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Economics Group

Special Commentary

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Fiscal Policy: Not Your 1960s' Model for Investors*

On any given day, the reality of life is that we sometimes experience temporary discomfort that leads us to feel less than great, but it is the persistence of a toothache, for example, that prompts us to recognize that something is really different. For investors, wealth managers and business decision makers, it is the persistence of large fiscal deficits that serve as a wake-up call that U.S. fiscal policy has taken on a very different character than in the past and, like a toothache, call for an adjustment in our decision making. Yet, much of the public discussion falls back on the simple countercyclical framework of the past, while, in fact, there has been little in the way of countercyclical fiscal policy such as balancing budgets at all levels of government when economic growth is strong. This is especially true when the direct costs of entitlement programs are brought into the picture.

At the outset, we recognize three distinct characteristics of fiscal policy today. First, unlike both the experience of the 1960s–1990s, and certainly in contrast to the rhetoric about balancing budgets, the current path of fiscal deficits is more likely to be both large and persistent over our investment horizon. Thus, there is little support for the case to model fiscal policy based on the countercyclical textbook models when, in fact, today's reality is that deficits are large and persistent. Second, while good policy would dictate certain and steady tax and spending policies, the current environment is more likely to deliver high and low alternating periods of taxes and spending initiatives with a subsequent increase in uncertainty for decision making. Finally, the systematic tendency on the part of policymakers to produce excessive deficits over the long run, not the countercyclical fiscal policy that was the basis of Keynes' proposals, suggests that counter to much of the rhetoric, it is not true that government currently or in the future will operate its budget in the same way as the average middle-income household in America.

There has been a clear shift in the position of fiscal policy today compared to prior years and prior economic recoveries.

Large and Persistent Deficits: A Brave New World of Fiscal Policy

As apparent in Figure 1, there has been a clear shift in the position of fiscal policy today compared to prior years and prior economic recoveries. Yet, conventional measures of the fiscal deficit have misrepresented the true federal budget situation for more than 40 years. The unfunded liabilities of the entitlement programs reflect a commitment to spend in the future without any set aside out of current revenues (Figure 2).

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* **Special thanks to Kaylyn Swankoski for help on this report. For more detail on the issues covered in this report, see David Romer. (2006). *Advanced Macroeconomics*. McGraw-Hill.**

Figure 1

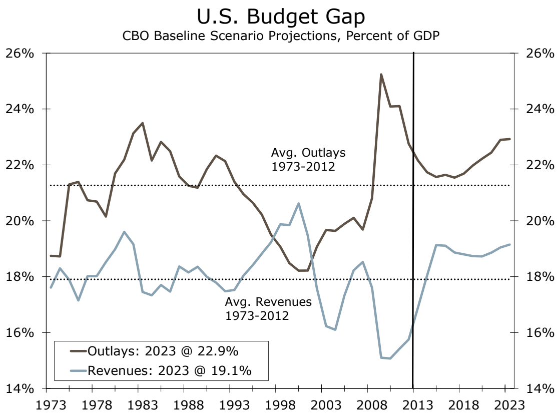
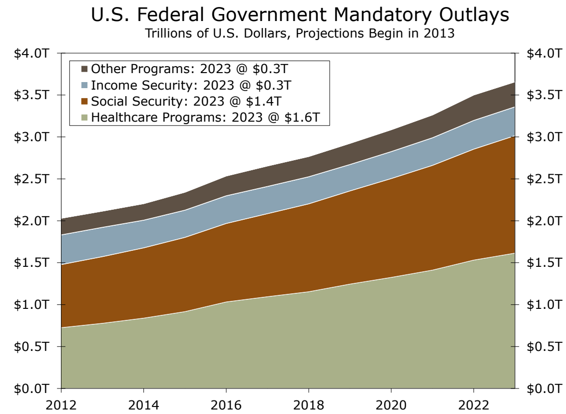


Figure 2



Source: Congressional Budget Office and Wells Fargo Securities, LLC

Unfunded liabilities at any level of government will increase future taxes, lower government spending or require greater debt financing.

