

Fiscal Uncertainty and How to Deal with It

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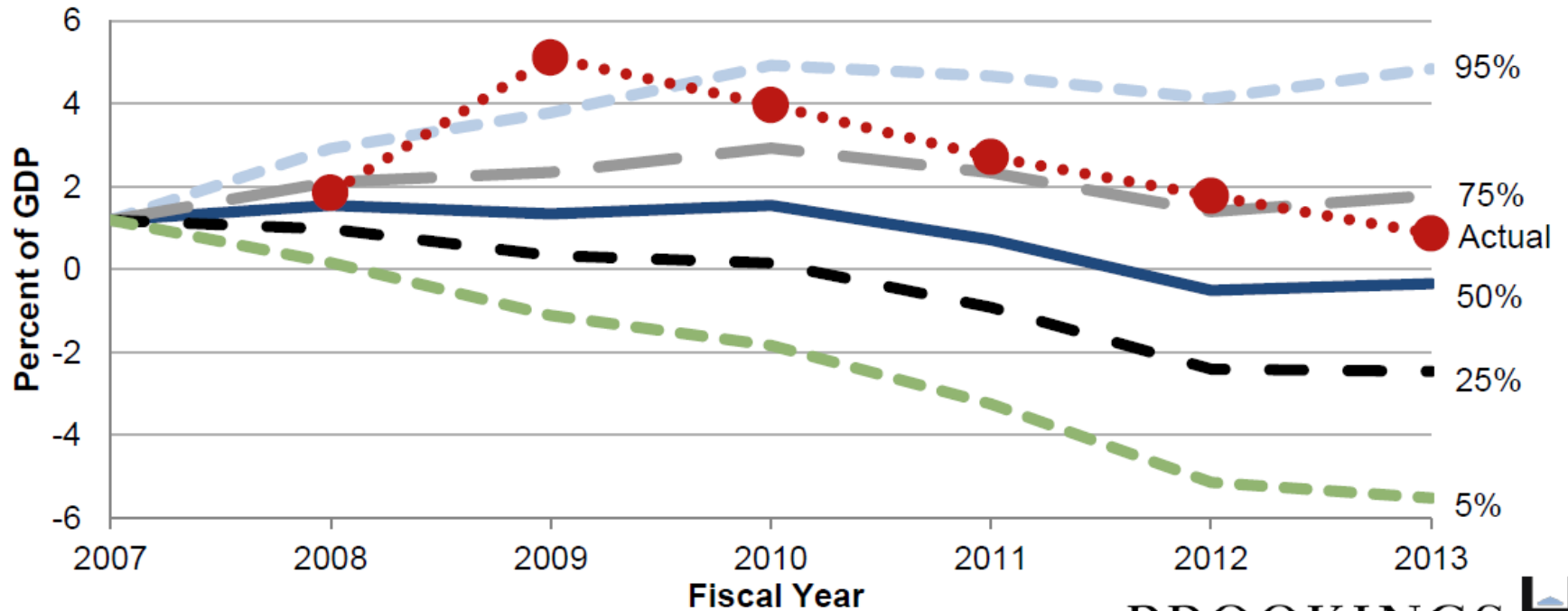
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- Long-term projections for the paths of federal revenues and expenditures look much worse than those for the very short term.
 - An unsustainable path without major changes from current policy; i.e. a large *fiscal gap*
- But projections are also subject to error that increases with the forecast horizon.

Figure 2. Current Policy Deficits

March 2008 Confidence Intervals



Source: CBO (2008) and author's calculations.

What to Do?

- Not how to deal with fiscal imbalances, but how our responses should change because of this uncertainty

Common Responses

- Stein's Law

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- Changes, but when and how?
- And how compare to a desirable transition?

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- But what does that mean?
 - Assume problems that are projected to be big and getting worse as of year t vanish in year $t+1$?

Taking Precaution

- If the future is very uncertain, a case for saving more for the future, whether by an individual or by a government
- Things more complicated when analyzing what government should do, but the main conclusion doesn't change

But...

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- This type of uncertainty may be something we wish to avoid, but not something we should ignore.

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- People will be better off in the future; they can absorb greater fiscal burdens.
- This is an argument about how to deal with projected fiscal imbalance, not uncertainty about it.
- Economic costs of very high future marginal tax rates or fiscal crises if adversity strikes push toward more active responses now.

But...

- We should wait until we have a better idea about the future.

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- The future will always be uncertain, and by waiting we restrict our options.
- Even if important types of uncertainty will be resolved, this should influence the types of measures we adopt now rather than our decision to act.

But...

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- We can't be changing policy continually whenever information changes.
- Yes, but then when we do act we should act more forcefully.
- We can also put in place some automatic responses if we can be fairly confident about what those responses should be as events unfold.

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- With greater uncertainty, projections are more susceptible to political influence.
- This may well be true.
- But it provides an argument for institutional protections and transparency; ignoring information is a bad second choice.

Summary

- Uncertainty means our policy choices will always turn out to be “wrong.”
- But ignoring uncertainty doesn't make it go away; a more active response can lessen its negative consequences.