Congressional CBO Budget Office
Summary

The Economic Outlook and Fiscal Policy Choices

This testimony reviews the Congressional Budget Office's (CBO's) recent analyses of the economic outlook and the potential impact on the economy of various fiscal policy options. It also adds to those analyses by quantifying the economic impact of extending some or all of the 2001 and 2003 tax cuts that are scheduled to expire in three months.

The Economic Outlook

CBO expects—as do most private forecasters—that the economic recovery will proceed at a modest pace during the next few years. In its projections released in August, CBO forecast that, under current laws governing federal spending and revenues, real (inflation-adjusted) gross domestic product (GDP) would increase by 2.8 percent between the fourth quarter of 2009 and the fourth quarter of 2010 and by 2.0 percent between the fourth quarters of 2010 and 2011. With economic growth so slow, the unemployment rate would remain above 8 percent until 2012 and above 6 percent until 2014. Since CBO completed that forecast, the economic data released have been weaker than the agency had expected, so if CBO was redoing the forecast today, it would project slightly slower growth in the near term.

The pace of recovery since the recession ended in June 2009 and the growth that CBO projects for the next few years are anemic relative to the rate of recovery following previous deep recessions. However, the most recent recession, spurred by a financial crisis, was unlike any this country has seen for a very long time, and there is reason to expect that the country's recovery will also be different from past ones: International experience suggests that recoveries from recessions that begin with financial crises tend to be slower than average.[1] Following such a crisis, it takes time for equity and asset markets to recover, for households to replenish their resources and boost their spending, for financial institutions to restore their capital bases, and for businesses to regain the confidence required to invest in new plant and equipment. In addition, the scheduled increases in taxes and the waning of fiscal policy measures that supported the economy earlier in this recovery will hold down spending, especially in 2011. The weak demand for goods and services resulting from those various factors is the primary constraint on economic recovery.

A weak economy has serious social consequences. In addition to the millions of Americans who are officially unemployed, many others are underemployed or have left the labor force. Moreover, the unemployment rate has risen disproportionately for men, for less-educated workers, and for people living in certain states, and long-term unemployment has increased strikingly—to the point that the incidence of unemployment lasting longer than 26 weeks is now the highest by far in the past 60 years. Of course, losing a job often has a significant impact on workers and their families, both in the short term and in the long term.

1. See, for example, Carmen Reinhart and Kenneth Rogoff, "The Aftermath of Financial Crises," *American Economic Review*, vol. 99, no. 2 (May 2009), pp. 466–472.

Fiscal Policy Approaches and Long-Term Budgetary Constraints

Policymakers cannot reverse all of the effects of the housing and credit boom, the subsequent bust and financial crisis, and the deep recession. However, in CBO's judgment, there are both monetary and fiscal policy options that, if applied at a sufficient scale, would increase output and employment during the next few years. Those same fiscal policy options would, though, have longer-term economic costs. In particular, the cuts in taxes or increases in spending that would provide a short-term economic boost would also increase federal debt.

Federal debt held by the public is already larger relative to the size of the economy than it has been in more than 50 years, and it is headed higher. According to CBO's baseline projections, under current law, debt held by the public would be close to 70 percent of GDP for most of the coming decade. But other policies could result in substantially more debt. For example, if the 2001 and 2003 tax cuts were extended, the individual alternative minimum tax (or AMT) was indexed for inflation, and future annual appropriations remained the share of GDP that they are this year, the deficit in 2020 would equal about 8 percent of GDP, and debt held by the public would reach nearly 100 percent of GDP.[2] Such a path for federal debt is clearly unsustainable. Persistent deficits and continually mounting debt would crowd out growing amounts of private investment, require rising interest payments, restrict the ability of policymakers to respond to unexpected challenges, and increase the probability of a sudden fiscal crisis.[3]

Despite that grim picture, there is no intrinsic contradiction between providing additional fiscal stimulus today, while the unemployment rate is high and many factories and offices are underused, and imposing fiscal restraint several years from now, when output and employment will probably be close to their potential. What does that mean in practice? If taxes were cut permanently, or government spending was increased permanently, and no other changes were made to fiscal policy, the federal budget would be on an unsustainable path, and the economy would suffer. Even if tax cuts or spending increases were temporary, the additional debt accumulated during that temporary period would weigh on the budget and the economy over time. Therefore, if policymakers wanted to achieve both short-term stimulus and long-term sustainability, a combination of policies would be required: changes in taxes and spending that would widen the deficit now but reduce it relative to current baseline projections after a few years. Developing such a combination would be feasible but not easy.

