

Comments on

Measuring U.S. Fiscal Capacity Using Discounted Cash Flow Analysis

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Outline

- Summary
- The Basic Question
- The Definition and Meaning of “Fiscal Capacity”
- Why is Debt $>$ Fiscal Capacity?
- Policy Responses
- Assessing Fiscal Policy

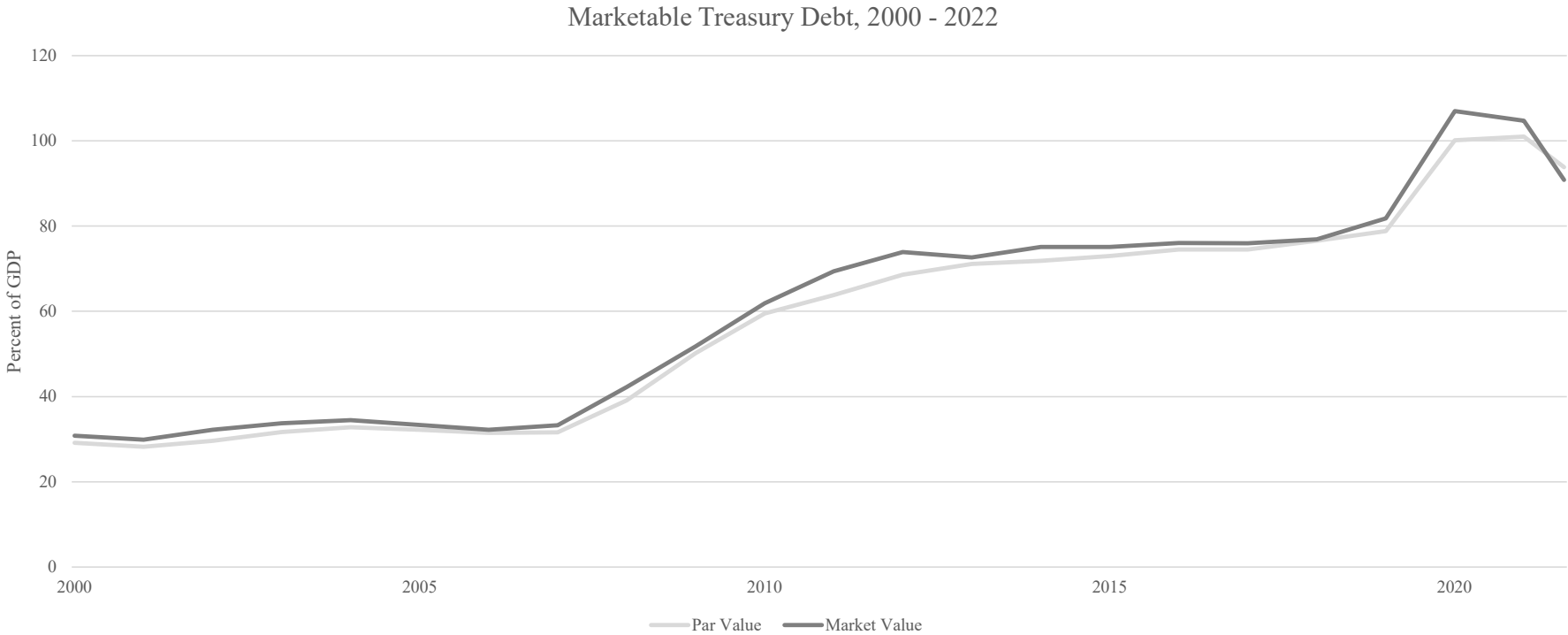
Summary

- Different Methodology, Similar Conclusions
 - We need to raise taxes or cut spending in the future
 - Lower interest rates significantly reduce the magnitude of the fiscal problem.

The Basic Question

- Current market value of federal debt $>$ PV of future primary surpluses?
 - Market Value of Debt
 - Surplus/Deficit Path
 - Discount rates

