TD Bank Financial Group

Special Report

December 2, 2010

TD Economics
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HIGHLIGHTS

- **The U.S. has a fiscal problem. In part due to the Great Recession, U.S. debt levels have risen 20 percentage points above historic norms.**
- **The U.S. is not yet in a crisis situation. Its position as the global reserve currency affords it time to deal with its fiscal situation.**
- **A weak economic recovery is likely to prevent significant fiscal tightening over the next two years, but by 2013 a plan for consolidation should be in place.**
- **Traditionally, the U.S. has depended on spending cuts to lower deficits. But, given the aging population and government commitments to entitlement programs, spending cuts alone will not be sufficient.**
- **Fortunately, among OECD countries the U.S. has relatively low tax rates, affording scope to raise taxes. By eliminating tax exemptions, the federal government could both raise revenues and increase efficiency.**
- **All told, as the impact of the U.S. recession wanes, fiscal austerity will likely slow the pace of real GDP growth. This is likely to be offset, in part, by continued accommodative monetary policy and lower long-term interest rates.**

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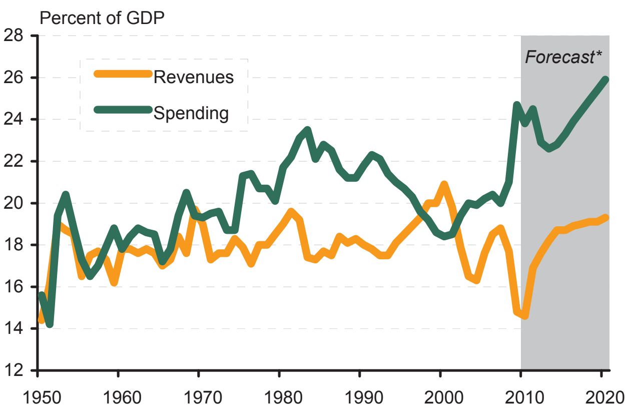
PUTTING THE U.S. FISCAL HOUSE IN ORDER

Fiscal austerity has been on many countries' agenda across the world as they attempt to dig out themselves from the massive deficits accumulated over the course of the Great Recession. As the bailout of Greece and now Ireland have shown, countries that have allowed their deficit and debt burden to run-up unchecked, put themselves at risk of punitive borrowing costs, or from being cut off altogether from the markets. Regaining market confidence then requires deep and painful cuts to government spending and often dramatically higher taxes.

In spite of escalating debt in the U.S., its position as the global reserve currency and safe-haven asset of last resort have prevented U.S. Treasurys from seeing the same kind of upward pressure faced by their European counterparts. However, in many ways, the situation in the United States is no less severe. Large deficits run up over the last several years have pushed the public debt-to-GDP ratio up over twenty percentage points from its historic norm of 40% to 62% in 2010. Moreover, according to the Congressional Budget Office (CBO), if current policies remain in place, the debt could rise to 185% of GDP by 2035.

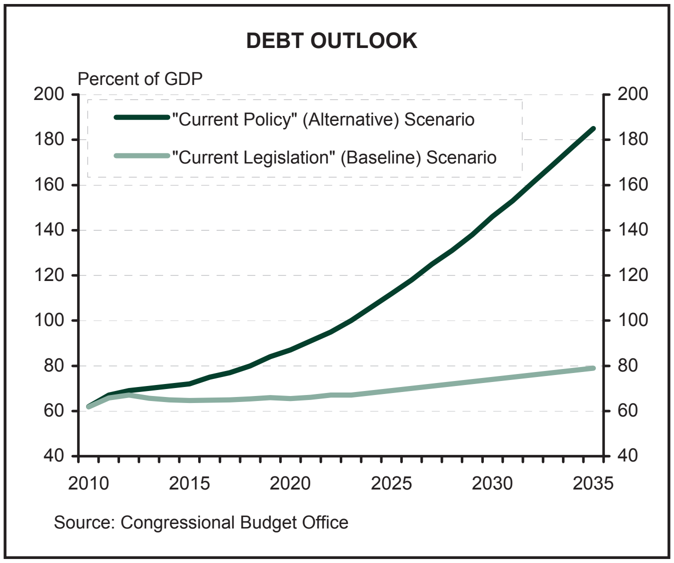
U.S. FEDERAL GOVERNMENT SPENDING & REVENUES



*CBO's alternative forecast.
Source: Congressional Budget Office

So, fiscal austerity is coming to America, but when will it take place? With such a tentative economic recovery in place it would be foolhardy to begin deep cuts too soon. In all likelihood, financial markets will expect significant restraint to begin after the next presidential election, which means 2013. By then the economy should be operating close to potential and the Federal Reserve will have raised rates off their current zero percent floor.

The first item on the fiscal austerity agenda must be to trim spending. Under the CBO's "policy as usual" forecast, total spending including net-interest costs rises to 35% of GDP by 2035. Holding this down will require significant cuts to both discretionary and mandatory spending. Nonetheless, over the next two decades, it is the government's three main entitlement programs – Social Security, Medicare, and Medicaid – that will eat up the largest share of the budget. With an aging population and rapid cost growth in health care, getting entitlement spending under control will not be easy. In the end, spending cuts can likely only get the government so far. While economic growth will provide a boost to revenues over the next several years, it will be inadequate to provide sufficient tax revenues to



resolve the fiscal issues. This leaves only tax hikes or tax efficiencies to fill the fiscal gap.

Fortunately, from a competitive point of view, taxes in the U.S. are relatively low – the fourth lowest, in fact, of all OECD countries. What is more, the United States has an incredibly complex tax system, chalk full of exemptions. Eliminating a significant portion of these would close a significant amount of the budget deficit; and, as has been suggested by the President's fiscal commission, may even allow broader income tax rates to be lowered. Another option available is a nominal Value Added Tax (VAT), similar to those in place in a majority of OECD countries. We estimate that a 5% VAT would raise revenues equal to 2% of GDP on an annual basis, which could at least balance the primary budget (revenues minus non-interest spending) by 2015.

