



Statement before the Senate Budget Committee  
*Fixing Broken Budget Process and Restoring Stability to Government Operations*

Kevin A. Hassett

Director of Economic Policy Studies and State Farm James Q. Wilson Chair

American Enterprise Institute

April 20, 2016

*The views expressed in this testimony are those of the author alone and do not necessarily represent those of the American Enterprise Institute.*

Chairman Enzi, and Members of the Committee, I thank you for inviting me to talk about the negative effects of uncertainty and dysfunction in the budget process. In my testimony, I will discuss the latest economic research investigating the impact of uncertainty on the overall economy, and relate uncertainty about the budget to this literature.

Few topics in Washington engender consensus among economists from both sides of the political spectrum. The existence of negative effects of budget uncertainty and dysfunction, however, seems likely to be one of them.

Uncertainty is, of course, with us every day. We don't know if it will rain tomorrow, or if a drought might begin that would cause severe harm to crops. A car manufacturer might wake up one day and find that Tesla has invented something new that fundamentally affects the demand for internal combustion engines. When uncertainty is higher, then economic agents become more cautious. If, for example, a manufacturer in a rapidly evolving industry came to you for a loan, you might be wary of making it, and charge a higher interest rate if you do.

There are many types of uncertainty that we cannot have much of an impact on, but there are some that are under the control of policymakers. If our citizens believe that tax and spending policies are unpredictable, then they will act as if the world is more uncertain, and be wary of making purchases and investments that they might otherwise make.

As we think about policy, there are two ways we should think about uncertainty increasing. First, suppose that we have a two party system, and the two parties have different views about the best level for the corporate tax rate. If one party is sure to have power, then there is not much uncertainty. Its desired rate will likely prevail. But if the odds of either party controlling the government move towards a true 50-50, then we can say that uncertainty has increased relative to a world the odds were, say, 70-30. Second, if the beliefs of the two parties concerning the best tax rate grow farther apart, with one party favoring much lower rates, while another favors much higher rates, then the widening of the spread between things that might happen is another form of increased uncertainty.

If we have become more evenly divided politically, and at the same time, the policy views of the parties have grown farther apart, then we can say with a great deal of confidence that the political situation has evolved in a way that could increase the harmful effects of economic uncertainty.

This is not just an abstract theoretical observation. As I will discuss in my testimony below, there has been an explosion of research that has suggested that the negative effects of policy uncertainty may be quite large indeed. In what follows, I will divide my testimony into an analysis of two types of uncertainty that policymakers should consider when designing optimal policies. Short-term uncertainty in a budgetary context concerns uncertainty likely to arise from events that happen at predictably shorter time horizons, like spending authorizations or the "fiscal cliff" of 2011, or even elections. Long-term uncertainty, by contrast, concerns the trajectory of events that occur over lengthier horizons. An example of such long-term uncertainty would be uncertainty about the fiscal trajectory of the United States more broadly, or, to take a concrete example, the solvency of the Social Security program.

Both of these types of uncertainty, distinct in theory, but interrelated in practice, are germane to the United States. On the long-run front, the CBO's March 2016 baseline project projections forecast that the deficit as a share of GDP will have increased by more than 60% over its 2015 level by 2026, and in the years that follow, deficits will remain on a trajectory that quite quickly could make the United States see a fiscal situation as bad as that of Greece today. When a path is unsustainable, policies must change. Uncertainty about how they might change is a major factor for decision makers. And on the short-run front, Congressional bottlenecks like the 2011 fiscal cliff seem almost as much a part of Washington as the cherry blossoms. As importantly, the wide disagreements between the parties about policy, and the potential for wild swings in key fundamentals around elections have clearly had a big impact on markets.

