Comment on Alan Auerbach, Fiscal Uncertainty and How to Deal with It

Peter Diamond

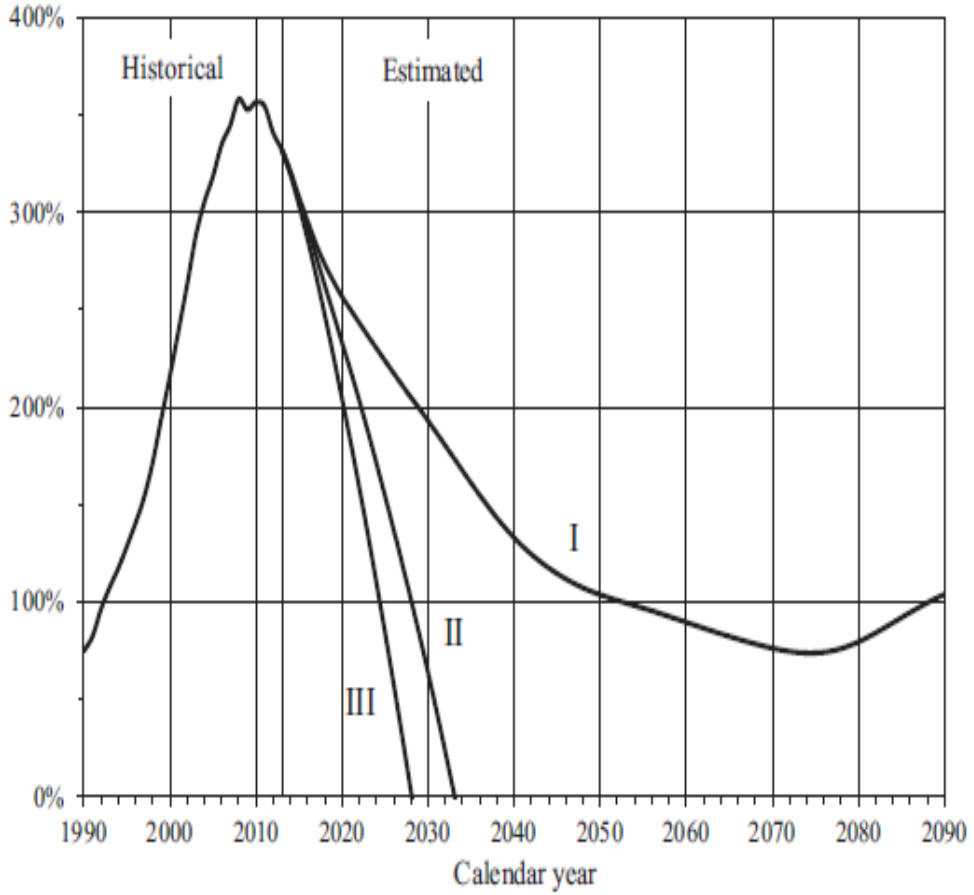
December 15, 2014

An open question is how agency communication of uncertainty would affect policymaking and private decision making. We now have little understanding of the ways that users of official statistics interpret them. … We know essentially nothing about how decision making would change if statistical agencies were to communicate uncertainty regularly and transparently.

COMMUNICATING UNCERTAINTY IN OFFICIAL ECONOMIC STATISTICS, Charles F. Manski, NBER Working Paper 20098, May 2014

