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Special Commentary

John E. Silvia, Chief Economist
john.silvia@wellsfargo.com • (704) 410-3275
Michael A. Brown, Economist
michael.a.brown@wellsfargo.com • (704) 410-3278

Reaching the Tipping Point: Tough Fiscal Policy Choices Ahead

Executive Summary

Much has been written about the current state of federal fiscal policy and the issues facing policymakers in the short run. Yet, beyond the hand-wringing, little comment has been provided from an economic perspective on the challenging trade-off between deficit reduction and economic growth over the long run. We begin by framing the economic problem of trading off growth in the long run from growth in the short run as deficit reduction is implemented. This framework will allow us to explore the costs and benefits of deficit reduction on the economic operating environment. To conclude, we examine the current fiscal situation to determine what is necessary to reduce the deficit over the next decade and put the nation on a path to reduce the amount of public debt outstanding to better align debt and potential economic output.

Framing the Debate: Give Me Growth Now or Growth Later

A basic tenant of the economics of public policy is what economists refer to as the intertemporal government budget constraint which states that the total debt outstanding has to be balanced by the present value of future government surpluses.[1] In other words, if the government runs deficits today and accumulates debt, down the road this implies that budget surpluses have to occur leading to debt reduction. This constraint over time is derived from the fact that governments are not able to run deficits and accumulate debt in perpetuity. So, the decision turns to a choice between smaller tax increases and budget cuts, or both, in order to avoid larger budget cuts and larger tax increases in the future.

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One of the most common arguments for delaying policy actions to reduce the deficit is that the act of deficit reduction will adversely harm economic growth today. The idea is that when the economy is experiencing softer economic growth, deficit reduction should be avoided. Among economists, there is in fact, little debate that deficit reduction does adversely affect short-run economic growth. The more honest perspective is that by making the tough choices today and accepting some reduced level of short-run economic growth as government spending is cut, fiscal policy can be put on a sustainable long-run path and result in a higher level of economic growth as more capital is free to be invested as opposed to being diverted to paying debt servicing costs.

Historically speaking, the U.S. has run budget deficits for a number of years (Figure 1). So why is this time different? The answer lies in the fact that the level of debt that has accumulated as a share of the size of the economy has reached elevated levels and continues to grow as the imbalance between revenues and outlays continues to add to the level of debt. When one examines Congressional Budget Office projections of federal spending out to 2024, the result is that for most years using the CBO's projections under current law, the rate of growth in total outlays exceeds the expected rate of growth in nominal GDP.[2] Besides the high level of debt relative to the size of the economy, the changing demographics of the country are another factor that is forcing the hand of policymakers to address the deficit. Large outlays are projected in order

[1] **Romer, D. (2006). *Advanced Macroeconomics.* (3rd ed.). McGraw-Hill Irwin. pp. 561.**
[2] **Congressional Budget Office. (2014). *Updated Budget Projections: 2014 to 2024.***

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to meet expected obligations to a large retiring baby boomer generation aside from the expansion of health care coverage under the Affordable Care Act. The question, from an economics point of view, is what are the costs and benefits of deficit reduction? We turn to these questions in the following two sections.

Figure 1

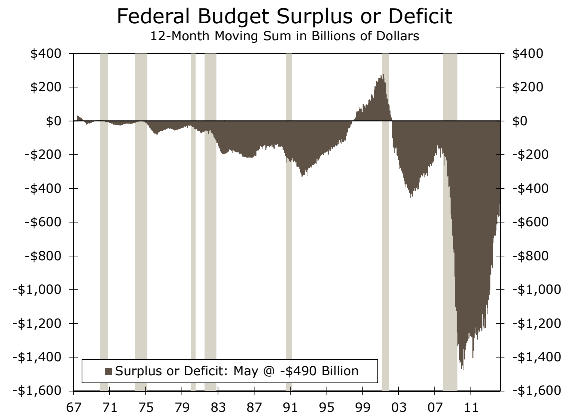
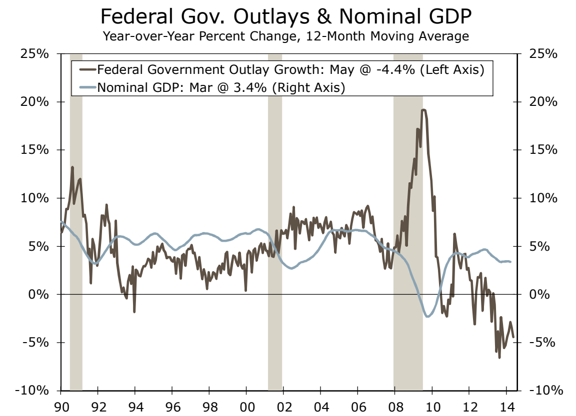


