Too Soon to Pull Back Fiscal Policy Support

By Mark Zandi
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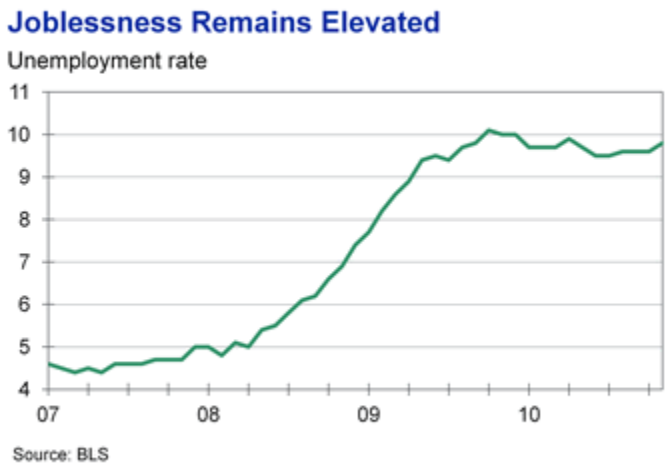
- The recovery is fragile; removing fiscal support via tax increases or spending cutoffs could easily send the U.S. back into recession.
- If tax cuts and unemployment insurance programs expire in 2011, the hit to the economy will approach $375 billion or 2.5% of real GDP.
- Among the expiring policies, emergency unemployment insurance benefits provide the biggest economic bang for the buck.
- Raising top-tier tax rates would normally have little macroeconomic impact but are too risky in the current environment.
- The Moody's Analytics macro model compares the consequences of alternative fiscal policy scenarios.

The U.S. recovery that began 18 months ago is intact, but fragile. As is clear from November's disappointing job market data, growth has not generated enough jobs to bring the unemployment rate down. With joblessness near double digits and still rising, the economy is extraordinarily vulnerable. The Federal Reserve has acknowledged these threats and provides massive monetary support, most recently through the resumption of quantitative easing.



In this context, it is important that fiscal policymakers also support the economy, or at least not allow fiscal policy to become a significant drag on growth—which it will unless the government acts quickly. Tax cuts passed a decade ago in the wake of the 2001 recession are set to expire at the end of this year, and a number of tax benefits passed in early 2009 to combat the Great Recession are also set to expire. Emergency unemployment insurance benefits have already ended, and unless policymakers act to extend that program, millions of unemployed workers will soon fall off the UI roles.

Dire risks of renewed recession

If Congress and the administration are unable to renew the expiring tax cuts and temporary government spending, the hit to the economy will approach $375 billion in calendar year 2011, equal to 2.5% of real GDP. The recovery would have substantial difficulty weathering this, and the U.S. would likely backtrack into recession. Adding to the risks of this scenario is the lack of a clear monetary or fiscal policy response to a renewed recession. The Fed would be in uncharted territory, and the federal budget deficit would balloon from its already-massive size, currently equal to 9% of GDP.

Table 1: Cost of Extending Various Expiring Tax Provisions Through Year-End 2011

	Billions $
Total	-374
Tax Cuts	-323
Bush Era Tax Cuts:	-157
Income Tax Provisions of Bush Tax Cuts	-113
Estate and Gift Taxes	-26
Reduced Tax Rates on Capital Gains and Dividends	-18
Other Major Tax Provisions:	
Making Work Pay Tax Credit	-43
Increased AMT Exemption Amount	-76
Refundable Credits	-46
Temporary Spending Increases	
Emergency Unemployment Insurance	-51

Source: Moody's Analytics

Given these threats, it would be prudent for fiscal policymakers to extend all the expiring tax cuts and temporary spending programs for one more year. Chances are good that with a bit more help, the recovery will gain traction in 2011 and evolve into a self-sustaining expansion by the year's end. That is, job growth will be sufficient to consistently reduce unemployment. The tax cuts and extra spending can be allowed to expire in 2012, at least in significant part, as the economy will likely be in position to cope with the resulting fiscal restraint. Then policymakers will need to quickly turn their attention to the nation's longer-term fiscal challenges.

Bang for the fiscal buck

A realistic view of current politics suggests Washington may not have the will to extend all the expiring tax breaks and temporary spending increases. Therefore it is useful to prioritize them based on their economic efficacy. Extending emergency unemployment insurance benefits would provide the most economic bang for the buck, defined as the near-term increase in real GDP per dollar of tax cut or spending increase. Emergency benefits go to those who have been out of work longer than the 26 weeks covered by regular benefits. With more than 40% of the 15 million-plus unemployed American workers in this predicament, many families depend on this program to meet daily living expenses.