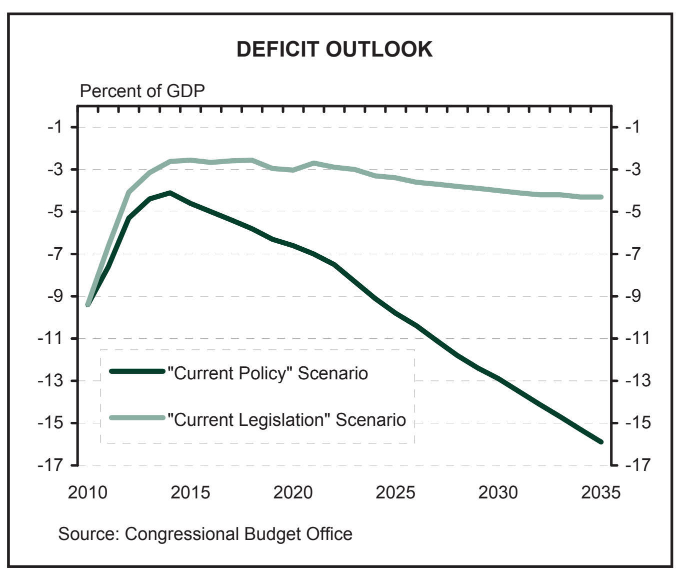
So, with some hard work on spending restraint, tax reform and tax hikes, the U.S. can close its structural deficit. For financial markets the implications are twofold. One, as the impact of the U.S. recession wanes, fiscal austerity will likely constrain the pace of real GDP growth. Two, the headwind on economic growth is likely to be offset in part by continued accommodative monetary policy and correspondingly lower than otherwise long-term interest rates.

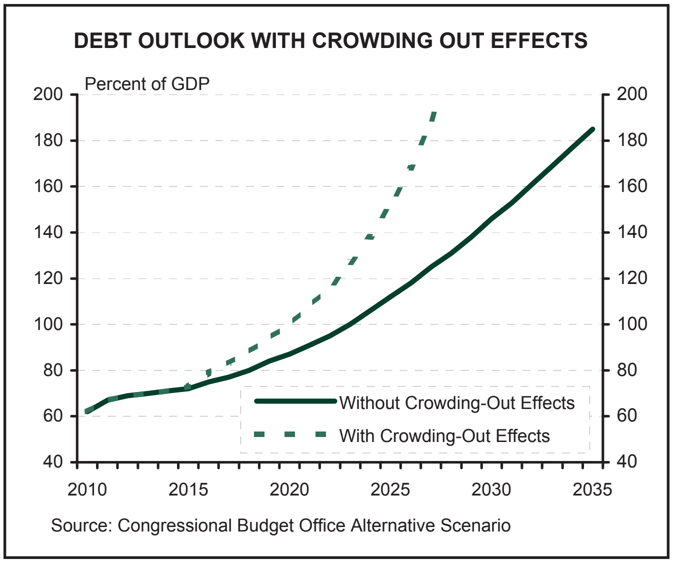
What keeps economists up at night – America's *future* fiscal problems

In June of this year, the CBO made two long-term projections for the path of the U.S. deficit. In their baseline projection, spending and expenditures evolve according to currently enacted laws, which implies most importantly that the Bush tax-cuts expire at the end of 2010. Given the likelihood that Congress will act in the consistent way it has in the past to extend expiring provisions, including these tax cuts, the CBO considers an alternative scenario. This alternative scenario follows more closely the most likely course of near-term policy and is the more relevant guideline to the federal government's future fiscal challenges.[1]

In the CBO's alternative projection, the federal deficit is cut in half over the next few years as economic growth rebounds, but then worsens significantly as entitlement spending and interest on debt pick up. By 2035, the deficit would reach an unprecedented level of 15.9% of GDP. Debt-to-GDP would climb to 90% by 2020 and then skyrocket to 185% by 2035. The massive debt load would also cause interest payments on outstanding debt to accelerate unrestrained, nearly tripling from 1.4% in 2010 to 3.8% of GDP within the first decade, and then spiraling upwards to 8.7% by 2035. With debt at such high levels, interest payments would account for half of total annual deficits. Under this scenario, there are no signs of the debt-to-GDP ratio ever stabilizing.

As unsettling as these figures are, the CBO actually underestimates the size the debt-to-GDP ratio if current policies remain in place. As the CBO points out, the estimates do not incorporate the negative feedback loop that rising debt loads have on economic growth, interest rates and debt itself. As the economy attempts to return to a normal pace of growth, rising government debt will crowd out private investment, leaving less capital available for more productive investment in other areas of the economy. Moreover, as government bond yields represent the floor or baseline for all other interest rates in the economy, increased government borrowing will drive up the cost of capital throughout the economy and reduce potential economic growth. If these consequences were incorporated, the debt-to-GDP ratio would be much higher (see chart next page).





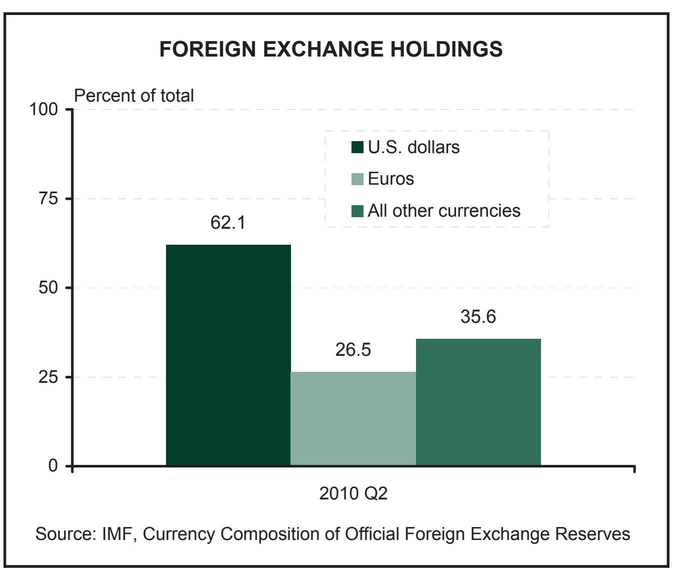
Does America face an imminent fiscal crisis?