Figure 2



Source: U.S. Dept. of the Treasury, U.S. Dept. of Commerce and Wells Fargo Securities, LLC

A Tough Transition: Determents to Short-Run Growth

The best way to think about short-term economic growth is through the lens of our standard GDP equation (GDP=C+I+G+NX).[3] In the short run, economic growth is primarily determined by demand factors, in particular: consumer demand, business demand, foreign trade and government demand for goods and services. Thus, in determining the effects of fiscal policy changes on aggregate GDP growth, the primary cost to economic activity in the short run comes from the fact that a reduction in government (discretionary) spending, has the effect of reducing G in the GDP equation and the result is a slower pace of GDP growth. This can be seen in Figure 3 below as negative contributions to GDP growth. Besides the direct effects of reducing discretionary spending leading to a reduced rate of government consumption, there are indirect effects on other parts of the GDP equation that depend on the alternative public policy choices made to reduce the deficit.

First, if higher taxes are used to reduce the deficit, there is a double-negative effect on GDP growth. The higher personal taxes would result in reduced consumer spending at the same time that government purchases are being reduced. In addition, there is some evidence to suggest that deficit reduction through increases in taxes alone is not as effective as spending cuts alone.[4] The second indirect effect would occur if policy makers chose to reduce transfer payments such as social security benefits, healthcare benefits or other payments to individuals that allow them to consume. If these transfer payments are reduced, there is also a double-negative effect on growth as both consumption and government spending are reduced under this policy option. Depending on the length of time that higher taxes or reduced benefit payments are imposed, would determine whether the double negative effects on GDP growth could be extended in to the medium-run as well.

There is also one other key result that occurs in the short run when deficit reduction is enacted, a negative feedback loop.

There is also one other key result that occurs in the short run when deficit reduction is enacted, a negative feedback loop. Given that reductions in government spending are taking place, perhaps at the same time that taxes are increased or federal benefits are cut, GDP growth is reduced. This reduced rate of growth in GDP also has effects on tax collections by the federal government. In addition, under current law, automatic stabilizers built into the federal budget when growth

[3] Where C is consumer spending, I represents investment, G is government consumption and investment and NX represents net exports.
[4] Alesina, A.F. and Ardagna, S. (2009). *Large Changes in Fiscal Policy: Taxes Versus Spending*. NBER Working Paper 15438. National Bureau of Economic Research.

slows, such as unemployment insurance benefits and lower tax liabilities also have the effect of countering cuts to discretionary spending (Figure 4). The slower rate of GDP growth can also have negative feedback effects on financial markets, which, in turn, can lower federal tax collections. This reduction in revenues as part of the negative feedback loop means that a one percent cut to discretionary spending does not necessarily translate into a one percent cut in the deficit.[5] Thus, greater budget cuts or tax policy changes are required in order to ensure that deficit reduction takes place in the short run.

Figure 3

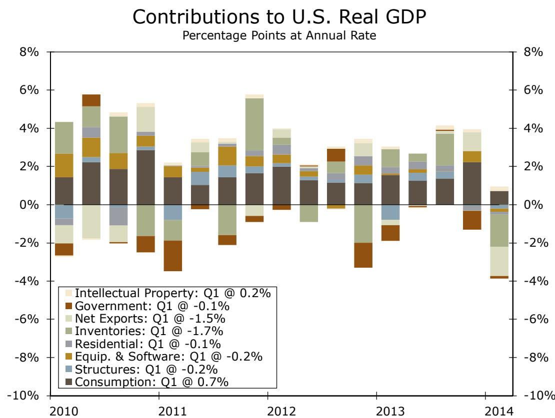
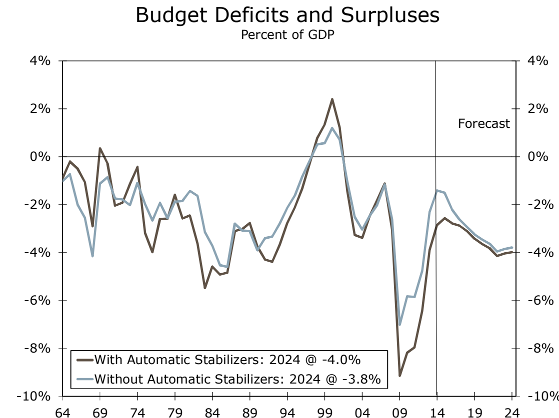


Figure 4



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

The Long Run: A Better Way Forward?