As a result, the current federal budget appears to be much closer to balance since the unfunded liabilities are not accounted for in budget calculations today. In this way, the public budget calculations for the past 40 years seriously overstated the positive position of federal, state and local budgets within the U.S. economy. Only in recent years have taxpayers learned the true state of fiscal deficits as the retirement and healthcare bills begin to accumulate. As illustrated in Figure 3, estimates by the Congressional Budget Office indicate that the burden of these unfunded liabilities will alter the expectations of fiscal policy.[1] These bills represent the risk of higher taxes, reduced after-tax incomes and the potential for a lower standard of living for taxpayers than they had anticipated. There is also the possibility that the federal government will resort to central bank financing of the deficit to pay the bills and thereby increasing the risk of higher inflation, higher interest rates and lower real growth and job gains in the future. This fiscal policy framework certainly alters the decision making calculus for investors, savers and business decision makers as they evaluate the path of growth, inflation and interest rates going forward. Moreover, the time horizon for federal tax and spending policy has shortened dramatically in recent years with increased partisanship in Washington.

Unfunded liabilities at any level of government will increase future taxes, lower government spending or require greater debt financing, which are all problems that have become evident during the past four years as government budgets have become tight in light of slower economic and revenue growth. At the federal level, the genesis of these problems have existed since the initiation of Social Security, Medicare, the expanded Prescription Drug Program (Medicare Part D) and a number of stimulus programs under both Democratic or Republican administrations, underscoring the fact that these issues are truly bipartisan problems.

In the short run, the budget conflicts and the hard choices have been avoided by employing "off-budget" spending, emergency spending programs, mandates imposed on the private sector, unrealistic budget and economic forecasts (the rosy scenario) that cover up the real nature of the fiscal problems. While the budget conflicts may have been avoided, the economic impacts on the real economy have not. The lack of the relationship between the fiscal deficit and the true budget constraint has been addressed without the real choices needed to sustain a steady fiscal policy over time.

[1] **Congressional Budget Office. (Feb. 2013). The Budget and Economic Outlook: Fiscal Years 2013 to 2023.**

Auerbach, Gale, Orszag and Potter build a case that current fiscal policies are far from addressing the federal government's real budget constraint.[2] The pressure on entitlement programs from demographics indicates that the ratio of working-age adults relative to those over 65 will decline in the decades ahead. In fact, the sharp drop in the employment-to-population ratio in recent years (Figure 4) already signals a fiscal problem as fewer workers begin to support a larger entitlement-benefiting cohort. In addition, medical care technology continues to put upward pressure on medical spending, while life expectancies currently exceed the expectations that existed when the structure of these entitlement programs were established. These forces are large and persistent thereby suggesting a widening gap between spending and revenues in the future, which, in turn, will require investors and business decision makers to reevaluate their expectations on growth, inflation and interest rates in an environment where there is little likelihood that the federal budget will be balanced over the economic cycle. The implication is that a large set of policy adjustments will be needed and those policy adjustments will influence the path of expected real after-tax incomes and profits. These policy options include some combination of tax increases, spending cuts or higher inflation to reduce the real value of the federal debt.

Pressure on entitlement programs from demographics indicates that the ratio of working-age adults relative to those over 65 will decline in the decades ahead.

Figure 3

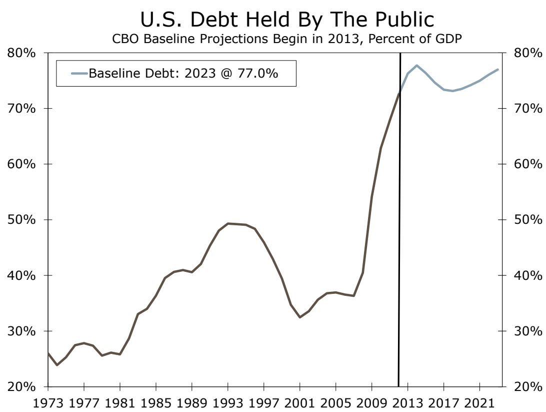
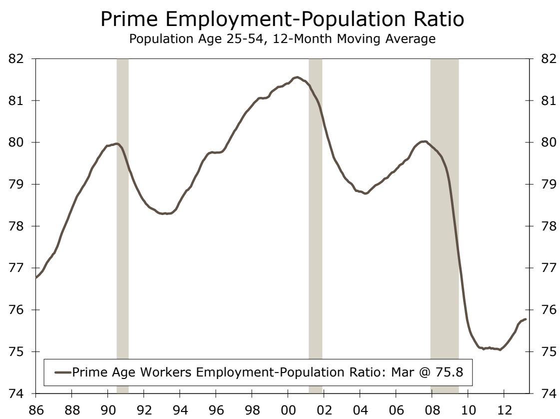


Figure 4



Source: Congressional Budget Office, U.S. Department of Labor and Wells Fargo Securities, LLC

