

Fiscal Policy Under Uncertainty

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Donald B. Marron

Institute Fellow, Urban Institute & Urban-Brookings Tax Policy Center



TAX POLICY CENTER
URBAN INSTITUTE & BROOKINGS INSTITUTION

Prediction is difficult. Especially about the future.

(Attributed to Niels Bohr, Yogi Berra, and others)

Fiscal policy involves myriad uncertainties



- Economic activity
- Interest rates
- Income distribution
- Demographics
- Program enrollment & costs
- Disasters, wars, epidemics



**All models are wrong.
But some are useful.**

(Attributed to George Box)

Strategies for analyzing fiscal uncertainties

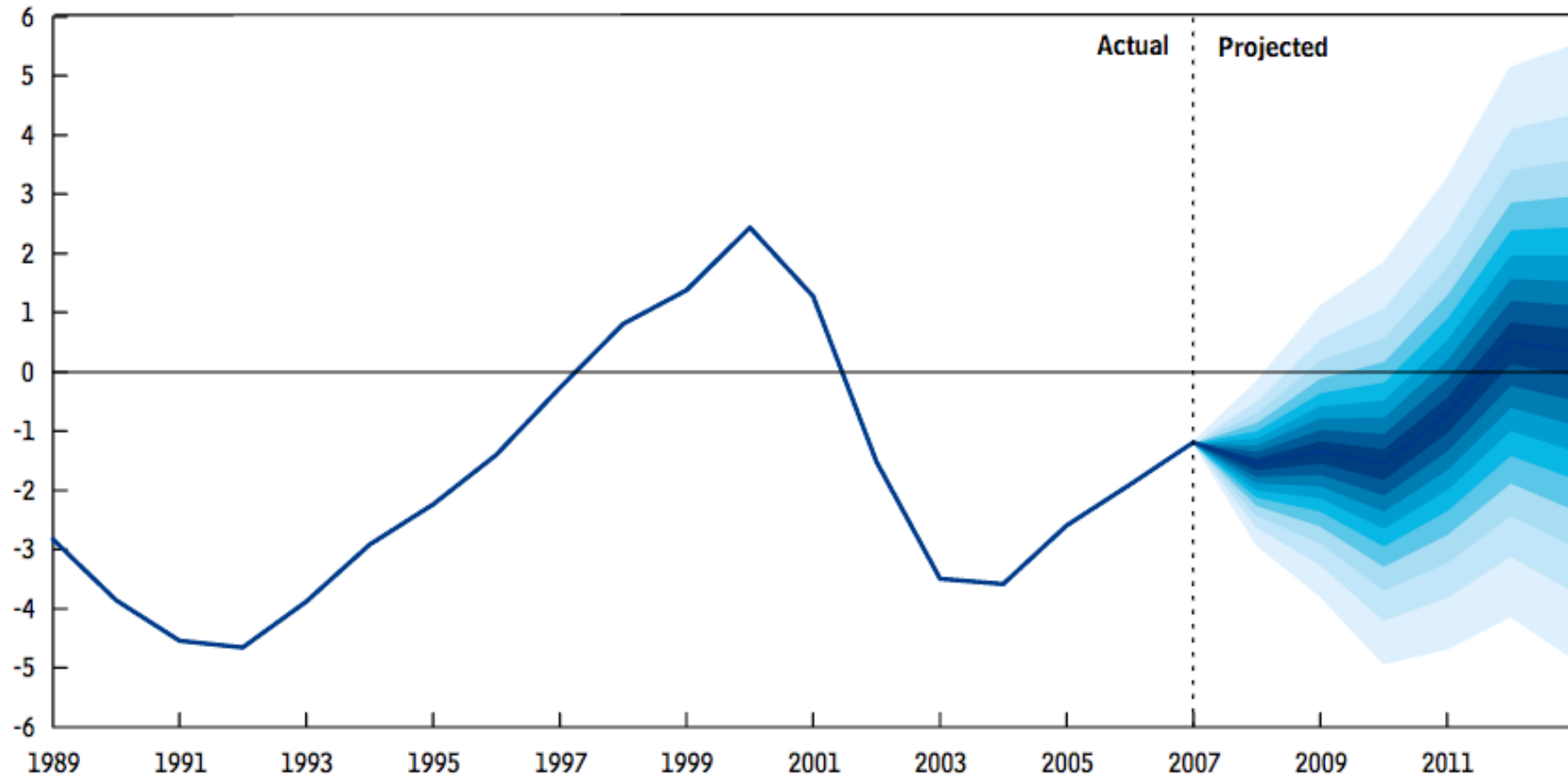


- Sensitivity to economic conditions
- Sensitivity to program costs and participation
- Scenario analysis of plausible legislation
- Probabilistic analysis with historical experience

CBO "fan chart" for the deficit, January 2008



(Percent)



Source: Congressional Budget Office.