While there are certainly costs in the short run to deficit reduction, the primary reason for policymakers to engage in such deficit reduction is to ensure long-run fiscal policy stability as well as to support future economic growth. As we discussed, the short run is characterized primarily by demand driven factors. In the long run, however, supply side factors are the key to perpetuating longer-run economic activity. Thus, the focus in the long run is to ensure that there is a larger amount of capital, labor, better technology and ideally, greater economic efficiency.[6] The idea behind the short-run pain of deficit reduction is that by reducing the deficit and not adding further to the stock of public debt outstanding, more capital is freed up for investment as opposed to going to debt servicing which does not add to economic activity. Furthermore, the act of reducing the deficit to a point where the amount of debt outstanding can be paid down is the ultimate goal of deficit reduction. Another byproduct of deficit reduction in the long run is a positive feedback loop where the act of deficit reduction can have the effect of maintaining or perhaps reducing interest rates as the amount of debt outstanding is reduced.[7] Another, and perhaps more important, byproduct of deficit and debt reduction is the greater flexibility that is provided to policy makers when responding to economic downturns or other crises such as wars. By reducing debt levels, the federal government has more room to borrow as needed in order to expand government spending during times when private sector growth slows or contracts.

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Besides the long-run effects on interest rates, there is also the potential for a lower rate of inflation. According to the Congressional Research Service, debt reduction may allow for lower inflation in the long run should investors perceive that the Fed would not need to step in if debt levels reach concerning levels or the appetite for U.S. debt begins to dry up.[8] The idea being that

[5] **Cottarelli, C. (2012). Fiscal policy in advanced economies: fiscal adjustment, efficiency and growth. *Presentation at the Milan Catholic University. International Monetary Fund.***
[6] **Blinder, A. S. (2013). *The Economy Needs More Spending Now: U.S. growth would be more robust if we didn't confuse short-term stimulus with long-term reform*. The Wall Street Journal.**
[7] **This assumes that there is enough deficit reduction to result in a budget surplus that is in turn used to pay down the public debt.**
[8] **Labonte, M. (2012). *The Sustainability of the Federal Budget Deficit: Market Confidence and Economic Effects*. Library of Congress, Congressional Research Service.**

the Fed would not need to step in to directly purchase Treasuries (which would violate the Federal Reserve Act), resulting in higher inflation.

While it is difficult from the perspective of the policymaker to understand the long-run benefits in light of the current fiscal environment, there are clearly both fiscal and economic long-run benefits to the short-term pain of deficit reduction. The question then becomes one of timing. When and at what pace is tightening fiscal policy appropriate? These are the questions we address in the next section.

Where Do We Currently Stand?

Historically speaking, fiscal policy has helped to serve as a counter balance to slowdowns in the growth in the private sector.

Historically speaking, fiscal policy has helped to serve as a counter balance to slowdowns in the growth in the private sector (Figure 5). When it comes to the appropriate timing and pace of fiscal tightening to reduce the deficit, there is not a purely optimal economic solution. There are however, some key fiscal and economic variables that policymakers can focus on in order to determine the appropriate pace and timing of deficit reduction.

First, and perhaps most important, is the economic growth environment. If current economic conditions are "soft" then the negative effects of deficit reduction in the short run would be more severe.[9] Over the past couple of years, GDP growth has been averaging around 2.0 percent to 2.5 percent. The unemployment rate has declined to 6.3 percent as of May. While the pace of economic growth has not been all that impressive, there is evidence both from our analysis and the CBO that suggests that the long-run rate of economic growth has shifted downward.[10] The new long-run rate of economic growth is now estimated to be around 2.0 percent to 2.5 percent. In addition, there are signs that the economy is reaching full employment or the natural rate of unemployment. The CBO estimates that the natural rate of unemployment is somewhere around 5.5 percent.[11] Assuming our current economic forecast holds, the unemployment rate should approach this level towards the end of 2015. Thus, if policymakers are waiting for a more robust economic growth environment in order to enact deficit reduction measures, it is unlikely that further actions to further reduce or eliminate the deficit will occur. The current growth environment does, however, suggest that the rate of fiscal policy tightening should not be too dramatic to severely diminish the rate of economic growth.