If policies that widened the deficit in the near term were enacted, observers might question whether, when, and how the difficult actions to narrow the deficit later would be carried out. The most important uncertainty facing families and businesses today is uncertainty about the path of the economy, but uncertainty about government policies is probably also a drag on businesses' hiring and investing and perhaps on consumer spending as well. The enactment of policies that improved the budget outlook beyond the next few years would help to reduce that uncertainty.

CBO's Analysis of Fiscal Policy Options

To assist policymakers in their decisions, CBO has quantified the effects that some alternative fiscal policy options would have on the economy. In a January 2010 report, CBO estimated the effects of a diverse set of temporary policy options.[4] The agency reported the results in terms of the two-year effect on the economy per dollar of total budgetary cost, what one might informally call the "bang for the

2. The baseline projections reflect an assumption that future annual appropriations will be held constant in real terms, yielding estimates of discretionary spending that would be low relative to GDP by historical standards.

3. Congressional Budget Office, *Federal Debt and the Risk of a Fiscal Crisis,* Issue Brief (July 27, 2010).

buck." The overall effects of those policies on the economy would depend also on the scale at which they were implemented; making a significant difference in an economy with an annual output of nearly $15 trillion would involve a considerable budgetary cost.

CBO's key conclusions from that analysis are as follows (see Figure 1):

- A temporary increase in aid to the unemployed would have a significant positive short-term effect on the economy per dollar of budgetary cost. Such an increase would slightly raise unemployment among the affected individuals, but it would also raise people's spending and thereby increase output and employment in the economy overall.

- A temporary reduction in payroll taxes—especially in the share of taxes paid by employers—would also have a significant positive short-term effect on the economy. This approach would boost output and employment both by increasing demand for goods and services and by providing an incentive for additional hiring.

- A number of other temporary policy options, including the expensing of business investment and providing aid to states, would have smaller positive short-term effects on output and employment.

- A temporary increase in infrastructure investment and a temporary across-the-board reduction in income taxes would have still smaller short-term effects on output and employment per dollar of budgetary cost.[5]

In its January study, CBO also explained that those policy actions would lead to the accumulation of additional government debt that would reduce income in the longer term unless other policies with offsetting effects on future debt were enacted. However, CBO did not quantify those future reductions in income.

At the request of the Chairman, CBO has now estimated the short-term and the longer-term effects of certain tax policy options being considered by the Congress. In particular, CBO studied the effects of extending the 2001 and 2003 tax cuts; extending the higher exemption amounts for the AMT that were in effect in 2009 (adjusted for inflation) for 2010 and subsequent years; and reinstating the estate tax, which expired completely in 2010, for 2011 and subsequent years at the rates in effect in 2009 and with the exemption amounts (adjusted for inflation) that applied in that year. CBO examined four alternative approaches to making those changes: a permanent change affecting all provisions (labeled a "full permanent extension"), a permanent change but without extending certain provisions that would apply only to high-income taxpayers (labeled a "partial permanent extension"), a change affecting all provisions but only through 2012 ("full extension through 2012"), and a change through 2012 but without extending certain provisions that would apply only to high-income taxpayers ("partial extension through 2012").

The methodology for this analysis was quite similar to the methodology that CBO uses in analyzing the President's budget each spring. CBO used several models that make different simplifying assumptions about people's behavior. The models used to estimate the effects on the economy in 2011 and 2012 focus on the policies' impact on the demand for goods and services, because CBO expects that

4. Congressional Budget Office, *Policies for Increasing Economic Growth and Employment in 2010 and 2011* (January 2010).