Strategies for managing fiscal uncertainties



- Nimble, responsive governance
- Counter-cyclical policies
- Program-specific triggers

Challenges in addressing fiscal uncertainties



- Limited base of evidence
- Political demands for “the” number
- Communications difficulties
- Radical uncertainty

Radical uncertainty goes by many names



Model uncertainty

Unknown probabilities (Knight)

Black swans (Taleb)

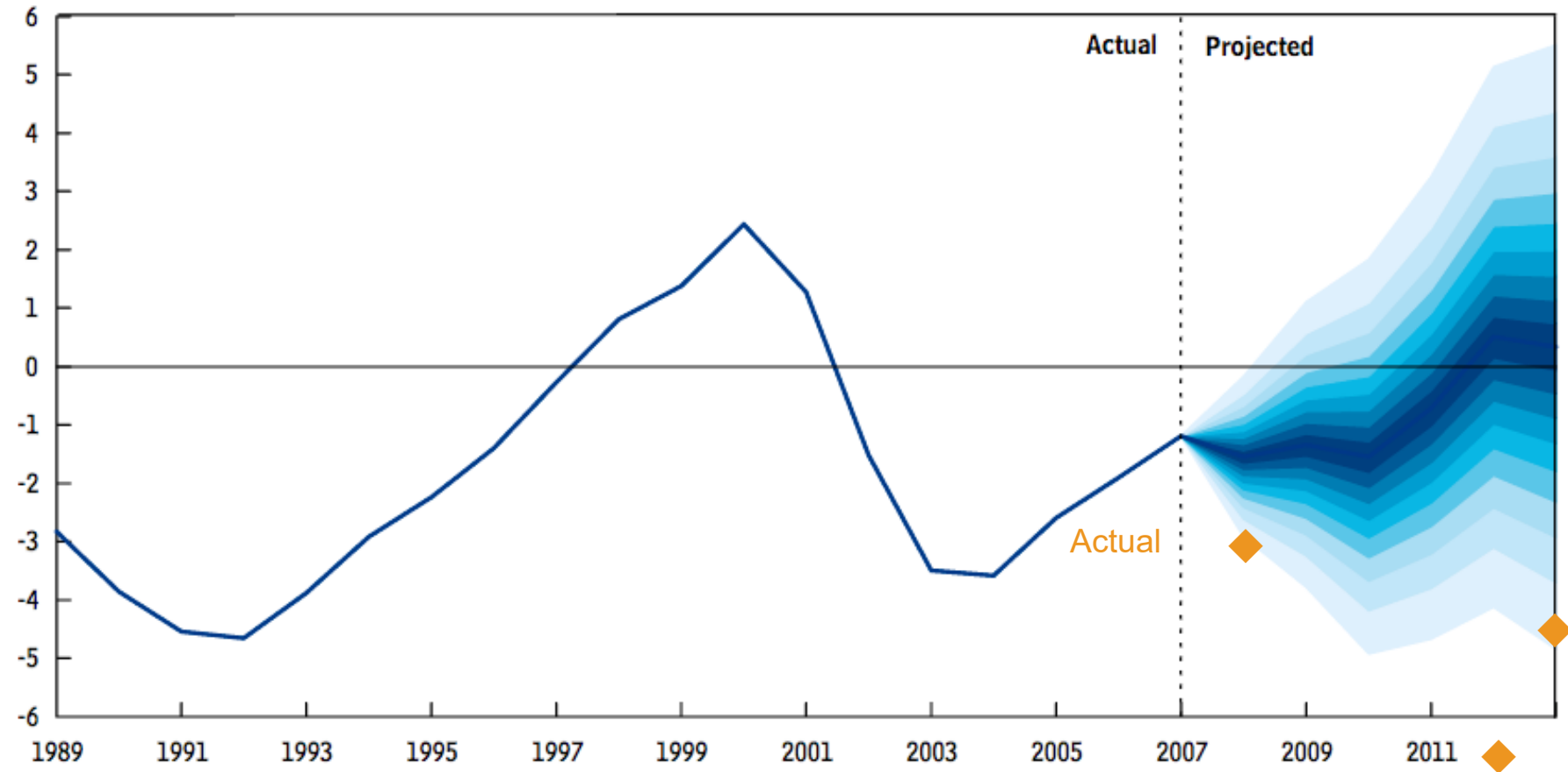
Unknown unknowns (Rumsfeld)