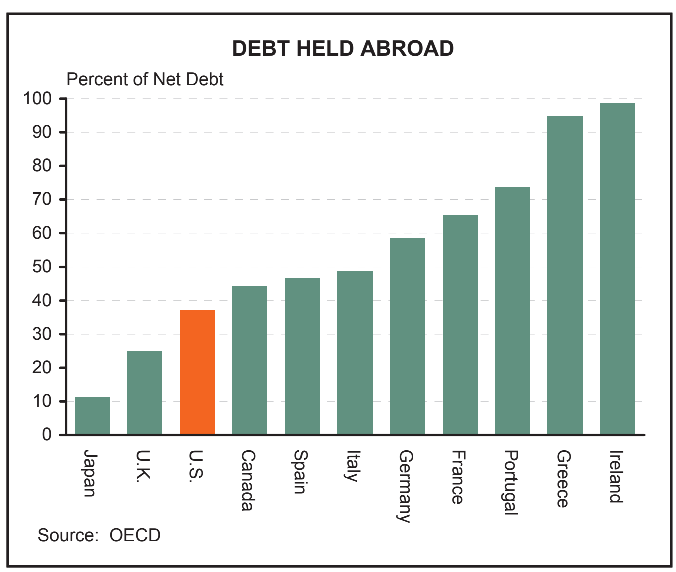
As the economist, Herbert Stein said, "If something cannot go on forever, it will stop." The CBO's projections show that under current policies, the current gap between government revenues and expenditures will not close with a pick-up in economic growth and will, therefore, require changes to government policy to put it on a sustainable path.

So, if ongoing U.S. deficits are known to be unsustainable, why hasn't the U.S. been pushed into the same kind of fiscal crisis that we have seen in other countries? The short answer is that the U.S. has both the time and the ability to turn its fiscal boat around. There are several reasons for this: Investors are likely to have a myopic view over the next two years, in which they will be focused on the stability of the global economic recovery rather than the risk that the U.S. government may eventually not be able to make good on its debt obligations in 10 to 20 years. In addition, any discussion of the U.S. fiscal picture must recognize the unique role that the U.S. plays in the global economy. The U.S. dollar is the world's reserve currency: 62% of the world's currency reserves are in U.S. dollars. The second single most held currency – Euros – makes up just 26%. What is more, there are currently no suitable candidates for replacing the U.S. dollar. Europe itself faces significant, more imminent fiscal problems and intrinsic pressures on the European Monetary Union make the euro arguably even more risky than the U.S. dollar. At the same time, developing economies' financial systems do not have the liquidity, or – specifically in the case of China – are not open enough to present a viable alternative to the current international monetary system.

Going back to the gold standard is not a serious option. Investors have increased holdings of gold as a hedge against depreciation of the U.S. dollar, pushing the value of gold up from less than $300 per troy ounce in 2000 to over $1,420 currently. But, a global money supply held fixed by the supply of gold would leave the economy vulnerable to demand shocks that could quickly spiral into deflation. Moreover, the run up in gold prices since 2000 – an asset in which over the long run yields little return – makes it a risky asset in its own right.

While the relative growth of global economies will likely lead to gradual movement away from the U.S. dollar, this is not a change that is likely to occur rapidly. The fact that U.S. government bonds have not built in a higher risk premium, despite rising deficits, illustrates the faith that investors have in the U.S. government to manage its fiscal store. Unlike some countries, like Greece and Ireland, that rely mainly on foreign investors to fund their borrowing, over 60% of





Deficit Reduction Proposals from Washington

Solving the U.S. fiscal deficit will not be easy, but this does not mean that we are at want for ideas on how to do it. Over the past several weeks, there have been two major bipartisan plans fielded on how to put the U.S. deficit on a sustainable path. On November 17th, the Bipartisan Policy Center released their plan for fiscal consolidation, and On December 1st, the President's National Commission on Fiscal Responsibility and Reform released their report (the highlights of which were included in a report by the co-chairs of the commission a few weeks earlier).

The two plans are quite similar and show the considerable amount of consensus among policy makers on what needs to be done. Both plans feature both spending cuts and revenue increases, and, similar to history, favor cuts to spending over higher revenues. In terms of timing, both plans call for their program to begin implantation in 2012.

Nonetheless, as we discuss in our report, the main source of future government spending growth is healthcare costs. In the end, both plans rely on an assumption that growth rate for healthcare spending is held to GDP growth plus 1 percent. Should this prove unattainable, the amount of revenue increases or cuts to other portions of the budget will have to be much greater than either plan assumes.

