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Special Commentary

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More Band-Aids, No Antiseptic: A Decision Maker's View of Fiscal Cliff Policy

For some time now, central government spending has been growing rapidly and federal government debt has risen to levels not previously experienced. Several temporary budget control programs have been put in place, but each of these programs were half-measures, and yet continued overspending on public projects and wars have left the government finances in desperate condition. Easy monetary policy has also been put into place. Unfortunately, economic growth remains disappointing and the budget/debt problems continue to grow worse with little prospect of getting spending under control. Such was the environment for the entry of John Law, the rapid depreciation of the French currency, roaring inflation, the boom/bust of the Mississippi Company and, inevitably, the French Revolution.

Plus ça change, plus c'est la même chose (the more it changes, the more it's the same thing)

Lessons for the Public Policymaker and the Private CIO or CFO

1. There is an inconsistency of the incentives and time horizons for politicians and businesses/households. Political decisions are incentivized by the short run, while businesses and households must plan with the long run in mind. Therefore, political solutions should not be expected to align with economic solutions.
2. The world today, the economy today, is not what it was in the past. However, there has been an anchoring bias in the fiscal policies and economic models used to direct decision makers: the world has changed but the models have not.
3. Uncertainty leads to more risk aversion on the part of businesses and households. There is a market price for fiscal uncertainty, and in the recent past that price has been subpar economic growth.
4. Current deficits finance current consumption. In the past, deficits helped finance public infrastructure that added to the physical capital of the nation and therefore the long-run growth of the economy. Today, however, deficits finance current consumption through transfer payments that detract from the capital needed for long-run growth.

Spending and Growth: Continued Misalignment

Short-run political compromises do not address the long-run economic imperatives.

As indicated in our prior essay, the fiscal cliff compromise did not move federal spending commitments in line with the pace of real spending growth.[1] Moreover, such short-run political compromises do not address the long-run economic imperatives facing the United States—nor was that anticipated. There is a critical problem here of incentives and time horizon. First, there is no need or even expectation that a political solution is or would be consistent with an economic solution. Moreover, political decisions are incentivized by the short run—the next election—and

[1] Silvia, John. E. (December 18, 2012). *Fiscal Cliff and True Reform: Short-Term Band-Aids and Long-Term Constructive Surgery*. Wells Fargo Economics Group. The paper was presented at the Global Interdependence Center's Conference: The Global Financial Crisis: Lessons from Japan, Session II: "How to Manage the Government Debt Hangover" in Tokyo, Japan on Dec. 3, 2012.

this is certainly true in the recent years of nonstop temporary programs (cash for clunkers, stimulus, first-time home-buyer's credit, temporary payroll tax cuts). Yet, households and businesses must plan for the long run, the next 10-30 years, and are incentivized by prices and profits. The incentives/goals are not the same. The time horizons are not the same. Perhaps the only bi-partisan item is the growth of the public debt.

Given this inconsistency of incentives and time horizons, how should decision makers, such as CIOs and CFOs of private and public institutions, interpret and act on the latest fiscal deal, and what is the future framework for decision making? First, contrary to some commentary, a "Grand Bargain" was not the most likely outcome anticipated by the private market and certainly was not ours. That is a straw man employed to make the current agreement appear to be progress when, in fact, there was no real progress, only delay, on the real issue—a sustainable path of federal spending consistent with a 2 percent growth rate in the economy. Two percent growth is indeed what we have had for the past three years—wishing for more does not work. There was no real progress on entitlements—that was not anticipated either but there was a sense that some spending restraint would be undertaken. For investors, taxpayers and decision makers, the tension remains between unsustainable federal spending and deficit trends and a seemingly intractable political decision-making process. While the policymakers debate, households and businesses still need to move ahead.

A debate without a fiscal resolution to a path of sustainable entitlement spending is pointless.