### **Short-term uncertainty and its negative effects**

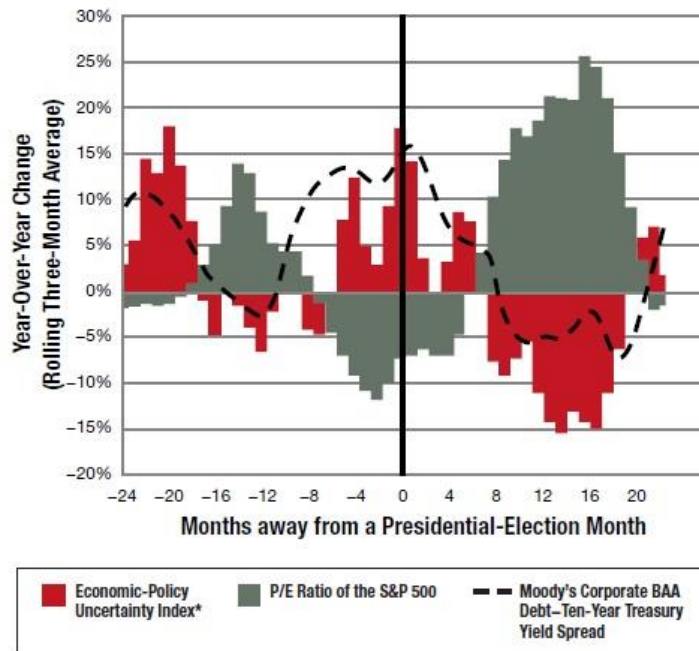
There now exists a large and still growing academic literature on the effects of uncertainty. Economists disagree about how to quantify uncertainty, how to best identify its effects, and on their magnitude. But they have developed a number of innovative measures, and found that uncertainty has a major impact on the economy.

Perhaps the best-known recent work on uncertainty has been performed by two economists at Stanford along with their colleague at the University of Chicago.<sup>1</sup> Baker, Bloom and Davis (2016) construct a measure of the uncertainty about policy by scraping through web sites and news stories to track the frequency with which observers mention the possibility of policy changes. They employ sophisticated econometric techniques to identify the link between uncertainty and economic activity, finding that the link is a powerful one. For example, they find that policy uncertainty around the Great Recession likely accounted for about an extra 1 percent drop in production. The harmful impact of policy uncertainty can be seen even without the sophisticated econometrics. The chart below, which draws from a paper my coauthor and AEI colleague Joseph Sullivan and I presented at a conference last year, plots both an index of economic policy uncertainty developed by Baker, Bloom and Davis, along with a measure of credit spreads and a measure of equity valuations throughout the four-year presidential election cycle. To make the data easy to interpret we changed the time scale over this sample period to "election time." Time zero is the November of a presidential election year, Time -1 is the October before said election, and time -24 is the midterm election.

---

<sup>1</sup> This work is summarized and updated at: <http://www.policyuncertainty.com/>, a website that hosts the index created by Scott Baker of Northwestern University's Kellogg School of Business (and who was a graduate student at Stanford when the index was first created), Nicholas Bloom of Stanford, and Steve Davis of the University of Chicago Booth School of Business, and links to a number of academic works that explore the impact of uncertainty on the overall economy.

## Policy Uncertainty and Asset Pricing Through the Election Cycle: January 1985–March 2015



The equity valuation metric, the price-to-earnings ratio of the S&P 500, measures the price a firm can charge an investor in exchange for the claim on the firm's earnings that a share of its stock represents. A relatively high P/E ratio serves as an indication that the firm can raise capital at a relatively low cost: When the P/E is higher, it means the market perceives the equity to be less risky. The spread between the yield on Moody's BAA-rated debt and the ten-year Treasury yield is an alternative measure of the risk premium. It indicates how much market participants demand in exchange for holding bonds that, according to Moody's, come with "moderate credit risk" and have "certain speculative characteristics." A larger spread indicates that market participants are charging businesses more for buying their bonds instead of the "risk-free" bonds of the U.S. government.