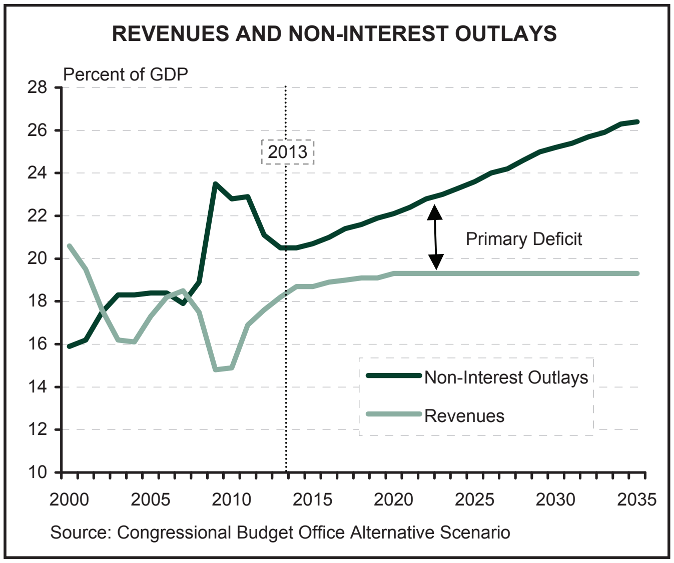
The main parameters of the two plans are as follows:

The President's Fiscal Commission:

- Reduce the deficit to 2.3% by 2015; reduce debt to 60% of GDP by 2023, and further to 40% by 2035.
- Cap total outlays and revenues at 21% of GDP by 2035. Plan entails roughly 70% of deficit reduction through spending cuts, and 30% through revenue increases.
- Freeze discretionary spending at 2011 levels in 2012, and reduce it to the 2008 real levels in 2013. Allow spending to grow at half the projected inflation rate thereafter. Cuts come from both defense and non-defense discretionary spending.
- Shore up the finances of the Social Security program by: increasing the percentage of wages subject to payroll taxes to 90% of total wages by 2050 (from its current 86%); reducing benefits for the top 50% of earners; using a more accurate measure of inflation than CPI to calculate Cost of Living Adjustments (COLAs); and, indexing retirement age to longevity, which is expected to lift the retirement age to 68 by 2050 and 69 by 2075.
- Trim healthcare costs by: reducing and potentially eliminating the tax exclusion of employer-provided insurance benefits; cutting physicians payments by 1% in 2014 and reforming the payment formula thereafter; reforming long-term care insurance; reforming the medical malpractice system; and, limiting growth in healthcare spending to "GDP growth plus 1 percent" starting in 2020.
- On the revenue side: the plan calls for broadening the tax base and eliminating exemptions. It lays out a number of options for doing so: One option eliminates all tax expenditure (i.e. exemptions, tax credits, deductions), consolidates the current six personal tax rates (which range from 10% to 35%) into three lower rates: 8%, 14% and 23%, and consolidates the corporate tax rate to a single rate of 26% (from a current range of 15% to 35%). Another option, preserves some of the tax expenditures, and only reduces the income tax rates to 12%, 22% and 28%, while cutting the corporate tax rate to 28%.

Bipartisan Policy Center:

- Payroll tax cut in 2011 to revive consumer spending and instill confidence in recovery
- Balance the primary budget (revenues minus program spending) by 2014, and reduce the debt-to-GDP ratio to below 60% by 2020.
- Cap total outlays at 23% of GDP, and raise revenue to 21.4% of GDP by 2020. Plan entails 55% of deficit reduction through spending cuts, and 45% through revenue increases.
- Freeze non-defense discretionary spending for 4 years and defense spending for 5 years. Allow discretionary spending to grow at the rate of GDP growth thereafter.
- Shore up social security by: raising the percentage of wages subject to payroll taxes to 90% of total wages; reducing the growth of benefits for the top 25% of earners; changing COLAs to accurate reflect inflation; and, indexing lifetime benefits to longevity. An individual could still retire at 66, but as the lifespan lengthens the benefits would be smaller.
- Restrain health care cost growth by: increasing Medicare premiums, capping and then phasing out the tax exclusion of employer-sponsored health insurance benefits, replacing the federal and state Medicaid cost sharing program with one that apportions funding responsibility to specific of the program; reforming the medical malpractice system; and, introducing measures to reduce obesity-related health expenditures. These changes are expected to constrain the growth of health-care spending to "GDP growth plus 1 percent", starting in 2018.
- Eliminate most tax expenditures. Reduce the number of income tax brackets to just two rates: 15% and 27 %. Cut the top corporate tax rate to 27% from its current 35%. Phase in over two years a 6.5% national value-added consumption tax, termed the Debt Reduction Sales tax.



outstanding government bonds are held by investors in the United States. All of these factors together buy the U.S. government time to deal with its fiscal challenges.

First stabilize the patient then begin therapy

Before the government can begin to actively reduce the deficit it must first insure that the economy is healthy enough to handle it. Currently the unemployment rate is at 9.6% and the "jobs deficit" – the difference between the actual number of workers and the full employment level – stands at over 10 million. Significant fiscal consolidation while economic activity is well below its potential level and the unemployment rate is stubbornly high could derail the recovery and throw the economy into a renewed downturn. This would be counterproductive – another recession would only exacerbate budget deficits.

As long as financial markets are willing to give the U.S. time, the federal government should wait on introducing fiscal consolidation until there are clear signs that growth has accelerated above potential on a sustained basis and the unemployment rate is much lower. In all likelihood, this is still a few years away. Moreover, given that the presidential elections will take place at the end of 2012, substantial fiscal tightening before this point is not only economically undesirable, but also politically infeasible.

