimics recent agreement with health industry)
  - X = 30, Z = 4.9 (the 30% that is waste is all removed over time)

Will Low Interest Rates Help?

- To the extent that the gap is due to past accumulation of debt, low interest rates help.
- To the extent that the gap is due to expected future obligations, low interest rates hurt.
- Under current conditions, lower interest rates raise the gap.

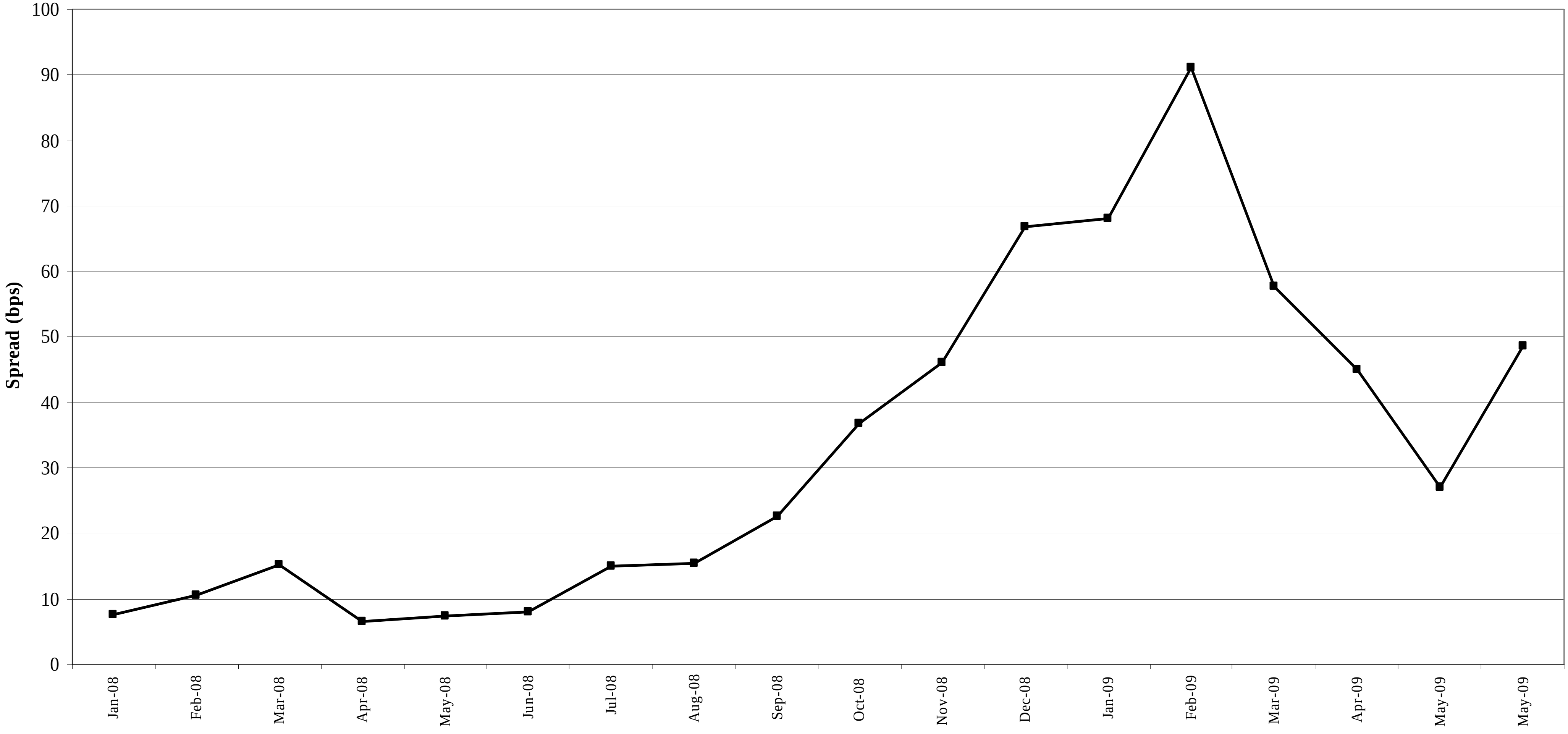
CDS Markets

- The price of default insurance on US Treasuries rose from 10 bp before Sept 2008 to 50-100 bp recently.

- Hard to know how to interpret this.
  – Protects against default in the next 5 years (not long term)
  – US interest rates are low, no big capital outflow
  – Who’ll be able to pay if the US defaults?

- Spreads are similar or in some cases substantially higher in other countries.

Figure 12
Price of Credit Default Swaps on 5-year Senior U.S. Treasury Debt



Source: Bloomberg. CDS spreads calculated by Bloomberg using the JP Morgan pricing model. Spread represents the amount paid per year for a given amount of default protection. Data are taken from the end of each month, except May and June.

Discussion

This is what "mortgaging the future" looks like

- The budget outcomes above are occurring after 25 years of strong economic growth and a remarkable demographic holiday (with baby boomers in their peak earning years), during which time these problems were largely ignored if not made worse.

- Now, from a seriously weakened position – with the economy in tatters, the boomers ready to retire, and the rest of the world possibly sated with its holdings of US debt – we have to face problems that are even bigger than in the past, because we delayed addressing them sooner.

Difficult policy choices

- Hard to impose fiscal discipline under the best of circumstances.
- A key issue now is balancing economic recovery and fiscal discipline:
  - Impose discipline too soon and the economy could tank again (Romer)
  - Hold off too long and markets may react badly (Ball/Mankiw, Rubin/Orszag/Sinai)

Why fiscal discipline will be even harder to impose now

- Fiscal problems of States will create pressure for ongoing aid.
  - Turning off the stimulus package after 2 years may be difficult.
- No serious tax discussion among political “leaders” and hence no public understanding of the trade-offs involved.
  - Both parties have sworn off any significant tax increase.
- The structure of outlays makes it hard to cut spending quickly.
  - The vast majority (70-80%) of outlays are for Medicare, Medicaid, Social Security, defense, and net interest.
- The relative speed at which different parts of the economy recover could create populist pressures
  - Financial markets recover quickly, labor markets slowly.

The Future is Now

- We are rapidly running out of time to address the issues in a deliberative way.
  - The gradual effects of fiscal imbalances will eat away at the capital stock, raise interest rates, etc.
  - Sudden effects could occur if markets hit a tilting point, which could force an immediate (poorly structured) policy response.
- We need political leadership – to discuss the problem and propose real solutions.

What a measured solution would look like

- Thread the needle between Romer's concerns and investor fears.
- Do not cut off aggregate demand currently.
- Raise significant revenues gradually, over the next 5-10 years.
  - Cap and Trade with real teeth?
  - A value added tax that rises over time?
- Start cutting future spending now.

Blinder’s Law

- There is (as far as I know) no serious disagreement about whether there is a fiscal problem.

- Hence, we are subject to the curse of Blinder’s Law: Economists have the least influence on policies where they are most in agreement.