As the chart shows, stock valuations and debt spreads both respond adversely to the increases in uncertainty that seem to come with the election cycle. The effects are large. So the fact that the parties have grown so far apart, adds significantly to uncertainty, raising the cost of funds for

investors and consumers. This higher cost of funds reduces economic activity, which may explain some of the large impact on jobs and growth found in the literature.<sup>2</sup>

The broader literature has documented similar effects in many different corners of financial markets. For example, public security markets exhibit higher volatility in close proximity to U.S. elections. Li and Born (2006) find that U.S. equity markets become more volatile as presidential elections approach.<sup>3</sup> In a pivot to the state level, Gao and Qi (2012) find that municipal bonds floated by state governments immediately before an election pay a premium of six to eight basis points due to this electoral proximity.<sup>4</sup> Jens (2013) estimates that gubernatorial elections reduce state-level investment by between 5% and 15%.<sup>5</sup> Finally, Julio and Yook (2013) find that flows of cross-border foreign direct investment but not portfolio flows are sensitive to proximity to the timing of foreign elections.<sup>6</sup>

Think about it this way. Suppose you were running a firm, and you were contemplating making a billion dollar investment in a new factory. As we look ahead toward this November, there is no question that there is a great deal of uncertainty concerning who might win, and what policy might look like depending on the victor. Given the wild swings in policy that are conceivable, one could easily imagine that you might decide to postpone making that investment until after you see the election results. The data suggest that these effects are very important for understanding the evolution of the economy, and in all likelihood, the weakness of the economy today.

It would not, of course, be advisable to seek to reduce uncertainty by eliminating elections. But if the Senate, in particular, could move more toward a policy consensus based on science and evidence, then markets would worry less that policy would change course on a dime at each presidential election. The reduction in uncertainty would likely, given the literature, have significant positive economic benefits.

The same authors have recently created indices that focus specifically on the prospects of a government shutdown or a failure to raise the debt ceiling. As with the broader uncertainty index, the chart measures uncertainty about the debt ceiling or a government shutdown by counting the fraction of articles in major newspapers that have language on the subject. The chart below plots how these metrics have changed through time. The events that one would expect to

---

<sup>2</sup> See <https://bfi.uchicago.edu/sites/default/files/research/hassett-sullivan.pdf> for more on the literature and this chart.

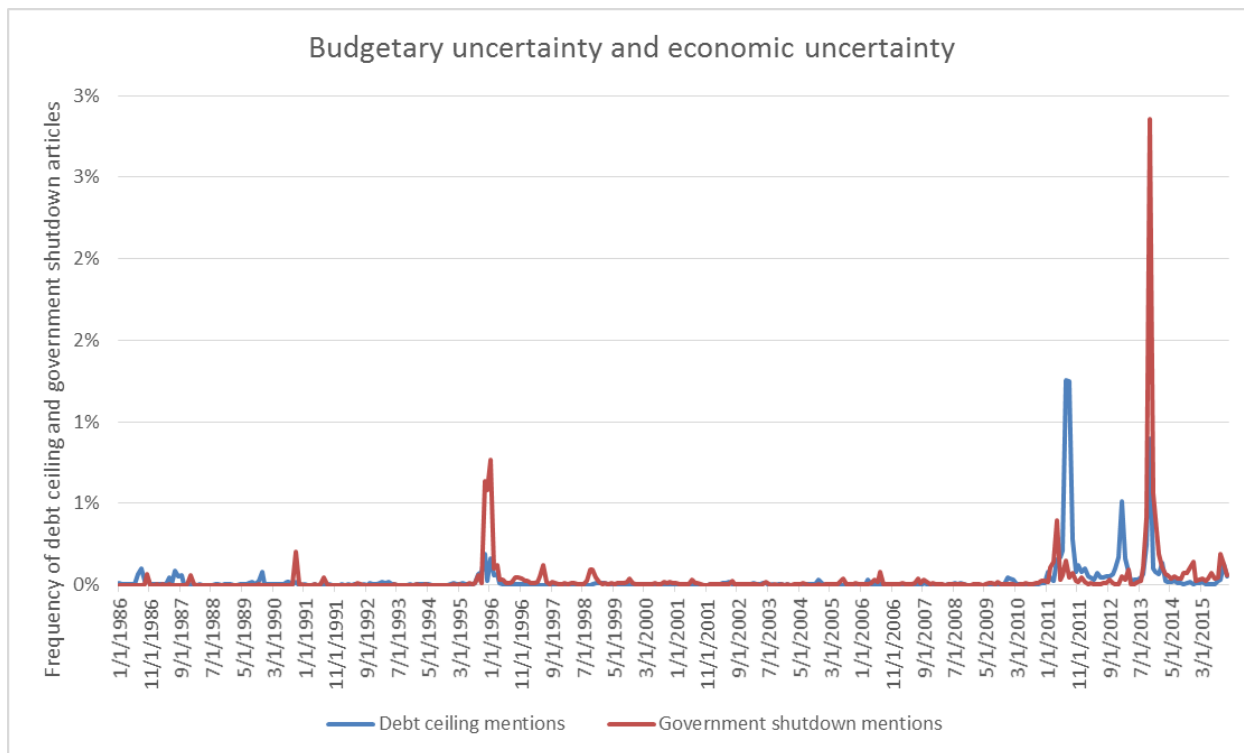
<sup>3</sup> Li, Jinliang, and Jeffery A. Born. 2006. "Presidential election uncertainty and common stock returns in the United States." *Journal of Financial Research* 29 (4): 609-622.