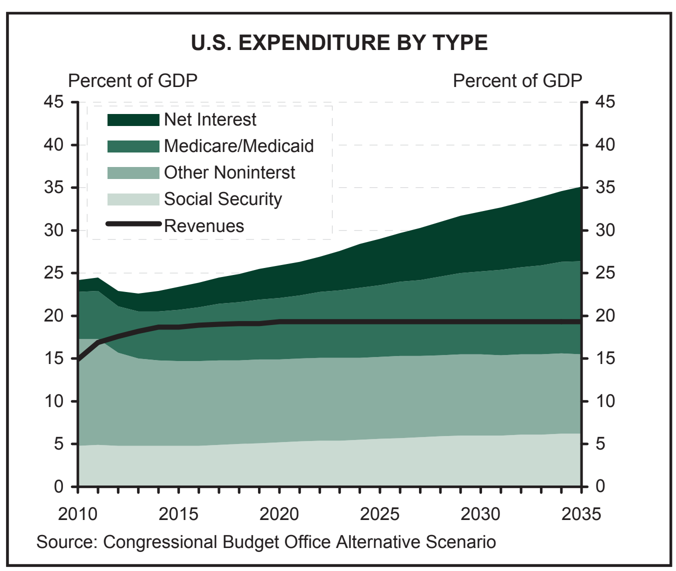
While fiscal austerity is never an easy choice, the moment that it ceases to be a threat to the economic recovery, is the moment that action should begin. At this point there will be both political and economic pressures pushing the government to act. The longer that fiscal adjustment is put off once a solid economic expansion is established, the higher the costs, both in terms of the direct cost of government financed debt, as well as the real economic costs of crowding out private investment.

By 2013, a plan for fiscal consolidation should be put in place. By this time the economy should be operating at close to full capacity and the cyclical portion of the deficit – likely around 2% of GDP - will wane. Likewise, the winding down of the fiscal stimulus and financial rescue packages will also fall out of the deficit. However, even with the return to trend economic growth and the unwind of temporary fiscal measures, a deficit of roughly 4% of GDP will remain and if action is not taken the deficit will continue to widen. This will have to be addressed with further fiscal consolidation.

What form should fiscal austerity take?

The gap between what the government takes in as revenue and what they spend can be closed with some combination of expenditure constraint and tax revenue increases. The challenge will be deciding on what mix of these to use. Historically, the U.S. has relied on both cuts to expenditures and increases in tax revenues, but with more emphasis on the former.

For instance, in the early 1980s, the U.S. Congress passed two significant bills aimed at reducing the budget deficit: the Tax Equity and Fiscal Responsibility of 1982 and the Deficit Reduction Act of 1984. Both leaned heavily on spending cuts to reduce the deficit, with expenditure constraint accounting for 75% of the reductions in the 1982 bill and 65% in 1984. Similarly, during George H. Bush's presidency, the Omnibus Budget Reconciliation Act of 1990, which established pay-as-you-go rules requiring new spending initiatives to be revenue neutral, also apportioned 70% of deficit reduction to spending cuts. Nonetheless, spending cuts have not always dominated deficit reduction strategies. In the Omnibus Reconciliation Act of 1993 signed into law



by President Clinton, spending cuts and tax increases carried almost equal weight.

Cutting spending

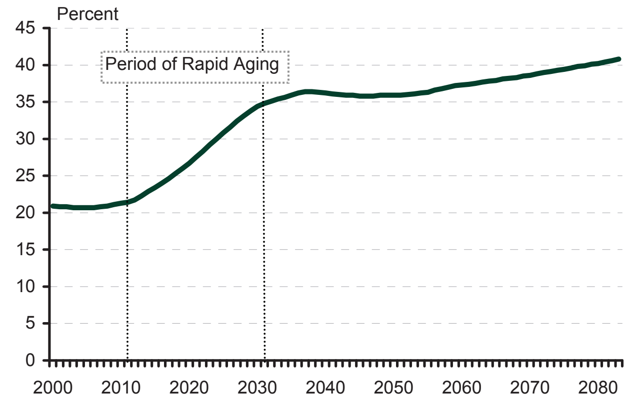
As has been the case in the past, future fiscal consolidation will require both expenditure constraint and increases in revenue. Let's first consider the prospects for spending cuts. Spending in the U.S. budget can be split into three main components:

1) mandatory spending – expenditures which have a commitment from previous legislation;
2) discretionary spending – expenditures made based on annual appropriation acts; and
3) net interest payments.

The fiscal authority only has control over the first two of these. Net interest payments are determined by the level of U.S. debt and the effective interest rate on that debt. Given an independent Federal Reserve and financial market forces, the only way that the government can influence net interest costs is by lowering deficits and debt.

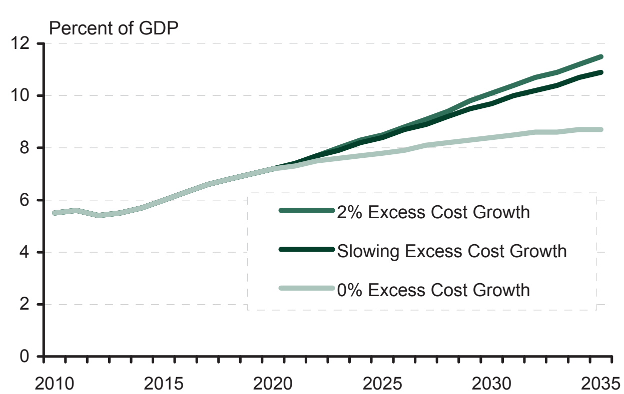
The CBO's projections assume that discretionary spending from future acts of Congress grows at a rate of 2.0% annually – the projected rate of inflation. To put this in context, discretionary spending grew at an average rate of 7.5% from 1999 to 2008. In 2009 discretionary spending rose to 9.0%, and in 2010 to a projected 10.9%, due mainly to provisions in the American Recovery and Reinvestment Act (ARRA). Reducing discretionary spending further will be necessary, but it will not come easy. Over half of discretionary spending is on defense, which grew at an average rate of 8.5% from 1999 to 2008 and by 7.1% in 2009. The CBO's assumptions are already a break from history in the direction of restraint – cutting further will require significant political will.