Table 2: Fiscal Stimulus Multipliers
As of 2010q2

	Bang for the Buck
Tax Cuts	
Refundable Lump-Sum Tax Rebate	1.22
Non-refundable Lump-Sum Tax Rebate	1.01
Temporary Tax Cuts	
Child Tax Credit, ARRA parameters	1.38
Job Tax Credit	1.30
Payroll Tax Holiday	1.24
Earned Income Tax Credit, ARRA parameters	1.24
Making Work Pay	1.17
Across the Board Tax Cut	1.04
Housing Tax Credit	0.88
Accelerated Depreciation	0.25
Loss Carryback	0.24
Permanent Tax Cuts	
Extend Alternative Minimum Tax Patch	0.50
Make Dividend and Capital Gains Tax Cuts Permanent	0.39
Make Bush Income Tax Cuts Permanent	0.35
Cut in Corporate Tax Rate	0.32
Spending Increases	
Temporary Increase in Food Stamps	1.72
Temporary Federal Financing of Work-Share Programs	1.69
Extending Unemployment Insurance Benefits	1.60
Increased Infrastructure Spending	1.57
General Aid to State Governments	1.41
Low Income Home Energy Assistance Program (LIHEAP)	1.14

Note: The bang for the buck is estimated by the one year $ change in GDP for a given $ reduction in federal tax revenue or increase in spending.

Source: Moody's Analytics

The broader macroeconomic benefit of emergency UI is straightforward, as unemployed workers are likely to spend any benefits they receive quickly. This creates critical demand for goods and services, particularly during the holiday shopping season. There are downsides to emergency UI: Some beneficiaries are surely taking advantage of the system, but with five unemployed workers for every current job opening (compared with fewer than two in normal times), most jobless workers and their families need the benefits.

Among the least economically effective fiscal policies being considered are the lower marginal personal tax rates for higher-income households. In normal times, allowing those tax rates to rise back to their 1990s levels would have little macroeconomic impact. The rates would rise by only a small increment and would still be relatively low by historical standards. Any negative supply-side effects would likely be modest.

Yet in the current uncertain environment, allowing tax rates on higher-income households to rise in 2011 would be taking an unneeded chance with the recovery. Affluent households account for a disproportionate share of consumer spending and have grown especially sensitive to their financial condition in the wake of the Great Recession. (See "The Economic Impact of Tax Cut Proposals: A Prudent Middle Ground," Zandi, September 2010). It is also reasonable to worry about the impact on successful small businesses. Smaller businesses remain vital to job growth and adding to their financial burdens would be counterproductive.

Simulating the macroeconomic impact

Given the range of options available to policymakers, the economic merits of each should be carefully considered. Moody's Analytics' macroeconomic model can be used for this purpose. At the request of the Center for Budget Policy and Priorities, the model was used to evaluate the impact of two temporary and two permanent policy scenarios.

The temporary simulation compares these policy scenarios:

- No extension of upper-income tax cuts, but a one-year extension of federal emergency unemployment insurance and a two-year extension of refundable tax credits, including the Child Tax Credit at $3,000, the Earned Income Tax Credit marriage penalty, the EITC third tier, and American Opportunity Tax Credit, costing $85 billion in fiscal 2011 through 2015. This is labeled the "UI scenario."
- A two-year extension of the upper-income tax cuts costing $94 billion in fiscal 2011 through 2015, but no extension of UI or refundable tax credits. This is labeled the "HI tax cut scenario."

Compared with the HI tax cut scenario, the UI scenario:

- Raises real GDP 0.4% in 2011; real GDP remains about 0.1 of a percentage point higher in 2012-2014.
- Raises payroll employment by 500,000 jobs in 2011; payroll employment stays at least 130,000 jobs higher in 2012-2014, with a cumulative addition of 1.1 million jobs in 2010-2015.
- Lowers the unemployment rate by 0.4 of a percentage point in 2011; the unemployment rate remains about 0.1 of a percentage point lower in 2012-2015 for a cumulative reduction in unemployment of 0.8 percentage point-years in 2010-2015.
- Adds $30 billion less to the budget deficit in fiscal years 2010-2015, taking into account the effect of stronger growth on the deficit.

Table 3: Economic Impact of Alternative Short-Term Fiscal Policy Assum

Calendar Years

	2009	2010	2011	2012	2013	2014	2015
Real GDP							
2-Years of High Income Tax Cuts							
Bil. 2005$	12,881	13,226	13,584	14,172	14,809	15,275	15,649
% Change	-2.63	2.68	2.71	4.33	4.49	3.15	2.45
1-Year of UI and 2-Years of Refundable Credits							
Bil. 2005$	12,881	13,232	13,638	14,187	14,825	15,288	15,656
% Change	-2.63	2.73	3.06	4.03	4.50	3.12	2.41
Payroll Employment							
2-Years of High Income Tax Cuts							
Mil.	131	130	131	134	139	142	144
Change, Mil.	-5.87	-0.67	1.19	2.67	4.44	3.67	1.96
1-Year of UI and 2-Years of Refundable Credits							
Mil.	131	130	132	134	139	142	144
Change, Mil.	-5.87	-0.61	1.63	2.31	4.47	3.63	1.90
Unemployment Rate							
2-Years of High Income Tax Cuts							
	9.28	9.69	9.91	8.73	6.89	5.84	5.73
1-Year of UI and 2-Years of Refundable Credits							
	9.28	9.64	9.52	8.62	6.76	5.74	5.68
Federal Budget Deficit,							
2-Years of High Income Tax Cuts							
Bil. $	-1,415	-1,294	-1,095	-909	-807	-739	-690
% of GDP	-10.02	-8.85	-7.24	-5.68	-4.74	-4.15	-3.73
1-Year of UI and 2-Years of Refundable Credits							
Bil. $	-1,415	-1,298	-1,091	-887	-803	-737	-689
% of GDP	-10.02	-8.87	-7.19	-5.54	-4.71	-4.13	-3.72