Finally, the fiscal cliff deal, and likely stand-alone debt ceiling deal, failed to put into place any mechanism for controlling federal spending over time; therefore, the failure to address long-term spending problems opens the door to a downgrade of U.S. sovereign debt. This inability to come to grips with the fundamental spending problem, not the acrimonious debate, is the core issue. Debate is healthy and long overdue on entitlements as they make up the largest share of federal spending and the fastest growing segment of spending (Figures 1 and 2). However, debate without a fiscal resolution to a path of sustainable entitlement spending is pointless.

Figure 1: FY 2012 Spending by Category

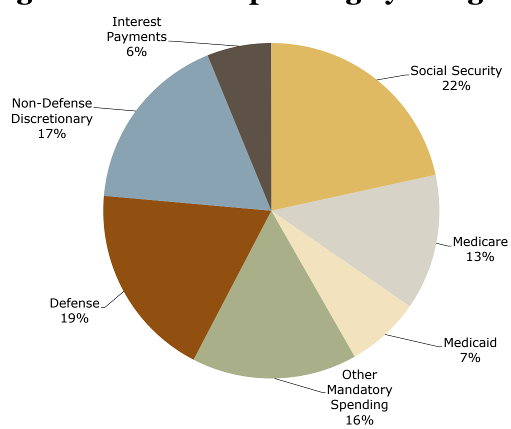
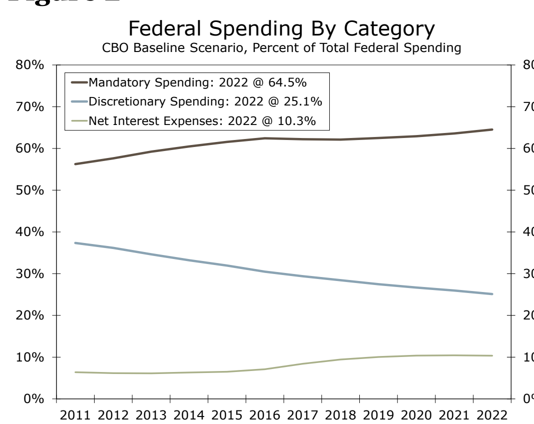


Figure 2



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

The Composition of Fiscal Policy Matters—A Lot

For decision makers, the fiscal cliff deal sends all the wrong signals and indicates weaker U.S. growth going forward and no real progress in addressing the long-run spending/debt issues. Raising taxes without any control on spending is exactly the wrong composition of fiscal policy moves.[2] In Alesina and Ardagna's study of OECD countries for the period 1960-1994, fiscal adjustments concentrated on the spending side and, in particular, on public wages and welfare spending are long lasting while fiscal adjustments which rely primarily on tax hikes do not lead to a permanent consolidation of government finances.[3] Australia (1987) and Ireland (1987-1989) are two particular cases of success via spending cuts, while the stop-and-go policies of Greece (1986-

[2] Alesina, A. & Ardagna, S. (Oct. 1998). Tales of Fiscal Adjustment. *Economic Policy*, 27.
[3] McDermott, J. & Wescott, R. An Empirical Analysis of Fiscal Adjustments. *IMF Staff Papers*, 43(4).

1989) were not successful. In contrast to Australia and Ireland, the long-run path of U.S. debt to GDP was not reduced to a sustainable pace with the fiscal cliff deal, especially given the outlook for entitlement spending.

Fiscal policy today operates in a different global framework than in the past.

Fiscal policy today also operates in a different global framework than in the past. Therefore, in contrast to some commentary, the failure of the fiscal stimulus to generate the growth and lower unemployment that was promised is also likely to be repeated on the restraint side, as a tighter fiscal policy is unlikely to generate the recession some anticipate. Again, the examples of extreme austerity in Greece or Spain are straw men dredged up to discourage any adjustment at all. Adjustment is required—just not a starvation diet. While expansionary stimulus did not deliver the economic results on the upside, this does not mean that sustained reasoned restraint will not deliver improvement over time.