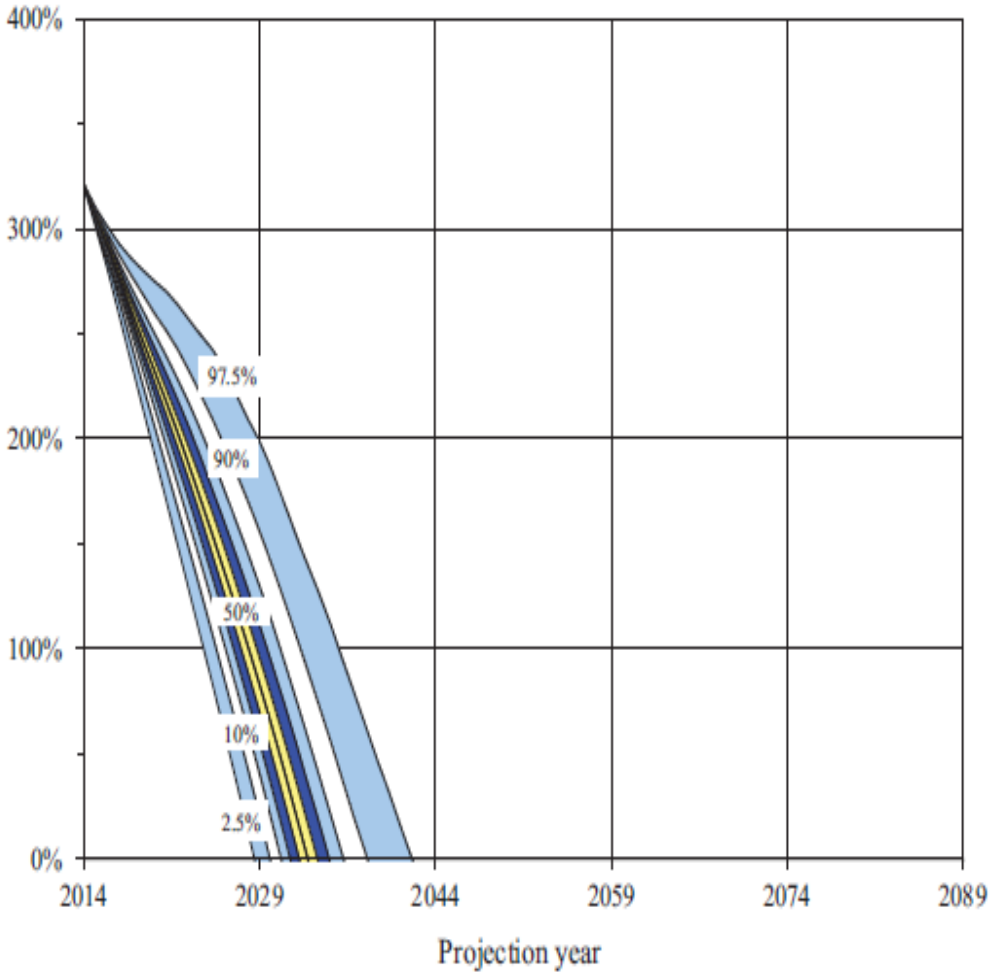
Long-Range OASI and DI Combined Trust Fund Ratios Under Alternative Scenarios

(Asset reserves as a percentage of annual cost)



Source: The 2014 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds.

Long-Range OASI and DI Combined Trust Fund Ratios From Stochastic Modeling



Source: The 2014 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds.

Uncertain projections

- automatic adjustments,
- legislation for future implementation,
- additional savings in response to increased uncertainty

CBO’s projections are based on the assumption that Social Security will pay benefits as scheduled under current law regardless of the status of the program’s trust funds.

CBO, The 2014 Long-Term Budget Outlook< July, 2014.

Responding to Fiscal Uncertainty

- If baseline forecasts tell us that we need to save, then uncertainty about these forecasts tells us that we need to save more and greater uncertainty that we should save still more.

Responding to Fiscal Uncertainty

- under reasonable assumptions about individual preferences, uncertain future earnings should induce more saving
- Formally, greater uncertainty leads to an increase in precautionary saving if the third derivative of the individual's utility function is positive, as would be the case for preferences exhibiting constant relative risk aversion.

Responding to Fiscal Uncertainty

- Since government decisions affect and should be guided by the well-being of individuals, much of the basic intuition regarding dealing with uncertainty and the determinants of precautionary saving carry over from the analysis of individual saving decisions.

OPTIMAL LONG-RUN FISCAL POLICY: CONSTRAINTS, PREFERENCES AND THE RESOLUTION OF UNCERTAINTY

Alan J. Auerbach Kevin Hassett

We … explore the impact of policy stickiness (specifically, a major reform will preclude future reforms for a generation) on optimal long-run fiscal policy. Under such circumstances, entitlement reforms exhaust a valuable option to move in the future.

COMMITMENT VS. FLEXIBILITY
Manuel Amador, Iván Werning, George-Marios Angeletos

We study the optimal trade-off between commitment and flexibility in a consumption–savings model. Individuals expect to receive relevant information regarding tastes and thus they value the flexibility provided by larger choice sets. … they also expect to suffer from temptation, with or without self-control, and thus they value the commitment afforded by smaller choice sets. The optimal commitment problem we study is to find the best subset of the individual's budget set.

The second chapter derives the non-linear income tax schedule which minimizes deadweight burden without any regard for redistribution. The features of this problem are shown to be equivalent to the Mirrlees' optimal income tax problem

Saez, Emmanuel "A Characterization of the Income Tax Schedule Minimizing Deadweight Burden", unpublished MIT Ph.D. thesis (chapter 2), 1999.

The tax schedule minimizing deadweight burden is an optimal income tax schedule in which the government applies particular marginal welfare weights at each income level. In the case of no income effects, these marginal welfare weights are the same for everybody.

Saez, Emmanuel “A Characterization of the Income Tax Schedule Minimizing Deadweight Burden”, unpublished MIT Ph.D. thesis (chapter 2), 1999.

Fundamental Public Finance Second-best Welfare Theorem with asymmetric information and income distribution concerns

Under the usual assumptions, generically, the *absence* of distorting taxes indicates a failure to achieve a social welfare optimum.

Fundamental Insurance Second-best Welfare Theorem with asymmetric information and individual uncertainty

Under the usual assumptions,

in the *absence* of distorting implicit taxes

there is not a social welfare optimum.