Figure 5

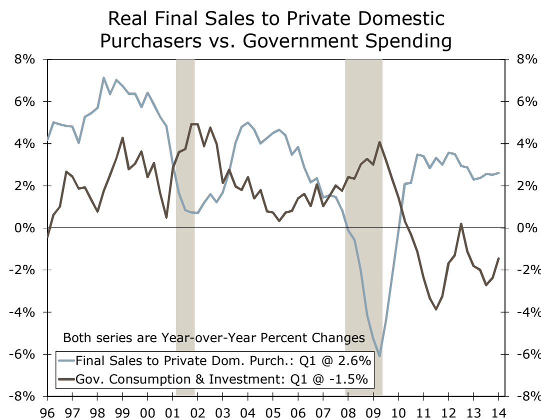
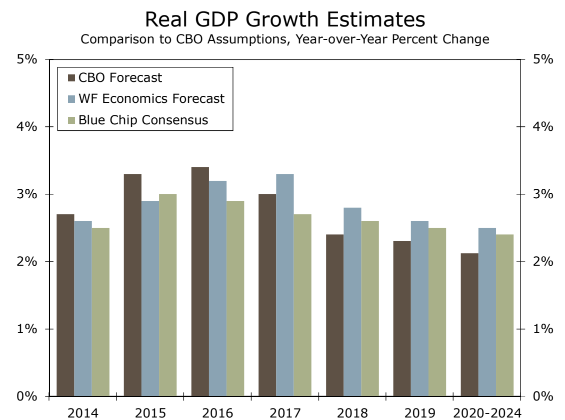


Figure 6



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

Second, in a relatively new finding, the monetary policy environment plays an important role in the timing of fiscal policy. Research has suggested that an optimal time to tighten fiscal policy is when monetary policy is no longer expansionary and the Fed Funds target rate is no longer near

[9] **Eberly, J. and Swagel, P. (2014). *Fiscal Balancing Act. Peter G. Peterson Foundation.***
[10] **Silvia, J.E. and Brown, M.A. (2014). *2014 Federal Fiscal Policy Outlook Part I: More Clarity, Less Uncertainty, Better Economic Growth.* Wells Fargo Economics.**
[11] **Congressional Budget Office. (2014). *The Budget and Economic Outlook: 2014 to 2024.***

zero.[12] As widely expected, the FOMC continues to wind down their asset purchases and is set to end their QE (stimulus) program by the end of October of this year. Given the gradual rise in the rate of inflation, we expect that a higher Fed Funds target rate is just around the corner, likely by the middle of 2015. Thus, when one considers the current monetary policy environment or more specifically the current changes in monetary policy, it becomes clear that the current monetary policy environment is conducive to enacting tighter fiscal policy.

The monetary policy environment plays an important role in the timing of fiscal policy.

Finally, fiscal challenges in the form of higher default risk or fiscal policy deadlines that force fiscal policy action are another path to deficit reduction. The other potential factor that could force policymakers to act would be anticipated higher borrowing costs if financial markets perceive some risk of future default. This phenomenon was briefly observed during the debt ceiling fight in 2013 that lead to a sharp increase in credit default swaps (CDS) for five-year U.S. Treasury notes (Figure 8). At present, there is no evidence to suggest that the appetite for U.S. debt is drying up. Thus, by this metric, there is not an urgent need for deficit and debt reduction. However, the reemergence of fiscal cliff debates or debacles over raising the debt ceiling could easily increase the future borrowing costs for the federal government in the case of additional downgrades to U.S. sovereign debt.

Currently, there is a looming deadline for policymakers to make such tough decisions. According to CBO's latest estimates, the Disability Trust Fund within the Social Security program is on track to be completely exhausted by 2017.[13] Thus, without any action on the part of policymakers, the result will be an automatic reduction in disability payments, an unlikely political outcome. Thus, the need to put the Disability Insurance program on a sustainable path will force policymakers to act in the near future. The earlier the needed reforms are enacted, the lower the likelihood that abrupt changes in policy, that could lead to an economic shock, will be enacted.