Variable and Growing Tax Burdens: Distortions in Economic and Investment Planning

For households and business firms with long horizons (beyond the next election cycle) who are looking into their future toward retirement, the growing problem is that bond-financed government spending today may appear to be costless as the bonds must be paid off by some future generation, but research suggests this premise may not be accurate. James Poterba and Lawrence Summers showed that most of the burden of retiring WWII debt was borne by households that were already working at the time.[3] Therefore, the bonds issued during this period were less likely to provide stimulus to the economy as current workers realized that the bonds would have to be paid off in their lifetime and not by some future generation. Thereby, bond financed fiscal stimulus programs would have less of a positive impact on increasing consumption and therefore less of a stimulative effect on aggregate demand. This may help explain the more

[2] Auerbach, A.J., Gale, W.G., Orszag, P.R. and Potter, S.R. (2003). "Budget Blues: The Fiscal Options for Reform, in Aaron, H. Lindsay, J. and Nivola, P. eds., *Agenda for the Nation*, 109-143, Washington, D.C.: Brookings Institution.
[3] James M. Poterba and Lawrence H. Summers. (Sep. 1987). Finite Lifetimes and the Effects of Budget Deficits on National Saving. *Journal of Monetary Economics* 20:369-391.

modest than expected impact of the 2009 stimulus program known as the American Recovery and Reinvestment Act.[4]

In addition, frequent tax and spending changes, along with the uncertainty around proposals for fiscal policy change, some very radical, as we have witnessed in recent years certainly alter the expected future returns to education and capital investment today. Over the past year alone, we have witnessed a series of fiscal policy cliff hangers and with each cliff hanger comes a sharp adjustment in tax and spending policies, which have lowered real disposable income for at least some households and small businesses. In turn, we can witness that personal consumption and business investment have also been below expectations during the recovery and certainly below the experience of prior economic recoveries. Reduced investment today would be consistent with slower trend growth in the future.

A further reason for the disappointing outcomes from fiscal programs has been the emphasis on temporary, not permanent, tax and spending programs.

A further reason for the disappointing outcomes from fiscal programs has been the emphasis on temporary, not permanent, tax and spending programs, such as the cash for clunkers program, the temporary 2 percent payroll tax cut and uncertainty around extending the Bush-Obama tax cuts. For households and businesses, their planning horizon exceeds that of the lifetime of these programs. These temporary programs and policies only alter the timing of economic activity, not the level of such activity.

One further complication during the 2008–2009 Great Recession period is that households were credit-constrained and thus could not sustain their spending at prior levels as personal income growth slowed or, in some cases, disappeared and access to credit became very limited. When the federal government issued bonds to be repaid by future taxes, those taxes would be repaid by current taxpayers sometime in the future. As a result, private lenders would perceive that these households would face increased future tax liabilities and thereby reduced after-tax income to pay back any loans that would be made in the future, in turn representing a greater credit risk. Therefore, without any change in credit standards, a rational lender would be more cautious in lending under these circumstances. As illustrated by Fumio Hayashi, borrowing by households can decline in line with increased government borrowing. Indeed, that is what we have witnessed in the latest recovery period.[5]

Another complication in recent years has been the perceived volatility and increasing certainty that tax rates are likely to rise. Tax distortions will likely increase with the level of taxation and these distortions are higher under a policy of variable taxes than a policy of steady taxes at the same average level growth.[6] With the back and forth of the Bush-Obama tax cuts and the uncertainty that taxes were going to increase, the problems for investors were obvious and the distortions created for investment and saving options increased, particularly for those investors and business leaders who had to make decisions regarding dividends payments.

High levels of taxation on one set of consumer, capital goods or any activity, particularly taxes on mobile capital, will distort incentives to engage in those activities and thereby misallocate consumer spending and business investment relative to the preferences of the marketplace. Variable taxation generates high levels of uncertainty on the returns for investment and thereby reduces investment over time.