There has been an anchoring bias in the projections of the fiscal impact in the short run that reflects a modeling and estimation approach based on an antiquated view of the U.S. economy in a post-WWII period where the United States was principally a closed economy with very liquid household and business budgets and strong labor force growth and demographics.[4] That is not the U.S. economy today. Therefore, these models have been consistently inaccurate in their forecasts of the impact of the stimulus program. The world changed but the models did not. Moreover, the position of monetary policy and the collapse of velocity certainly has been an offsetting factor to any fiscal stimulus. Finally, the character of the U.S. labor market also has changed over time, further limiting the effect of fiscal policy on the upside. Fiscal policy matters, but the repeated, short-term spending programs and the lack of response in growth and jobs intimates that the rules of the road are different in the 21st century. The actual outcomes bore no resemblance to the projections of the policymakers.

The Price of Uncertainty and Temporary Programs

There is too much emphasis on short-run stabilization at the cost of long-run stability.

Beyond the change in the economic model, the character of policy has also been a counterproductive force, and the latest fiscal cliff deal continues this tradition of policy failures. There continues to be too much emphasis on short-run stabilization and fiscal deals at the cost of long-run stability and unsustainable budget deficits and debt.

Croce, Nguyen and Schmid examine the impact of fiscal policy on long-term growth when private sector decision makers, businesses and households, are uncertain about the range of future fiscal policy.[5] This has certainly been the story for many years as decision makers have faced a litany of short-term temporary tax cuts and spending programs. The authors also examine the implications of government spending when financed by debt issuance and distortionary taxes on labor income—which is certainly the character of the latest fiscal cliff deal that created further distortions in the return to labor as we will review later. Even before the latest fiscal deal, decision makers faced a series of short-term tax breaks and yet logic would dictate that firms will not hire long-term employees based on short-term tax incentives for if, or more likely when, Washington removes the tax incentive you still have the worker. An effective hiring decision must be justified on the long-run outlook for sales and worker productivity—not a temporary tax break.

The losses to long-run growth outweigh the benefits of short-run stabilization.

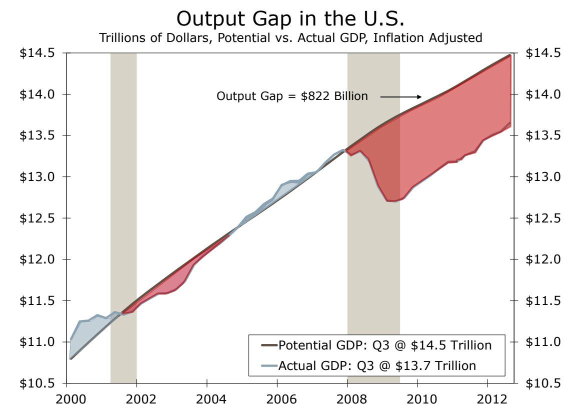
Croce et. al, find that as workers and business decision makers are less certain of the model of the economy and future fiscal policy, they become more risk averse in terms of the perceived distortion of taxes on economic activity. Therefore, there is less incentive to work or grow a business, resulting in a reduction in long-term growth in consumption and welfare losses to society. We can see the negative impact on long-term growth in the three year string of 2 percent growth in the U.S. economy and the failure to close the gap with potential GDP illustrated in Figure 3. There is a market price for fiscal uncertainty. Moreover, the losses to long-run growth outweigh the benefits of short-run stabilization. Doubts about future taxation also impact the

[4] For further discussion on this bias of decision making see, Silvia, J.E. (2011). *Dynamic Economic Decision Making: Strategies for Financial Risk, Capital Markets, and Monetary Policy* (pp. 71-73). New York: Wiley Finance.

[5] Croce, M.M., Nguyen, T.T. & Schmid, L. (March 2012). The Market Price of Fiscal Uncertainty. *Journal of Monetary Economics*.

pace of innovation and, thereby, higher expected future taxes reduce the incentive for innovation and growth in the long run. Thus, reducing short-run uncertainty through persistent public deficits or surpluses come at the cost of bringing more risk for long-run profits.[6]

Figure 3



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

Short-run fiscal adjustments deliver political dividends as policymakers appear to be doing something. But these short-run adjustments can be bad for the economy in the long run. Household work/leisure decisions and consumption/saving and business investment decisions in the private sector are based on a long-term horizon, so that anticipated higher future taxes will discourage work today and saving. This impact is even more accentuated given the anticipated unsustainable pace of federal spending.