Figure 7

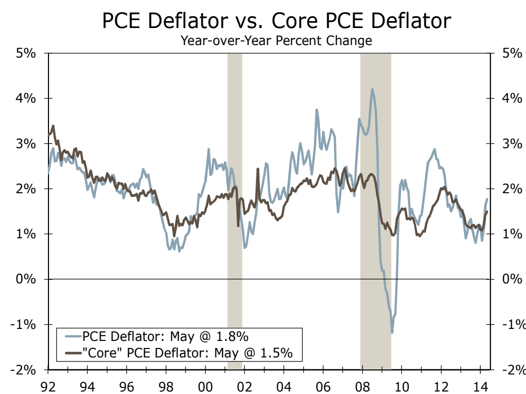
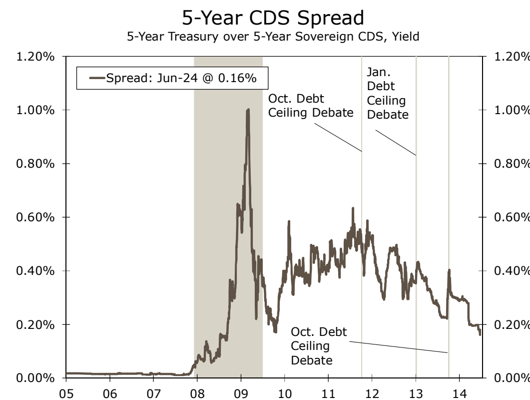


Figure 8



Source: U.S. Department of Commerce, MarkIT Partners and Wells Fargo Securities, LLC

In the current fiscal policy and economic environment we as a nation are standing at a crossroads. We can choose to hope for stronger economic growth, which is unlikely to occur, to help reduce the deficit and perhaps the debt. The alternative would be to understand the new long-run rate of economic growth, the changing monetary policy environment and the need to address impending shortfalls in existing entitlement programs and make the tough choices to reduce the deficit for the benefit of stronger longer-term economic growth. Based on our analysis of the current economic and fiscal operating environment, the time to begin changing the course of fiscal policy is upon us.

[12] **Eberly, J. and Swagel, P. (2014). *Fiscal Balancing Act*. Peter G. Peterson Foundation.**
[13] **Congressional Budget Office. (2014). *The Budget and Economic Outlook: 2014 to 2024*.**

Wells Fargo Securities, LLC Economics Group

Name	Title	Phone	Email
Diane Schumaker-Krieg	Global Head of Research, Economics & Strategy	(704) 410-1801 (212) 214-5070	diane.schumaker@wellsfargo.com
John E. Silvia, Ph.D.	Chief Economist	(704) 410-3275	john.silvia@wellsfargo.com
Mark Vitner	Senior Economist	(704) 410-3277	mark.vitner@wellsfargo.com
Jay H. Bryson, Ph.D.	Global Economist	(704) 410-3274	jay.bryson@wellsfargo.com
Sam Bullard	Senior Economist	(704) 410-3280	sam.bullard@wellsfargo.com
Nick Bennenbroek	Currency Strategist	(212) 214-5636	nicholas.bennenbroek@wellsfargo.com
Eugenio J. Alemán, Ph.D.	Senior Economist	(704) 410-3273	eugenio.j.aleman@wellsfargo.com
Anika R. Khan	Senior Economist	(704) 410-3271	anika.khan@wellsfargo.com
Azhar Iqbal	Econometrician	(704) 410-3270	azhar.iqbal@wellsfargo.com
Tim Quinlan	Economist	(704) 410-3283	tim.quinlan@wellsfargo.com
Eric Viloria, CFA	Currency Strategist	(212) 214-5637	eric.viloria@wellsfargo.com
Sarah Watt House	Economist	(704) 410-3282	sarah.house@wellsfargo.com
Michael A. Brown	Economist	(704) 410-3278	michael.a.brown@wellsfargo.com
Michael T. Wolf	Economist	(704) 410-3286	michael.t.wolf@wellsfargo.com
Zachary Griffiths	Economic Analyst	(704) 410-3284	zachary.griffiths@wellsfargo.com
Mackenzie Miller	Economic Analyst	(704) 410-3358	mackenzie.miller@wellsfargo.com
Donna LaFleur	Executive Assistant	(704) 410-3279	donna.lafleur@wellsfargo.com
Cyndi Burris	Senior Admin. Assistant	(704) 410-3272	cyndi.burris@wellsfargo.com

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