5. CBO focused on the effects of policy options during 2010 and 2011, and most of the across-the-board tax cut studied would not occur until halfway through that period. If CBO updated those estimates today and examined the impact during the 2011–2012 period, a temporary across-the-board reduction in income taxes would have a larger effect per dollar of budgetary cost but would still, by that measure, significantly trail most of the other options studied.

economic growth in the near term will be restrained by a shortfall in demand. All else being equal, lower tax payments increase demand for goods and services and thereby boost economic activity. In contrast, the models used to estimate the effects on the economy in 2020 and later years focus on the policies' impact on the supply of labor and capital, because CBO believes that economic growth over that longer horizon will be restrained by supply factors. All else being equal, lower tax revenues increase budget deficits and thereby government borrowing, which crowds out investment, while lower tax rates increase people's saving and work effort; the net effect on economic activity depends on the balance of those forces. Because the responsiveness of people's work effort to changes in their after-tax compensation is uncertain, CBO produced estimates based on alternative assumptions about such behavioral responses.[6]

Notwithstanding CBO's use of alternative models and assumptions, the actual effects of the policy options studied could fall above or below the estimates that CBO reports. With that caveat, the key findings are these:

- All four of the options for extending the expiring income tax cuts would raise output, income, and employment during the next two years, relative to what would occur under current law (see Figure 2). A full permanent extension or partial permanent extension would provide a larger boost to income and employment in the next two years than would a temporary extension, and a full extension would provide a larger boost than would the corresponding partial extension.

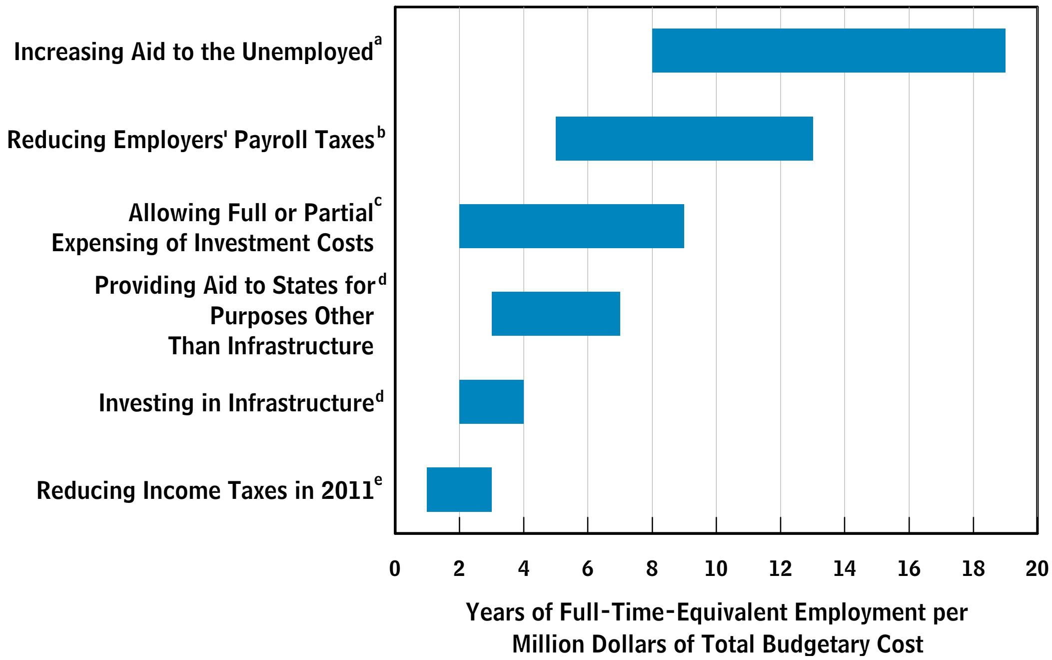
- But the effects of those policy options on the economy in the longer term would be very different from their effects during the next two years. For some of the options, the estimates based on different models and assumptions cover a broad range. Still, the estimates indicate that all four of the options would probably reduce income relative to what would otherwise occur in 2020 (see Figure 3, which shows the averages of the projected changes in GNP across the various models and assumptions). Beyond 2020, and again relative to what would occur under current law, the reductions in income from all four of the policy options would become larger. Either a full or a partial extension of the tax cuts through 2012 would reduce income by much less than would a full or partial permanent extension.