POPULATION AGES 65 OR OVER AS A PERCENTAGE OF POPULATION AGES 20 TO 64



Source: Congressional Budget Office

MANDATORY SPENDING ON HEALTH CARE UNDER DIFFERENT ASSUMPTIONS ABOUT EXCESS COST GROWTH



Source: Congressional Budget Office Alternative Scenario

Moreover, slowing growth in discretionary spending alone will not be enough to close the budget gap. Discretionary spending accounts for just under 40% of non-interest outlays, a share that is expected to fall going forward. Even if discretionary spending were frozen at 2010 levels for the next ten years, this would only shave the deficit by an average of 0.5 percentage points of GDP annually.

Mandatory spending currently accounts for close to 60% of non-interest outlays. The vast majority of this (70%) is accounted for by the federal government's three main entitlement programs – Medicare, Medicaid and Social Security. Perhaps the most significant source of future mandatory spending growth is demographic pressures – population aging and the retirement of the baby boomers. Over the next twenty-five years, the share of the adult population 65 years and older will rise from 13% to above 20%. As a result, the number of people who will qualify for Medicare and Medicaid will rise by 25 million by 2020, while the number of people who qualify for Social Security will rise by 18 million. According to the CBO's estimates, population aging will be responsible for about 45% of the total rise in government healthcare spending over the next 25 years, and 30% of the increases after that.

Nonetheless, population aging is not the only source of rising costs for mandatory spending programs. Over the last 25 years, per-capita health-care expenditures adjusted for age distribution have outgrown nominal GDP by an average of 1.9 percentage points annually. The CBO calls this "excess cost" growth and builds it into their assumptions for future healthcare spending. Technological advancement in healthcare tends to be cost enhancing rather than cost saving. On top of this, demand for healthcare increases as incomes rise, which makes slowing per-capita health care spending below the rate of per-capita economic growth a significant challenge.

A good starting point for cutting future healthcare costs is getting the incentives right. As the CBO notes, in many cases the incentives of patients, insurers and practitioners are not aligned with a goal of constraining future cost growth. Raising health care premiums, raising the eligibility age for Medicare, increasing the excise tax on private care plans, and reforming medical malpractice and remuneration policies are all options that could all help to reduce the impact of future health care expenditures on the U.S. deficit. However, many of these options will prove politically unpopular and will increase the burden on more vulnerable segments of the population. History and international experience suggests that slowing the health care pac-man is much easier said than done.

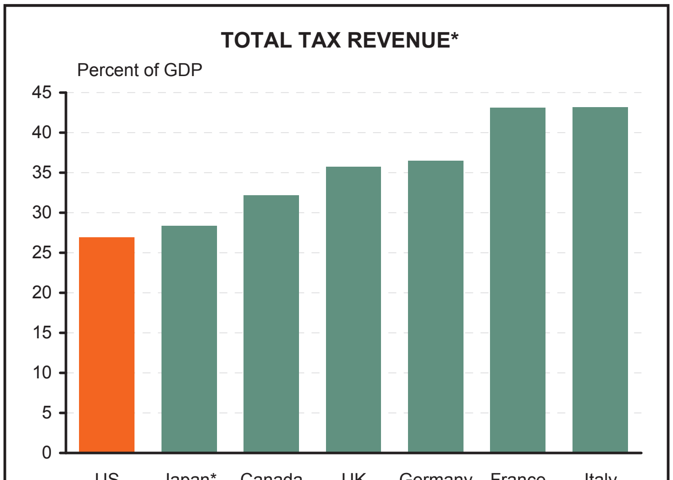
Given commitments that have been made by past federal governments, fiscal austerity purely through reduced spending is unlikely to be sufficient to put budget balances on a sustainable path. Even if discretionary spending is frozen, demographic change and excess cost growth in healthcare will continue to drive entitlement spending above the rate of GDP growth, and will be the main source of the widening future gap between what the federal government takes in revenues and what it spends. Short of major reductions in government entitlement programs, tax revenue will have to rise. The issue then is how to do this with the least impact on living standards and competitiveness.

Raising revenues

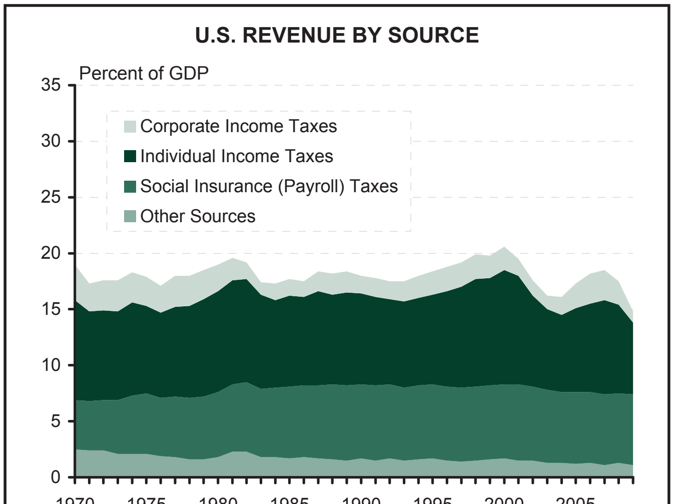
On a comparative basis, taxes as a share of GDP are very low in the United States. Federal government revenues have ranged between 15% and 21% of GDP over the past 40 years, and averaged 18.1%. Tax revenue as a share of GDP is the fourth lowest of 30 countries in the OECD. While taxes are always associated with dead-weight loss, this leaves room for taxes to rise in the United States before they impose a serious competitive disadvantage. The CBO's alternative projection assumes that revenues improve to 18.2% by 2013, then rise gradually to 19.3% of GDP, where they remain for the remainder of the forecast. A fiscal consolidation plan that reduces the debt-to-GDP ratio to 40% by 2035 and splits the pain 50-50 between revenue cuts and tax increases could be accomplished with an increase in revenues to 23%. This would still require expenditures to be constrained to 22% of GDP, which is significantly below the CBO's assumptions of 26%.

