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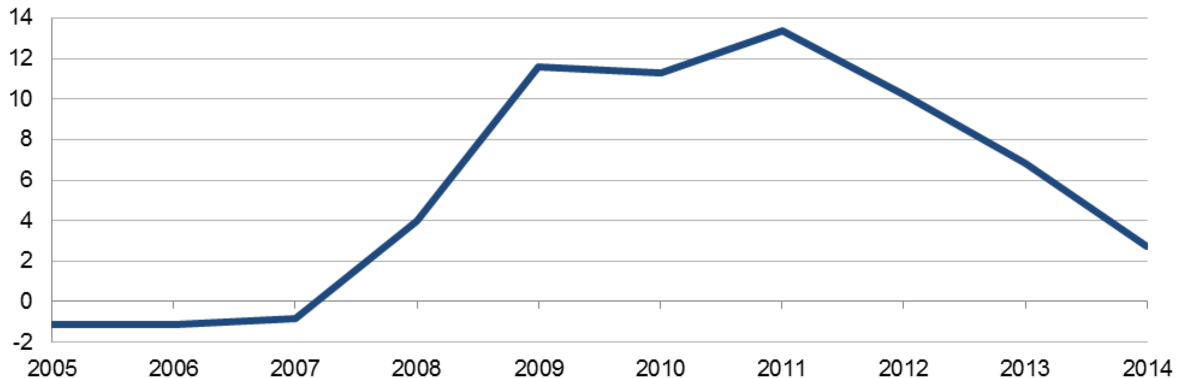
Fiscal Uncertainty and How to Deal With It

Long-term projections of the federal budget show significant future imbalances, but these projections are enormously uncertain. Some argue that this uncertainty means we should pay **less** attention to the long-term budget projections, so as to avoid taking painful measures that may prove to be unnecessary. But Alan Auerbach, professor of economics and law at the University of California, Berkeley, argues that, in general, the appropriate response to uncertainty is instead to take **more** action now, as a precautionary measure against the possibility of worse-than-expected outcomes.

Auerbach highlights the enormous uncertainty in fiscal projections. For example, between fiscal years 2005 and 2014, the average absolute ten-year error in the forecast of the deficit amounted to 6.3 percent of potential GDP. Auerbach notes that much of the uncertainty in the short and medium run deficit is related to the business cycle, which is less of an issue over the long run. Instead, the main sources of budget uncertainty over the next 25 years are the rate of productivity growth, the interest rate on the federal debt, and the rate of excess health cost growth. Auerbach notes that if all these factors move in a favorable direction, no fiscal response is needed in order to stabilize the national debt as a share of GDP, whereas an adjustment of 2.5% of GDP per year would be needed if the factors move in an unfavorable direction.



Source: Author's calculations based on CBO data

In response to this uncertainty, Auerbach argues that the United States should take an active approach by increasing its rate of saving, either through a reduction in spending, an increase in taxes, a reduction in the size of implicit government liabilities, or some combination of these actions. The possibility of outcomes being worse than projected should weigh more heavily in planning for the future than should the opportunity cost of saving now if outcomes turn out to be better than expected. A precautionary increase in savings would allow for a longer planning horizon, granting more flexibility in dealing with economic shocks when they occur, and would reduce the need to increase marginal tax rates in the face of budget pressures.

Auerbach suggests that more effectively conveying uncertainty, perhaps by requiring the Congressional Budget Office to include a quantitative assessment of the degree of uncertainty present in their forecasts, would be a step in the right direction towards addressing the uncertainty involved with fiscal policymaking. Another policy option would be to subject the government budget to some sort of a "stress test," in order to determine the government's ability to meet its needs if unfavorable conditions arise. Finally, he argues in favor of expanding the use of automatic adjustments to provide budget stability and ensure appropriate risk-sharing across generations, which reduces the need for Congress to continually make changes to legislation in response to changes in circumstances. Auerbach concludes by noting "What is clear is that hoping for a better future does not constitute an appropriate policy response to uncertainty, and waiting until the size of the problem is known is waiting too long."