<sup>4</sup> Gao, Pengjie, and Yaxuan Qi. 2012. "Political uncertainty and public financing costs: Evidence from US municipal bond markets." [http://extranet.isnie.org/uploads/isnie2012/qi\\_gao.pdf](http://extranet.isnie.org/uploads/isnie2012/qi_gao.pdf)

<sup>5</sup> Jens, Candace. 2013. "Political uncertainty and investment: Causal evidence from US gubernatorial elections." [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2176855](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2176855)

<sup>6</sup> Julio, Brandon, and Youngsuk Yook. 2013. "Policy Uncertainty, Irreversibility, and Cross-Border Flows of Capital." [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2024612](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2024612)

observe—the 1995 government shutdown, the 2011 flirtation with the debt ceiling, and the 2013 fiscal cliff—are all visible on the chart.



Interestingly, my own analysis performed while preparing this testimony finds that these spikes in uncertainty have negative effects that are quite similar in magnitude to those already linked to policy uncertainty more generally. To link this to presidential uncertainty, we estimated the average values of our measure of credit spreads and our measure of equity valuations when either the debt ceiling or government shutdown series were more than two standard deviations above their average values. When debt ceiling uncertainty rose two-standard deviations or more above its average, the S&P 500 P/E ratios were 28.9% lower than in normal periods and credit spreads were 8.75% higher.<sup>7</sup>