When it comes to raising revenues, the U.S. government has a number of choices. U.S. revenues rely primarily on personal income taxes and corporate taxes. If economists were able to design the U.S. tax-system from scratch, these would carry a significantly smaller weight. Nonetheless, despite this reliance on income taxes, the U.S. tax code also has considerable deductions, exemptions, and exclusions that lead to significant revenue leakage from the tax system. This alone provides a great opportunity to simplify the tax code, reduce distortions and taxes on productive investment, while still maintaining or even augmenting revenue generation.

Broadening the revenue base, while lowering tax rates has been the mantra of tax reform advocates for decades. Yet, the U.S. has seen tremendous growth in "tax expen-



*Federal and State Tax revenue for 2008. For Japan 2007 value.
Source: OECD



Source: Congressional Budget Office

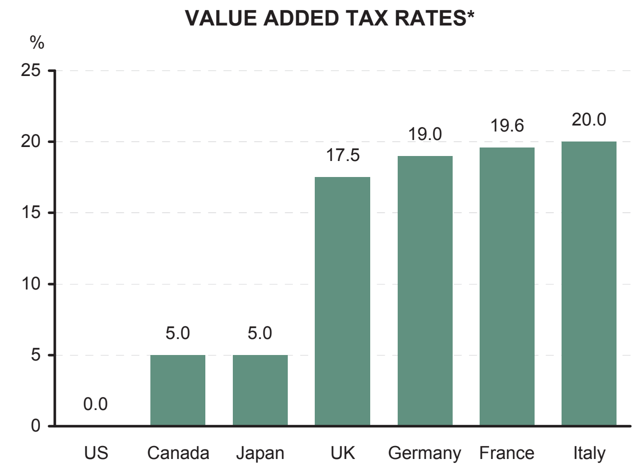
ditures" – one off exemptions related to certain activities. Tax expenditures are estimated to have an annual value of over $1.2 trillion.[2] Tax shelters are often distortive and regressive - creating an incentive, especially for high earning individuals, to invest in products that reduce taxable income rather than in productive investments that increase the quantity and quality of goods and services. As an example, the deduction for mortgage interest costs overwhelmingly favors high income earners. While those earning less than $30,000 account for 52% of total filers, they make up only 9% of the total deductions for mortgage interest. In contrast, a full 36% of the deductions are claimed by filers with income over $100,000.[3]

Limiting tax expenditures by phasing out deductions for mortgage interest costs, state and local taxes, and other exemptions could go a long way to closing the fiscal gap. According to the CBO, replacing the 100% mortgage-interest deduction (for mortgages under $1.1 million), with a 15% tax credit on mortgages under $500,000 in 2013 would raise a cumulative $387.6 billion by 2020.[4]

The advantage of a value-added tax

Another option for raising revenues that is already in place in a majority of major competing jurisdictions is an aggregate consumption tax. The most efficient form of this type of taxation is a VAT.[5] Currently, some form of VAT is in place in 150 countries, but not the U.S.[6] The major advantages of a VAT are that it does not reduce the after-tax rate of return on saving and imposes significantly less compliance costs on taxpayers than the current income tax system.

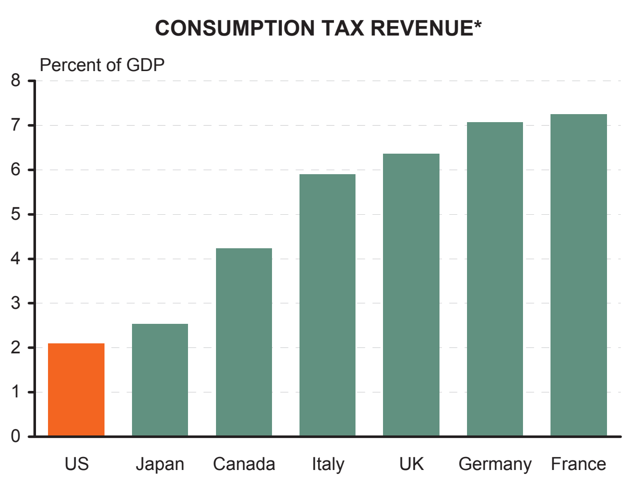
In combination with expenditure constraint, broad based tax reform that includes a modest VAT would go a long way to closing the U.S. budget deficit. A 5% VAT with minimal exemptions would likely raise around $300 billion annually, or just over 2% of GDP.[7]



*Rates for 2010.
Source: IMF

There are, of course, valid concerns over consumption taxes – they alter spending decisions and impose a larger burden on low-income individuals for whom consumption takes up a higher share of total income. There are measures that the federal government can take to alleviate some of the negative impacts. Exceptions on necessities would lower the burden on low-income individuals (but would also reduce the overall efficiency of the tax). Alternatively, the distributive consequences of a VAT could be dealt with through income transfers.

Opposition to VATs also typically involves the view that the relative ease at which a VAT can be increased once initiated could lead to an expansive growth in government spending. Evidence of this is the correlation between the level of government spending and the size of a VAT tax in many countries. However, the evidence on this is inconclusive. The fact that high spending countries also have VATs does not mean that they lead to higher government spending, but rather that high government spending requires efficient forms of taxation, and a VAT does the best job of filling that role. Tax reform involving a VAT should be made as part of a broader tax reform that lowers personal and corporate income taxes and broadens the tax base by reducing exemptions. This is the tack chosen in the U.K. where the budget plan includes, among other things, an increase in the VAT from 17.5% to 20% and a decrease in the corporate tax rate from 28% to 24%.



*Federal and state consumption taxes for 2008.
Source: OECD

One final consideration that inevitably must be made in imposing a VAT is the bureaucratic burden faced by businesses in states with both a state sales tax and a federal VAT. Optimally, state taxes would be harmonized with the federal tax and revenues distributed on an equitable basis to state governments. Nonetheless, imposing a federal VAT will impose an uneven burden across states and opposition will likely form in states where sales taxes are already the main source of state revenue.