Sources: BEA, BLS, Treasury Department, Moody's Analytics

The permanent simulation compares these two policy scenarios:

- No extension of upper-income tax cuts, but a one-year extension of federal emergency unemployment insurance, a permanent extension of the refundable credits mentioned above, a one-year extension of the Making Work Pay tax credit, and a two-year jobs credit modeled on the credit in the Hiring Incentives to Restore Employment Act enacted in March of 2010, costing $345 billion in fiscal 2011-2015. This is labeled the "expanded UI scenario."
- A permanent extension of the upper-income tax cuts costing $694 billion in fiscal 2011-2015, but no extension of UI or refundable tax credits. This is labeled the "permanent HI tax cut scenario."

Compared with the permanent HI tax cut scenario, the expanded UI scenario:

- Raises real GDP 0.9% in 2011, 0.6% in 2012, and 0.3% in 2013; GDP remains higher through 2020.
- Raises payroll employment by 1.2 million jobs in 2011, 840,000 jobs in 2012, and 430,000 jobs in 2013, leading to a cumulative 3.3 million job-years added in 2010-2020.
- Lowers the unemployment rate by 0.9 of a percentage point in 2011, 0.7 of a percentage point in 2012, and 0.3 of a percentage point in 2013, reducing unemployment by 2.5 percentage point-years from 2010 to 2015.
- Adds $441 billion less to the budget deficit in fiscal years 2010 through 2020, taking into account the effect of stronger growth on the deficit.

Table 4: Economic Impact of Alternative Long-Term Fiscal Policy Assumptions

Calendar Years

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Real GDP												
Permanent High Income Tax Cuts												
Bil.2005$	12,881	13,226	13,584	14,175	14,812	15,278	15,652	16,012	16,366	16,723	17,081	17,440
% Change	-2.63	2.68	2.71	4.35	4.49	3.15	2.45	2.30	2.21	2.18	2.14	2.10
1-Year of UI and Permanent Refundable Credits												
Bil.2005$	12,881	13,232	13,712	14,261	14,854	15,301	15,661	16,015	16,373	16,734	17,100	17,471
% Change	-2.63	2.73	3.63	4.00	4.16	3.01	2.35	2.26	2.24	2.20	2.19	2.17
Payroll Employment												
Permanent High Income Tax Cuts												
Mil.	131	130	131	134	139	142	144	146	147	148	149	150
Change, Mil.	-5.87	-0.67	1.19	2.67	4.44	3.67	1.96	1.33	1.18	1.05	1.03	1.00
1-Year of UI and Permanent Refundable Credits												
Mil.	131	130	133	135	139	142	144	146	147	148	149	150
Change, Mil.	-5.87	-0.61	2.33	2.31	4.03	3.47	1.81	1.27	1.22	1.08	1.07	1.04
Unemployment Rate												
Permanent High Income Tax Cuts												
	9.28	9.69	9.91	8.73	6.89	5.84	5.73	5.70	5.72	5.75	5.76	5.78
1-Year of UI and Permanent Refundable Credits												
	9.28	9.64	8.98	8.07	6.55	5.66	5.66	5.68	5.67	5.68	5.67	5.68
Federal Budget Deficit, FY												
Permanent High Income Tax Cuts												
Bil. $	-1,415	-1,294	-1,095	-914	-837	-739	-690	-681	-669	-701	-657	-679
% of GDP	-10.02	-8.85	-7.24	-5.71	-4.92	-4.15	-3.73	-3.55	-3.36	-3.40	-3.07	-3.07
1-Year of UI and Permanent Refundable Credits												
Bil. $	-1,415	-1,298	-1,133	-920	-810	-695	-638	-623	-603	-629	-576	-591
% of GDP	-10.02	-8.87	-7.42	-5.71	-4.74	-3.90	-3.45	-3.25	-3.03	-3.04	-2.69	-2.66

Sources: BEA, BLS, Treasury Department, Moody's Analytics

Other scenarios can and should be considered, and the Moody's Analytics model is available to policymakers for this purpose.

Critical juncture

The U.S. recovery is at a critical juncture. Much progress has been made toward correcting the problems that sparked financial panic and led to the Great Recession. The banking system is much better capitalized, household deleveraging is well under way, and corporate America is very profitable. Yet businesses remain reluctant to hire and job growth is insufficient to reduce the unemployment rate. Until the jobless rate is falling definitively, the recovery will not be securely on track toward a self-sustaining expansion.

The nation's fiscal challenges are very serious, but they will become overwhelming if the recovery does not gain traction. The Federal Reserve, Congress, and the administration must remain aggressive in their policy support until that happens.