### Longer Term Uncertainty and Fiscal Consolidation

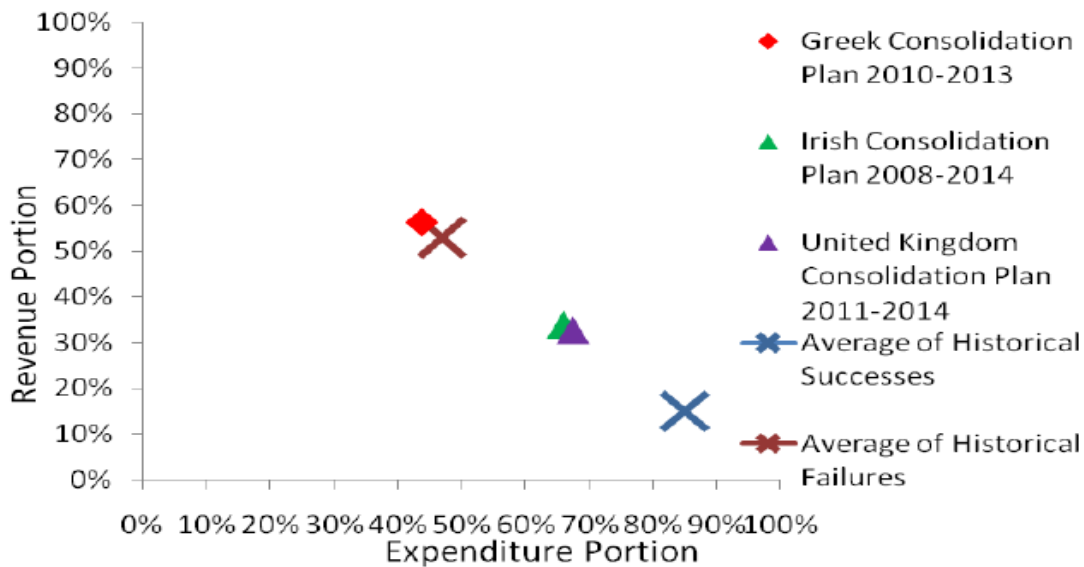
Uncertainty surrounding the budget stems, at least in part, from the unsustainable deficits that the government seems to run year-after-year. If the U.S. exhibited at least some capacity to make the combination of spending and tax adjustments necessary to eliminate or even reduce its deficit, uncertainty about the long-term fiscal trajectory of the United States would be diminished. In such a world, after all, budget fights would be less complex and consequential: if tax revenue funded government spending, merely keeping existing policy in place would suffice. The

<sup>7</sup> The sample for this estimate runs from January 1986 to November 2015.

interconnected web of spending authorizations and expiring tax cuts that beguiled legislative attempts at resolving the fiscal cliff would no longer make their regular appearance.

Other countries have undergone fiscal consolidation in the past, providing us examples of policies that are successful and as well as examples of those that have failed. Along with two colleagues, I have written an analysis<sup>8</sup> exploring policy mixes in successful and failed fiscal consolidations in 21 OECD countries, with the measure of success simply being that the consolidation accomplishes the objective of stabilizing the debt. We found that fiscal consolidations based more heavily on expenditure cuts than revenue increases are more likely to be successful at producing lasting reductions in debt.

Using a range of different methodologies, we find that the average unsuccessful fiscal consolidation relied upon 53 percent tax increases and 47 percent spending cuts, while a typical successful consolidation consisted of 85 percent expenditure cuts. We also found that cuts to social transfers were more likely to reduce deficits than other expenditure cuts. The chart below shows the composition of average successful and unsuccessful consolidation plans, along with a few measures taken recently by other countries.



Other research has reported similar findings, most notably an earlier paper by Alesina and Perotti<sup>9</sup>, which found that consolidations successful in reducing debt consisted of 64 percent spending cuts and 36 percent tax increases. Similarly, McDermott and Wescott found in a survey

<sup>8</sup> Andrew G. Biggs, Kevin A. Hassett, and Matthew Jensen, “A Guide for Deficit Reduction in the United States Based on Historical Consolidations That Worked,” AEI Economic Policy Working Paper 2010-04 (2010) <http://www.aei.org/paper/100179>.

<sup>9</sup> Alberto Alesina and Roberto Perotti, “Fiscal Adjustments in OECD Countries: Composition and Macroeconomic Effects,” *NBER Working Paper 5730* (1996)

of fiscal consolidations that expenditure-based consolidations had a 41 percent chance of success, while revenue-based consolidations have only a 16 percent success rate.<sup>10</sup>

Normally, tax increases and spending cuts might be expected to have near-term negative effects on the overall economy. The tendency of successful fiscal consolidation to at times even have positive short term growth effects likely reflects the positive effects on sentiment, consumer spending and investment that accompany reduced uncertainty. Such positive effects are quite intuitive. For example, one might not have a great deal of confidence in an investment in Greece precisely now. Your successful factory might well be served by a rotting infrastructure poorly supported by a bankrupt government, and still be taxed with abandon in the future. But if Greece could restore fiscal sanity, an investment might be a good deal more attractive. That's why consolidations can lead to positive economic developments.