Short-term pain for long-term gain

Fiscal austerity will be a headwind on economic growth when it takes place. However, if fiscal consolidation comes in 2013, the recovery will be more firmly entrenched and supported by private demand, and austerity should not derail economic growth.

A recent study by the IMF finds that fiscal consolidation equivalent to 1 percentage of GDP results in a roughly a 0.5 percentage point reduction in total GDP after two years.[8] While fiscal consolidation has a close to one-to-one effect on domestic demand, net exports offer an important offset, as imports decline and a falling exchange rate gives support to exports. The impact of consolidation can also be lessened by more accommodative monetary policy. Finally, the immediate costs will also depend on the fiscal policy choices taken. Tax hikes typically impose higher costs than spending cuts, especially if the spending cuts are focused on cuts to government transfers.

A credible, clear and targeted plan for fiscal consolidation can also have offsetting positive impacts on consumer and business confidence. Provided households are sufficiently forward looking they will view permanent fiscal consolidation as a reduction in their future tax burden and, therefore, an increase in lifetime income. Hence, this positive income shock could then have a positive impact on the current level of consumption and militate against the initial increase. A credible fiscal consolidation plan that provides a clear long-term objective – such as to lower the debt-to-GDP ratio from its current path – has the best chance of benefitting from this offsetting gain in household confidence.

In any case, fiscal consolidation will not be painless, but short-term pain must be compared to long-term gain. If consolidation is successful in changing the trajectory of the U.S. debt, the impact over the long haul will be lower real interest rates, a higher stock of productive capital and, therefore, higher potential GDP growth. Moreover, if the government succeeds in lowering the budget deficit and debt in one year, it also lowers interest obligations and the deficit the next year. As such, there is a positive chain reaction that makes it easier to lower future deficits once consolidation has been initiated. However, since interest payment reduction is a positive side-effect of a lower debt, fiscal austerity needs to take action first. In the long run, the savings generated through lower net-interest costs can also be used to fund tax cuts, providing an added boost.

So, how long does it take for the positive long-term benefits to exceed the short-term costs? Simulations run by the IMF suggest that five years after fiscal consolidation is initiated, the long-term benefits begin to outweigh the costs. This is especially important considering the demographic reality of the United States. The share of the U.S. population in their prime working years is close to a peak in the United States and is set to decline going forward. By 2035, the U.S. population aged 16-65 will fall from 65% of the total to under 60%. In other words, the longer fiscal consolidation is put off the more difficult it will become.

Conclusion

Saying the U.S. has a fiscal problem is stating the obvious, but while the current trajectory of the debt-to-GDP and must be addressed, the U.S. is not facing an imminent fiscal crisis. The U.S. dollar remains the global reserve currency and U.S. Treasury bonds are highly liquid, which, in turn, permits the U.S. to run large deficits and sustain higher debt levels in the near term. However, America will not be able to rely on this advantage indefinitely.

Fiscal consolidation should come sometime in 2013, or soon thereafter. Historically, the emphasis of fiscal austerity has been on spending cuts, and it definitely makes sense to exhibit discipline on the expenditure side before pulling on tax levers. However, given looming demographic pressures, fiscal austerity purely through spending cuts won't be adequate and in all likelihood higher taxes are inevitable. There are a number of choices in raising revenues: the government could reduce tax exemptions, especially those with negligible economic benefits, raise Social Security contributions, and possibly introduce an aggregate value-added-tax.

All told, there are no painless solutions. As the U.S. economy recovers from the recession and fiscal austerity becomes more prominent, the implication is the medium-term trend rate of economic growth in the U.S. economy is likely in the range of 2.0% to 2.5%, which will constrain how high U.S. bond yields rise over the next decade. Nonetheless, a well-designed austerity program that shares the pain has the best chance of succeeding. Finally, reforms that stabilize and lower the debt-to-GDP ratio should raise the economic potential of the country in the long run.

Endnotes

1 Even assuming the expiration of the tax cuts, more will be required to put the U.S. budget on a sustainable path. While debt-to-GDP remains relatively stable over the next decade in the baseline scenario, population aging and rising entitlement costs would lead it to rise to 79% by 2035.

2 "Restoring Fiscal Sustainability", OECD Economic Surveys: United States, Chapter 2, Volume 2010/15, September 2010.

3 Gerald Prante, "Who Benefits from the Home Mortgage Interest Deduction?", Tax Foundation, February 3, 2006.

4 "Budget Options" Congressional Budget Office, Volume 2, August 2009.

5 Unlike a sales tax, which is collected only once – upon the sale of the good – a VAT is collected and remitted to the government at every stage of production. The cost of inputs is then credited back to producers so that the tax applies only to the "value-added" from production: the difference between the revenues attained from the sale of good and the cost of its production. The main advantage over a sales tax is that businesses do not pay taxes on intermediate investment goods. Moreover, since the tax is collected earlier in the production process and the cost of inputs credited back to producers, it is more difficult to evade than a sales tax.

6 William G. Gale and Benjamin H. Harris, "A Value-Added Tax for the United States: Part of the Solution", Brookings Institution and Tax Policy Center, July 2010.

7 Our estimates indicate for every 1 percentage increase in the VAT rate, the U.S. could raise between 0.36 - 0.40 percent of GDP in tax revenue, which is on the conservative side compared to other industrialized countries with VATs. In Canada and Japan, for every 1 percentage point of VAT, governments raise on average 0.52 percent of GDP in tax revenue, whereas in Germany and France every 1 percentage point in VAT raises an average 0.37 percent of GDP in tax revenue.

8 "Will it Hurt? Macroeconomic Effects of Fiscal Consolidation", International Monetary Fund, World Economic Outlook: Recovery, Risk and Rebalancing, Chapter 3, October 2010.