This impact of higher, uncertain, future taxes in the face of unsustainable federal spending may also help explain the decline in labor force participation of both men and women, and even more so, for young people 18-24 years old as well as the less-than-expected 2 percent growth. The latest fiscal cliff deal, with an emphasis on higher labor income taxes and no spending constraint further aggravates future policy uncertainty.

Debt and Distortionary Taxes on Labor Income: A Fiscal Policy to Maximize Unemployment

Since the Great Recession, there has been a clear downshift in the ratio of employed to the population as illustrated in Figure 4.

[6] **Croce, M.M., Nguyen, T.T. & Schmid, L. (March 2012). The Market Price of Fiscal Uncertainty. *Journal of Monetary Economics* (p. 38).**

Figure 4

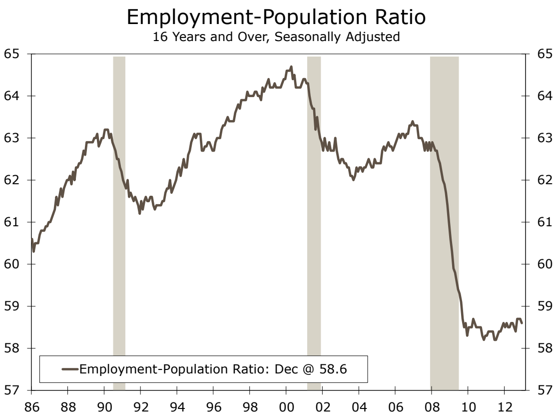
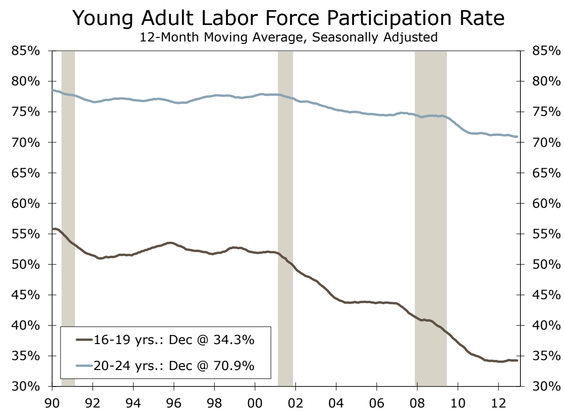


Figure 5



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

Distortionary taxes and policy changes under the fiscal cliff agreement further aggravate this problem. Starting in 2009, just as the recovery was beginning, the rise in the minimum wage immediately discouraged the hiring of young workers with limited skills since the wages of these workers exceeded their productivity. This helps explain the sharp drop in the participation rate for young workers in this recovery (Figure 5).

The deal's tax increases on labor impact the upper middle income groups, not just the millionaires and billionaires.

Three different aspects of the fiscal cliff deal create distortions in the return to workers and thereby discourage gains in employment. The resumption in the payroll tax reduces the reward for work and thereby reduces the willingness of workers to supply their labor and provides a push to higher unemployment. Second, the phase-out of personal exemptions and itemized deductions also reduces the return to labor and thereby discourages the supply of labor. Third, the additional payroll tax hike in line with the Affordable Care Act of 0.9 percent of income above $250,000 will further discourage the supply of labor. Notice that these tax increases on labor are not limited to millionaires and billionaires but impact the upper middle income groups, especially in families where two income earners reside.

For the economy, the reduction in the labor supply results in slower long-term growth over time. As a follow-up, it is interesting that we have witnessed in the past four years a continued decline in the labor force participation rate for both men and women.

Note also that the higher marginal wage income tax will discourage working for the smaller wage earner in any household as their marginal after-tax take-home pay will be reduced. This is especially true to the extent that the disparity in income between earners in the same household is extremely significant. Once again, we see further erosion of labor force participation.

Distortions on the Spending Side—Industrial Policy as Not Everyone Plays by the Same Rules

The deal directs spending and tax breaks toward politically favored special interests.

