Fiscal Uncertainty and How to Deal with It

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• Long-term projections for the paths of federal revenues and expenditures look much worse than those for the very short term.
  – An unsustainable path without major changes from current policy; i.e. a large *fiscal gap*
• But projections are also subject to error that increases with the forecast horizon.
Figure 2. Current Policy Deficits

March 2008 Confidence Intervals

Source: CBO (2008) and author's calculations.
What to Do?

• Not how to deal with fiscal imbalances, but how our responses should change because of this uncertainty
Common Responses

• Stein’s Law
Common Responses

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• Changes, but when and how?
• And how compare to a desirable transition?
Common Responses

• Stein’s Law

• Projections beyond [   ] years are so uncertain that we should ignore them
Common Responses

- Stein’s Law
- Projections beyond $[\_\_\_]$ years are so uncertain that we should ignore them
- But what does that mean?
  - Assume problems that are projected to be big and getting worse as of year $t$ vanish in year $t+1$?
Taking Precaution

• If the future is very uncertain, a case for saving more for the future, whether by an individual or by a government

• Things more complicated when analyzing what government should do, but the main conclusion doesn’t change
But...

• It’s not that we are very uncertain about the future; we really have no idea.
But...

- It’s not that we are very uncertain about the future; we really have no idea.
- This type of uncertainty may be something we wish to avoid, but not something we should ignore.
But...

- People will be better off in the future; they can absorb greater fiscal burdens.
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- People will be better off in the future; they can absorb greater fiscal burdens.
- This is an argument about how to deal with projected fiscal imbalance, not uncertainty about it.
- Economic costs of very high future marginal tax rates or fiscal crises if adversity strikes push toward more active responses now.
But...

- We should wait until we have a better idea about the future.
But...

- We should wait until we have a better idea about the future
- The future will always be uncertain, and by waiting we restrict our options.
- Even if important types of uncertainty will be resolved, this should influence the types of measures we adopt now rather than our decision to act.
But...

- We can’t be changing policy continually whenever information changes.
But...

- We can’t be changing policy continually whenever information changes.
- Yes, but then when we do act we should act more forcefully.
- We can also put in place some automatic responses if we can be fairly confident about what those responses should be as events unfold.
But...

• With greater uncertainty, projections are more susceptible to political influence.
But...

- With greater uncertainty, projections are more susceptible to political influence.
- This may well be true.
- But it provides an argument for institutional protections and transparency; ignoring information is a bad second choice.
Summary

• Uncertainty means our policy choices will always turn out to be “wrong.”
• But ignoring uncertainty doesn’t make it go away; a more active response can lessen its negative consequences.