Utter cluelessness (Roy and Romeijn)

Radical uncertainty can savage your forecasts



(Percent)



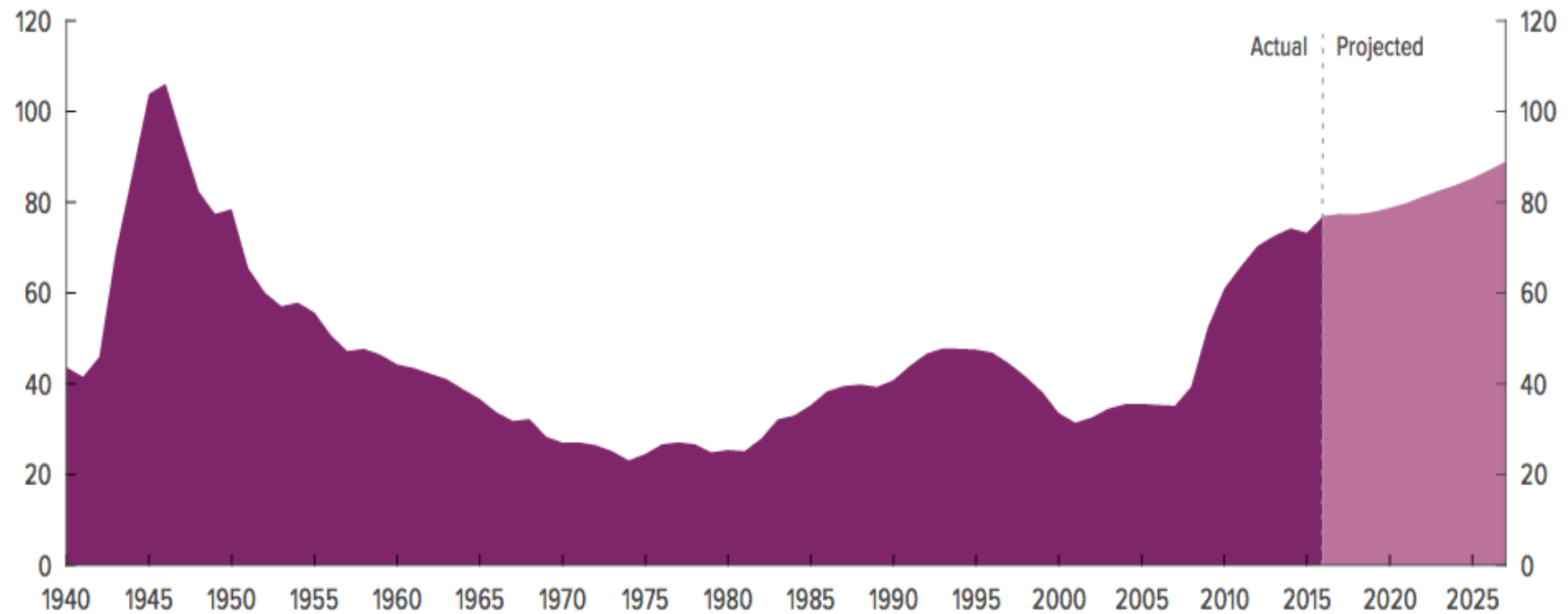
Source: Congressional Budget Office.

Public debt doubled relative to GDP



Federal Debt Held by the Public

Percentage of Gross Domestic Product



Source: Congressional Budget Office.

**Radical uncertainty implies
precaution, not inaction.**

- Focus on downside risks (upside risks take care of themselves)
- Consider dire scenarios (stress testing)
- Limit irreversible commitments
- Emphasize resilience

Four pillars of fiscal resilience & precaution



Operating Capacity

Economic growth
Fiscal space
Monetary space

Assets

Prefunding
Sovereign wealth

Borrowing Capacity

Welcoming debt markets
International institutions

Insurance

Fiscal union
International institutions

- Macroeconomic volatility often reduces long-run growth
 - Automatic stabilizers promote inclusive growth
- Individual volatility especially hard for the poor
 - Social insurance promotes inclusive growth

THANK YOU

For more information please contact:

Donald B. Marron
dmarron@urban.org

For more information about US fiscal policy, please visit
www.taxpolicycenter.org