Much has been made of the tax increases and budget cuts during the 1993–1995 period and the subsequent pick-up in economic growth. Here, the perspective is that both businesses and households saw the cuts in spending as less future borrowing and thereby less future taxes. Higher taxes meant paying the bills today and thereby reinforced the message that future taxes would not be raised to pay for spending today. In both cases, reduced future taxes signaled a rise

[4] The American Recovery and Reinvestment Act of 2009 was passed in February 2009 with the intent of providing government stimulus spending to offset some of the contraction in private sector spending. The intent of the legislation was also to create and save jobs while investing for the future.
[5] Fumio Hayashi. (1987). Tests for Liquidity Constraints: A Critical Survey and Some New Observations, in Truman F. Bewley, ed., *Advances in Econometrics*, 2:91-120. Cambridge: Cambridge University Press.
[6] Support for this common sense observation comes from Robert J. Barro. (Oct. 1979). On the Determination of the Public Debt. *Journal of Political Economy*. 87:940-971.

in the present value of real after-tax income for both households and businesses. Note the contrast with fiscal policy the past few years where outsized spending increases served as a signal that future taxes were going up, thereby lowering expected future after-tax income, in turn, providing a disincentive to investment and economic growth. This provides an explanation for the continued subpar pace of investment spending and job growth now in the fourth year of the economic expansion.[7]

The 1993–1995 experience of tax increases and spending cuts followed by stronger economic growth was not an isolated incident.[8] Many commentators ignore the greater restraint put into place on government spending and the implications of future tax expectations as an incentive to both households and businesses at that time. The role of expectations is key here. A cut in federal spending signals a lower probability of future tax increases and possibly future tax cuts as spending declines. Households respond positively to the prospect of lower taxes as expectations of permanent after-tax income increases, which leads households and businesses to increase their spending. In contrast, the outsized spending increases in 2009 signal higher future taxes and thereby could help explain the subdued response to the outsized Recovery Act stimulus program.

A cut in federal spending signals a lower probability of future tax increases.

Moreover, the type of fiscal restraint also matters. Deficit reductions coming from cuts in government employment are more likely to be maintained than deficit reductions coming from tax increases.[9] Therefore, spending cuts can be expansionary, while tax increases aimed at reducing the deficit in the context of continued government spending are not.

Interest rate changes and expectations are also a channel for stronger economic growth that might arise from a more restrictive fiscal policy. First, reduced government spending lowers the expectations of future deficit financing, which, ceteris paribus, would lower expectations of higher future interest rates leading to increased real investment and a rise in the present value of households' lifetime after-tax incomes and thereby present consumption.

Second, fiscal contractions today reduce the likelihood of a future fiscal crisis, lower interest rates and, thereby, raise the estimates of future income again raising current consumption and investment.[10] Even today, we see a separation of euro sovereign risk premiums between governments that have brought their spending in line with growth and those countries that have not.

The Long-Term Deficit Bias and Its Economic Implications

As most evident today in the sovereign debt issues in Europe, but also possibly present at several levels within the United States, is the theme of a deficit bias in fiscal policy. For many years, federal fiscal policy has spoken to eventually balancing the budget, and yet, the balanced budget never shows up. Moreover, there is little evidence that policy follows a cyclical pattern trending toward balance.

How does this deficit bias come about? James Buchanan and Richard Wagner argue that the benefits of high purchases and low taxes are direct and evident, while the costs lower future purchases. Higher future taxes are indirect and less obvious. If voters do not recognize the extent of the costs or believe they will not pay these costs then there is a tendency toward excessive

[7] For an earlier review on these issues and several channels by which a traditionally defined contractionary fiscal policy could lead to more rapid economic growth see our earlier essay: Silvia, J.E. (Jan. 2012). *How Might Fiscal Restraint Generate Economic Growth?* Wells Fargo Securities, LLC.

[8] See evidence for Denmark and Ireland as presented by Giavazzi, F. and Pagano, M. (May 1990). Can Severe Fiscal Contractions Be Expansionary? Tales of Two Small European Countries. *NBER Macroeconomics Annual* 5:75-111.

[9] Alesina, A. and Perotti, R. (Aug. 1996). Fiscal Adjustments in OECD Countries: Composition and Macroeconomic Effects. IMF Staff Papers. 44:210-248.

[10] Bertola, G. and Drazen, A. (Mar. 1993). Trigger Points and Budget Cuts: Explaining the Effects of Fiscal Austerity. *American Economic Review* 83:11-26.

deficits.[11] This bias becomes even more accentuated when some voters perceive that they will not bear the tax burden of current and future spending.

The euro crisis reflects the fundamental disconnect with patterns of current fiscal policy spending that could not be sustained over time giving an ever-rising ratio of debt to GDP. The shock of the 2007–2009 recession made the debt-to-GDP imbalance an immediate crisis. Belated attempts to deal with the crisis resulted in sharp contractions in fiscal policy, a large decline in aggregate demand, major repercussions for capital and foreign exchange markets and the potential for government default.