Spending allocations in the fiscal cliff deal direct spending and tax breaks toward politically favored special interests. Unfortunately, this often is a misallocation of resources that can be illustrated by the famous incident of the armor-plate scandal. Under President Woodrow Wilson, Congress appropriated money to build armor plates for the Navy at a lower cost than the private sector. The plant was finished three years after World War I ended, millions of dollars over budget, and could not produce armor for less than nearly double what the private steel companies charged. The plant was shut down after one batch of armor plates was produced, and never reopened.[7]

[7] Gordon, J.S. (2001). The Armor-Plate Scandal. In *The Business of America* (pp. 157-161). New York: Walker & Co.

Limited economic resources allocated with political goals in mind are not likely to be economically efficient.

Federal spending through tax extenders (loopholes by their common name) produce efficiency losses for the economy as resources are redirected from one sector/manufacturer towards a less efficient sector or manufacturer. In the fiscal cliff agreement there are tax breaks for Hollywood movie studios, rum manufacturers, plug-in motorcycles, wind turbines and other green energy initiatives even after all of the failures associated with solar panels and battery manufacturers. The essential problem is that limited economic resources allocated by political means and with political goals in mind are not likely to be economically efficient.

This misallocation of capital produces several negative consequences. First, the misallocation of capital in general would squander capital resources and thereby result in less capital and less economic growth over time. Second, tax extenders would alter the rewards to production and the relative competitiveness of firms, individuals, states and localities.

For example, for investors, this creates a risk that tax extenders provide a competitive advantage to certain sectors/companies and thereby alter the investment returns for the advantaged and disadvantaged firms/states/localities. Political allocation towards special interests creates pockets of success or failure. In these cases, not everyone is playing by the same rules. Politics, not economics, dictates economic outcomes with the risk that economic growth and jobs would disappoint over time.

Model Uncertainty: The Evolution of Fiscal Policy Benchmarks over Time

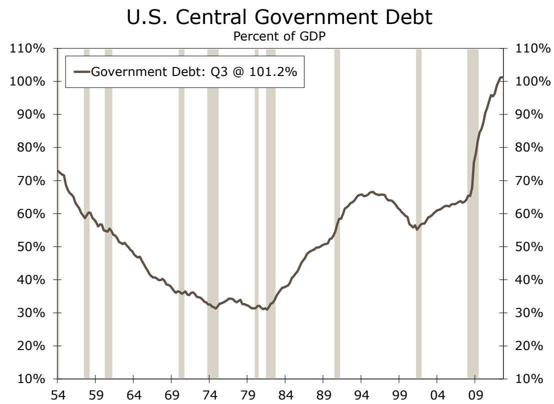
The impact of fiscal policy today could be quite different than in the past.

Beyond the simple discussions of the impacts of fiscal policy, there is an evolution in the character of that policy, which intimates that the impact of fiscal policy today could be, and probably is, quite different than in the past. The macro model changes again. This may help explain why the fiscal policy stimulus appeared to be quite ineffective in generating the promised benefits. Traditionally, countercyclical fiscal stimulus was sold as offsetting the weakness in the private sector. However, as the economy revived and tax revenues rose, fiscal policy was positioned as moving toward a more neutral position so that, over the business cycle, the fiscal budgets would be balanced. On net, therefore, there was no obvious expansion of the public sector and no obvious rise in tax burdens.

However, this is not the model for fiscal policy today and, therefore, it is likely that household and business behavior would be different than under the traditional model. Since this model is different than commonly assumed, we are likely to see this different behavior evolve into a different economic outcome than what some have projected.

First, the economic impact of fiscal deficits that are perceived to be permanent and unsustainable will be different from deficits that are temporary and self-correcting. Permanent deficits must be financed by taxes/debt finance and possibly rising inflation over time. In addition, when deficits are perceived to be unsustainable, the risk is that future taxes will rise, debt finance will grow (see Figure 6) and inflation has a strong bias to the upside. Higher future taxes intimate greater caution of current taxpayers who anticipate higher future taxes will reduce after-tax disposable incomes. Greater future debt finance further raises the probability of higher taxes and/or higher inflation. Finally, permanent, unsustainable future deficits negate the employment of traditional fiscal policy models based on the traditional assumption of temporary and self-correcting deficits. The framework of fiscal policy has changed, and the anchoring bias of basing current economic estimates on outdated models is very obvious today.