### **Looking ahead: entitlement reform**

The data suggest that the U.S. is overdue for a fiscal consolidation.

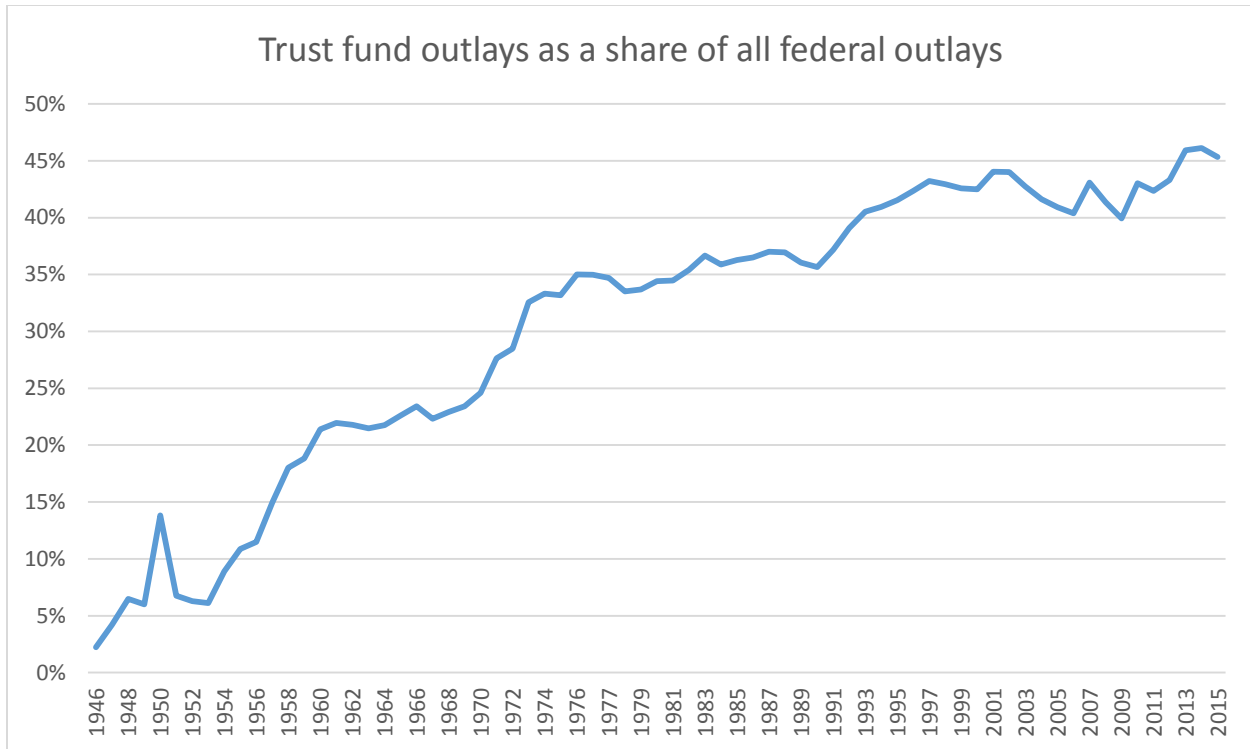
The “trust fund” share of federal outlays—the share attributable to Social Security or Medicaid funds—has steadily risen since World War II. In 1946, these were only 2.2% of federal outlays. By 2015, however, they have become no less than 45.3% of federal outlays, according to data from the Office of Management and Budget.<sup>11</sup>