Market and Par Value of Federal Debt

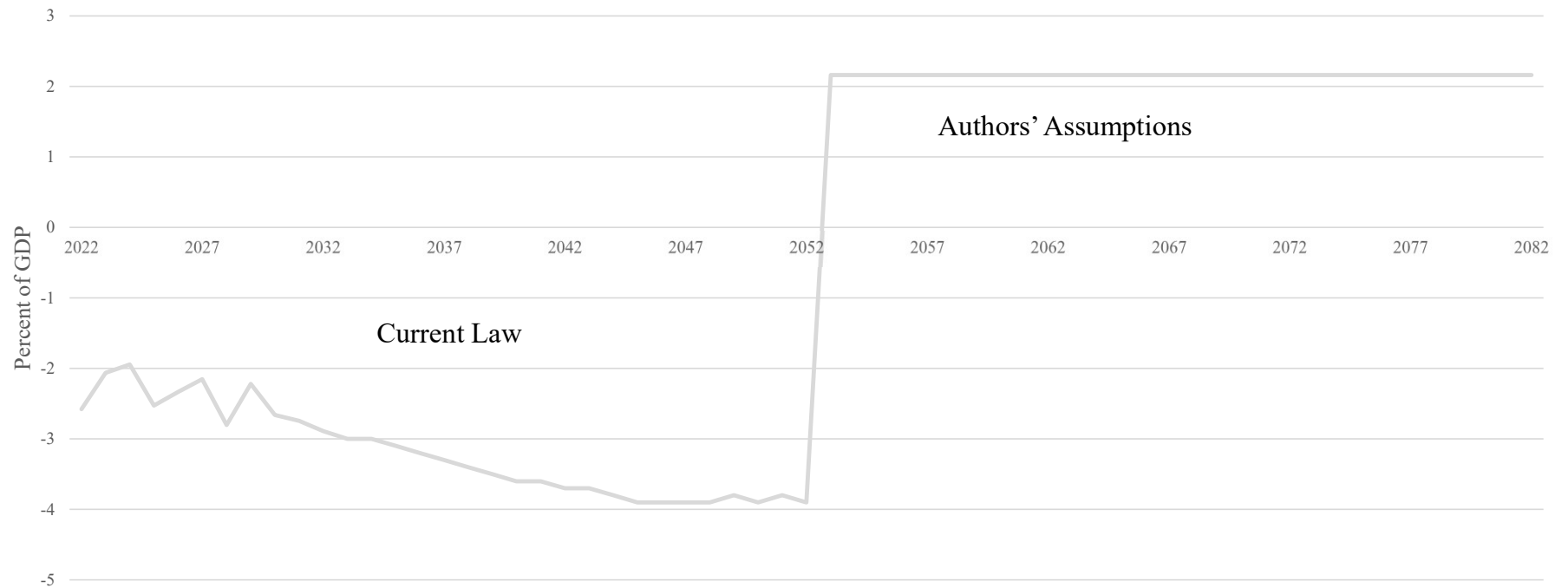


Source: Federal Reserve Bank of Dallas

Deficit path

- CBO current-law projections for 30 years; assume that “nothing changes;” not intended to be realistic
 - Spending programs are re-authorized
 - Temporary tax provisions expire
 - Discretionary spending is constant in real terms
 - Trust funds continue to pay full benefits regardless of financing status
 - Debt ceiling is raised as needed
- Surpluses after 2052

Projected Path of Federal Primary Budget Surpluses, 2022 - onwards



Source: Data from 2022 – 2052 is projection for current law from CBO (2022), 2052 and beyond is authors' assumption

The Basic Question

- Current market value of federal debt $>$ PV of future primary surpluses?
 - Me – yes (current law thru 2052, realistic budgets post 2052, even with gov't DR)
 - Authors – yes (current law thru 2052, optimistic budgets post 2052, and private DR)

Fiscal Capacity: An Intuitive Definition

- $FC = \text{Current Debt} + \text{“Fiscal Space”}$
- Fiscal Space = The extent to which “... public deficits [can] increase without putting fiscal sustainability at risk, given the specific macroeconomic situation...” (OECD)
- Starts with actual debt level; hard to operationalize
- Key implication: $\text{Debt} > FC$ is a problem.

Fiscal Capacity: Authors' Definition

- $FC = PV(\text{future primary surpluses}) [+ \text{seignorage}]$
- Starts with infinite projections, also hard to operationalize.
- Key implication: If $\text{Debt} > FC$, we need to raise future taxes or cut future spending.
 - Relative to the baseline, which assumes no policy changes for 30 years
- But $\text{debt} > FC$ is not necessarily a problem.
 - Ex. Suppose $\text{debt} = 0$ and all future primary surpluses = 0.
 - FC as defined by the authors would be zero.
 - But government could borrow and should borrow.

Why is $\text{Debt} > \text{PV}(\text{Future Primary Surpluses})$?

- Bubble in Treasuries
- Investors are rational but have different assumptions than the authors
 - Primary surpluses
 - Inflation
 - Discount rates

Why is Debt $>$ PV(Future Primary Surpluses)?

- The model may be using the wrong measure of debt. The burden of debt that “has to be paid back” should be measured:
 - Net of government’s holding of financial assets and
 - Net of government’s holding of federal debt (e.g., trust funds... and the Fed?)

	% of 2021 GDP	\$ Trillions
Fiscal Capacity at end of 2021 (Authors)		
PV Primary Surpluses	55.4	12.4
PV Primary Surpluses + Seignorage	73.0	16.4
Alternative Calculation		
Debt held by the Public (Par Value)	99.6	22.3
Less Financial Assets Held by the Government	7.3	1.7
Less Debt Held by the Federal Reserve	24.3	5.4
Equals Net Debt Held Outside the Federal Government	68.0	15.2

*This measure already excludes the Trust Fund holdings of government debt

(Source: Table 1-3 in CBO (2022), “The Budget and Economic Outlook: 2022 – 2032.”)

Why is Debt $>$ PV(Future Primary Surpluses)?

- Bubble in Treasuries
- Investors are rational but have different assumptions than the authors
 - Primary surpluses
 - Inflation
 - Discount rates
 - Fed purchases of government debt

Policy Responses to Debt $>$ FC

- Solution 1 – Cut spending, raise taxes
 - Policy changes have the same effect in the authors' model (Table 5) as in conventional models (CBO, Auerbach and Gale) because the government's budget is affected by the interest rate the government pays, not the rate at which investors discount debt.
- Solution 2 – Alter the cyclical properties of taxes and spending
 - Bad idea

Assessing the Fiscal Policy Stance

- It's complicated
 - Federal government is the most complicated financial institution in the world
 - Short-term stimulus versus long-term burden
 - How the money is raised and spent matters as well – e.g., investment versus consumption
- Insufficient statistics
 - Blanchard's $r-g$ and Furman and Summers' net interest criterion are not sufficient statistics.
 - Neither is the estimate of FC based on infinite-horizon projections.
- But each criterion is still useful in its own way.