Figure 6



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

Financing current consumption through transfer payments may detract from the capital needed for long-run growth.

Second, current deficits finance current consumption. This also is a significant change from the past when deficit finance focused on public infrastructure, such as highways, that added to the physical capital of the nation and added, therefore, to the potential improvement in long-run growth in the economy. Financing current consumption through transfer payments such as Social Security and Medicare support current consumption, of course, but detract from the capital needed for long-run growth. These unfunded liabilities—entitlements—allowed the U.S. economy to exhibit above average consumption in recent years, which was above the pace of consumption consistent with income gains and thereby allowed the U.S. economy to appear to be doing better than it really was. The U.S. economy is living on borrowed time and detracting from the wealth of future generations.

Current fiscal policy favors today's voters at the cost of future generations.

Finally, there is a time shifting in taxation and deficit finance that provides a bias for more spending today. Current fiscal policy—government-financed consumption—favors today's voters at the cost of future generations who are not voters. This helps explain the unfunded liabilities of entitlements at the federal, state and local levels which reinforces the risk to current workers, who are not entitlement recipients, to expect higher taxes/debt finance/higher inflation over time and therefore limits their spending today when deficits are perceived to be permanent and unsustainable. When faced with the choice of "pay me now" or "have someone else pay later," current entitlement recipients and policymakers shift the burden to future taxpayers (nonvoters).

The altered model of fiscal policy helps to explain why current spending did not generate the economic growth or jobs that were promised. The lack of stimulus follow-through on the demand side also helps explain why interest rates have not risen as some anticipated, although the impact of the supply of credit from China, Japan and the Federal Reserve helps explain the continued low interest rates. Analysts have argued that the failure to observe higher interest rates indicates that deficit financing did not have a negative impact and therefore, we can spend even more money. However, that argument only takes a pure-demand-side view of the credit market and overlooks the impact of the supply of credit from China, etc., as well as the depressing effect on current consumption and higher saving and/or the deleveraging of current taxpayers who are discounting the impact of higher future taxes on their disposable incomes. Deficits without tears?

The price of uncertainty has been subpar economic growth.

Fiscal deficits have delivered a stretch of subpar economic growth of 2 percent over the past three years as well as two years of job growth of 151,000 per month on average for each year, which has been, unfortunately disappointing. After more than three years into the recovery we still remain 4 million jobs short of the pre-recession high-water mark. The price of temporary programs, policy uncertainty and model uncertainty has been subpar economic growth. Moreover, federal debts are paid in a fiat currency, the dollar, of which the Federal Reserve has increased the supply dramatically over the past five years. This increases the risk of higher inflation sometime in the future.

"By a continuous process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens. By this method, they not only confiscate, but they confiscate arbitrarily; and while the process impoverishes many, it actually enriches some."

- John Maynard Keynes, *The Economic Consequences of the Peace*[8]

Default is the topic of the day when analysts focus on the debt ceiling, but it is practical to recall that governments can effectively default when they pay their debts in depreciated dollars. President Franklin Delano Roosevelt took the United States off of the gold standard—the gold clauses that required the debtor to repay the creditor in gold dollars of the same weight and fineness as borrowed. Later the government, by fiat, raised the price of gold, thereby effectively increasing the value of gold at the Federal Reserve, allowing the Fed to further inflate the money supply. Nothing in our essay argues for returning to the gold standard. Instead, the problem is using monetary policy easing to support fiscal policy spending. As for our friend Louis XVI, currency depreciation was the initial means of paying the debts. The final payments came with his head.

[8] Keynes, J.M. (1920). The Economic Consequences of the Peace. New York: Harcourt, Brace and Howe.

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