---

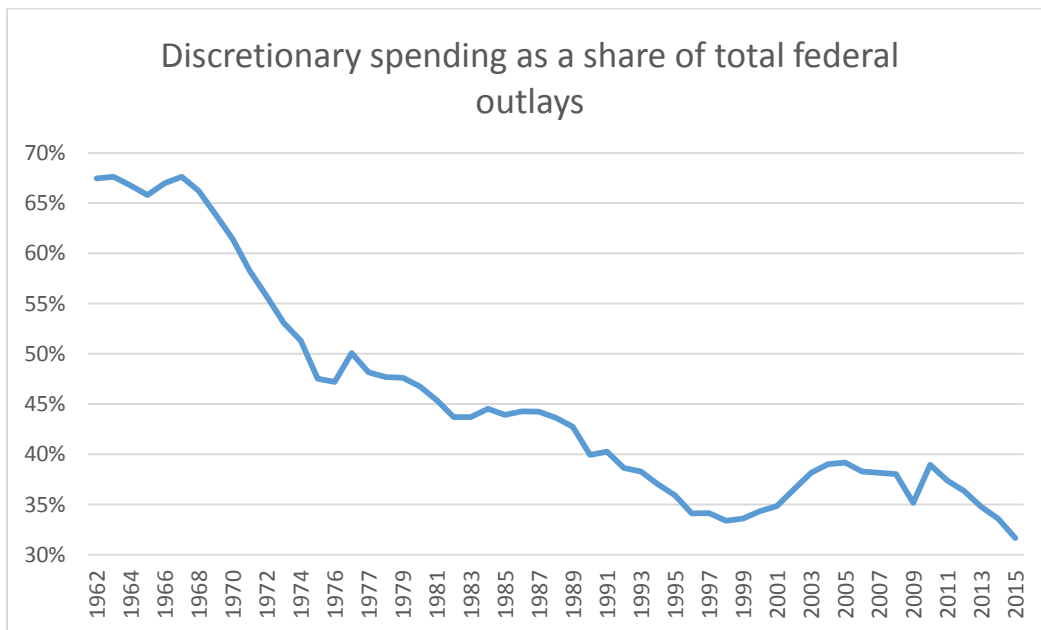
<sup>10</sup> McDermott, C. John and Wescott, Robert, An Empirical Analysis of Fiscal Adjustments (June 1996). IMF Working Paper, Vol. pp. 1-26, 1996. Available at SSRN: <http://ssrn.com/abstract=882959>

<sup>11</sup> The data come from Table 1.4: Receipts, Outlays, and Surpluses or Deficits (-) by Fund Group: 1934-2021, available at: <https://www.whitehouse.gov/omb/budget/Historicals>.





Perhaps as a consequence, then, the share of federal outlays attributable to discretionary spending has also fallen considerably. Though discretionary spending constituted 67.4% of outlays in 1962, today that number has fallen to 31.6%, according to the Office of Management and Budget.<sup>12</sup>



<sup>12</sup> The data come from Table 8.7: Outlays for Discretionary Programs: 1962-2021, available at: <https://www.whitehouse.gov/omb/budget/Historicals>

Neither of these trends seem sustainable: just as it is difficult to imagine trust fund spending as a share of the federal budget continuing to increase in the 21<sup>st</sup> century in the same way that it increased during the second half of the 20<sup>th</sup> century, it is difficult to imagine discretionary spending continuing to shrink as a share of the federal budget at the same rate as it has over the last half of the 20<sup>th</sup> century during the 21<sup>st</sup> century.

It is clear, then, that the situation of America's entitlement programs generates substantial long-run uncertainty. Either we will face solvency issues or policymakers will need to undertake bold and politically difficult entitlement reform.

Clearly, Ben Franklin's famous saying should be modified. Today, nothing can be said to be certain except death, taxes, and uncertainty. The latest economic literature suggests that this uncertainty is harmful in both the long and short runs, and that the benefits of policies to address it could be significant.