In sum, and as CBO has reported before, permanently or temporarily extending all or part of the expiring income tax cuts would boost income and employment in the next few years relative to what would occur under current law. However, even a temporary extension would add to federal debt and reduce future income if it was not accompanied by other changes in policy. A permanent extension of all of those tax cuts without future increases in taxes or reductions in federal spending would roughly double the projected budget deficit in 2020; a permanent extension of those cuts except for certain provisions that would apply only to high-income taxpayers would increase the budget deficit by roughly three-quarters to four-fifths as much. As a result, if policymakers then wanted to balance the budget in 2020, the required increases in taxes or reductions in spending would amount to a substantial share of the budget—and without significant changes of that sort, federal debt would be on an unsustainable path that would ultimately reduce income. Similarly, even temporary increases in government spending would add to federal debt and reduce future income, and permanent large increases in spending that were not accompanied by other spending reductions or tax increases would put federal debt on an unsustainable path. Compared with the options examined here for extending the expiring tax cuts, various other options for temporarily reducing taxes or increasing government spending would provide a bigger boost to the economy per dollar of cost to the federal government.

6. CBO's models incorporate different magnitudes of the responsiveness of saving to changes in the return on saving, but CBO did not produce explicit sensitivity analyses of the effect of variations in this parameter.

Figure 1.

Ranges of Cumulative Effects of Policy Options on Employment in 2010 and 2011, Assuming Enactment in Early 2010



Source: Congressional Budget Office, *Policies to Increase Economic Growth and Employment in 2010 and 2011* (January 2010).

Note: Estimated as years of full-time-equivalent employment (40 hours of employment per week for one year) with the policy option in effect minus years of full-time-equivalent employment without the policy option. The total budgetary cost is the amount of tax revenues or budget authority over the full duration of the policies' effects unless otherwise specified.

a. Assumed spending began in March 2010, and no benefit payments would be made after July 2011.

b. Assumed to be in effect for 2010 only.

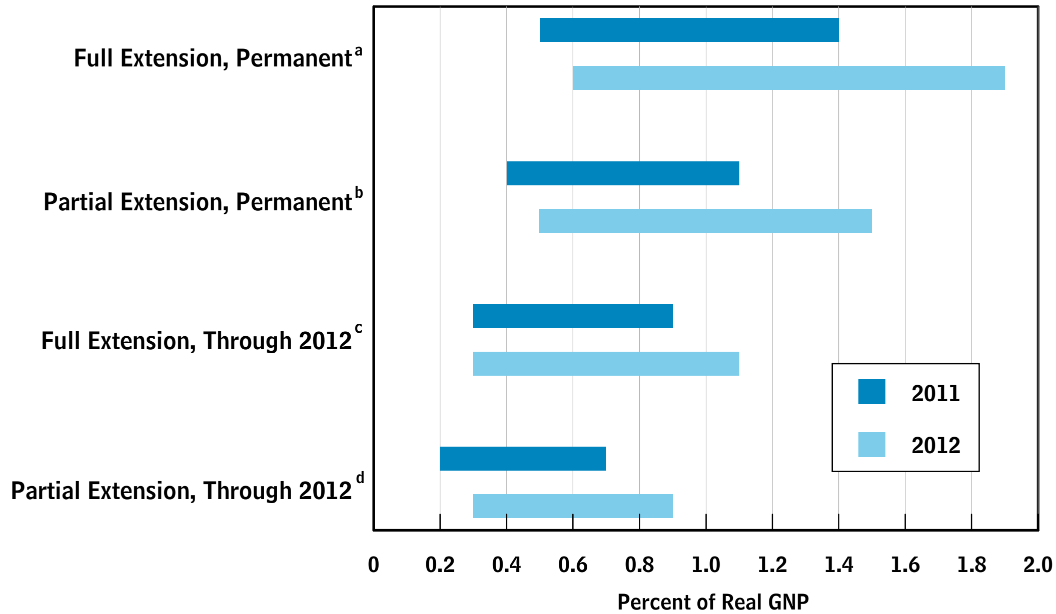
c. Assumed to be in effect for 2010 only. Initial reductions in revenues would be nearly fully offset by later increases. The policy's effects were therefore estimated per dollar of the present discounted value of the policy (discounted at businesses' cost of debt and equity) instead of per dollar of total budgetary cost.

d. Assumed budget authority was provided as of April 2010, and timing of spending from new funding would follow historical experience.

e. Assumed to extend, through 2011, the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Jobs and Growth Tax Relief Reconciliation Act of 2003 that are scheduled to expire at the end of 2010, and to provide relief from the individual alternative minimum tax by extending the higher exemption amounts that were in effect in 2009 (indexed for inflation) for 2010 and 2011.