The euro experience follows a long history of financial crises that illustrate that transitions from an unsustainable fiscal deficit position are rarely smooth, especially when the markets recognize that such a debt position is really unsustainable. For example, we have witnessed a default, sharply lower real exchange rates, increased inflation and recessions, such as the case in Mexico. These crises disrupt capital markets, lower real investment and reduce real economic growth.

Transitions from an unsustainable fiscal deficit position are rarely smooth.

For the United States, one path to a fundamental crisis is the realization that the trend growth for the United States is closer to 2.75 percent in the near term rather that the 4 percent that some forecasters estimate for the next two years and the belief that long-run trend growth is more like 3 percent–3.5 percent. Unfortunately, we are already seeing this disconnect as the pension and healthcare benefits promised over the past 40 years at the federal, state and local levels certainly were made with expectations of stronger growth than we are currently experiencing and stronger than we expect going forward. Simply stated, there is not likely to be enough tax revenues to pay the entitlement bills based on current projections of economic and job growth. With the realization of weaker trend growth, private investors would begin the migration away from U.S. Treasuries as they will be unwilling to hold Treasury debt at current interest rates and the current exchange rate.

This process may already be starting when we appreciate the implications of the Bank of Japan's decision to follow Prime Minister Abe's program to ease monetary policy and promote an increase in inflation. In this case, the implication is that the yen would depreciate against the dollar. Yet a policy of monetary ease would also indicate a decreased interest by the Bank of Japan to buy Treasury debt, and with Japan as one of three dominant buyers (along with China and the Fed, Figure 5), the decrease in Japanese buying would put some upward pressure on U.S. interest rates even while the size of Treasury debt issuance remains large. As in many markets, when traders and investors in China and the Cayman Islands sense the direction of the bond market has changed, then market rates will likely rise much faster than generally incorporated in current forecasts.

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[11] **Buchanan, J.M. and Wagner, R.E. (1977). *Democracy in Deficit: The Political Legacy of Lord Keynes*. New York: Academic Press.**

Figure 5

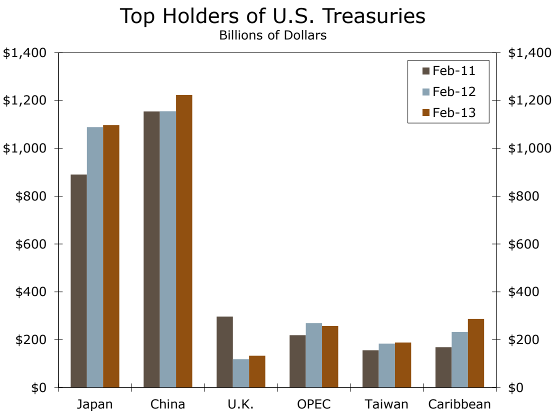
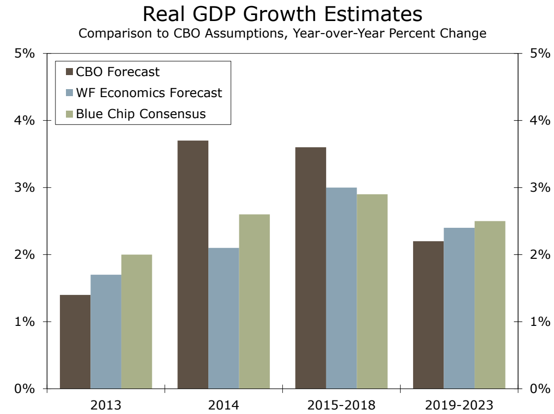


Figure 6



Source: U.S. Department of the Treasury, Congressional Budget Office and Wells Fargo Securities, LLC

The Future Will Not Resemble the Past

For decision makers, the current environment of fiscal policy is no longer the textbook-based Keynesian countercyclical fiscal policy with the goal of balancing the federal budget over the economic cycle. Instead, we are experiencing large and persistent deficits along with a fundamental change in the demographics of the labor force and therefore an expected downshift in the long-run pace of economic growth. In the short run, a variable and growing tax burden has created a set of distortions in economic growth that further aggravates the budget deficit and growth imbalance. Finally, given the inherent bias toward fiscal deficits, the current path of deficits could face a crisis in finance that may be beginning with changes in the global capital marketplace.

The current environment of fiscal policy is no longer the textbook-based Keynesian countercyclical fiscal policy.

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