Figure 2.

Ranges of Effects of Four Tax Policy Options on Real GNP in 2011 and 2012



Source: Congressional Budget Office.

Note: Estimated as gross national product adjusted for inflation (real GNP) with the policy option in effect relative to real GNP without the policy option.

a. This option would extend the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Jobs and Growth Tax Relief Reconciliation Act of 2003 that are scheduled to expire at the end of 2010; extend the higher exemption amounts from the individual alternative minimum tax that were in effect in 2009 (adjusted for inflation) for 2010 and subsequent years; and reinstate the estate tax—which expired completely in 2010—for 2011 and subsequent years at the rates in effect in 2009 and with the exemption amounts (adjusted for inflation) that applied in that year.

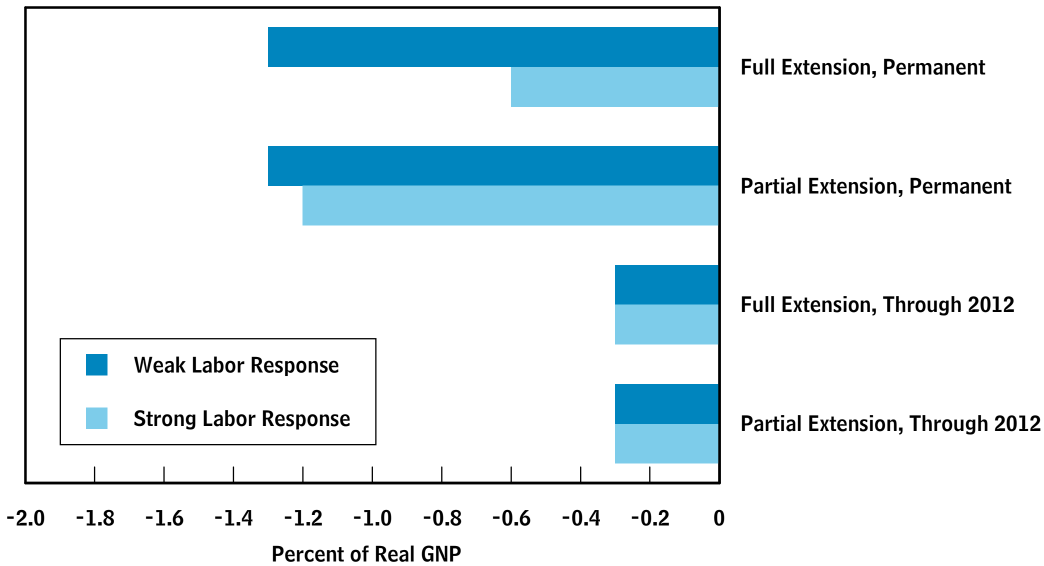
b. This option is the same as the full extension, except that certain provisions would expire that would otherwise have applied to married couples with income of $250,000 or more and single taxpayers with income of $200,000 or more. Those provisions include the lower tax rates in the top two income tax brackets, the lower 15 percent tax rates on capital gains and dividends, and the elimination of the phaseout of itemized deductions and personal exemptions.

c. This option would make the same changes as the full extension, but through 2012 rather than permanently.

d. This option would make the same changes as the partial extension, but through 2012 rather than permanently.

Figure 3.

Effects of Four Tax Policy Options on Real GNP in 2020



Source: Congressional Budget Office.

Note: Estimated as gross national product adjusted for inflation (real GNP) with the policy option in effect minus real GNP without the policy option. Based on the average of four estimates of effects from a life-cycle model, which accounts for additional policy changes needed to put fiscal policy on a sustainable path in the long run, and two estimates of effects from a "textbook" growth model, without additional policy changes. Averages are reported to the nearest tenth. Weak and strong labor responses correspond to the responsiveness of hours worked to changes in the effective marginal tax rate on labor income. For a description of the tax policy options, see the notes to Figure 2.