



Congressional Budget Office

Fiscal Policy Choices in Uncertain Times

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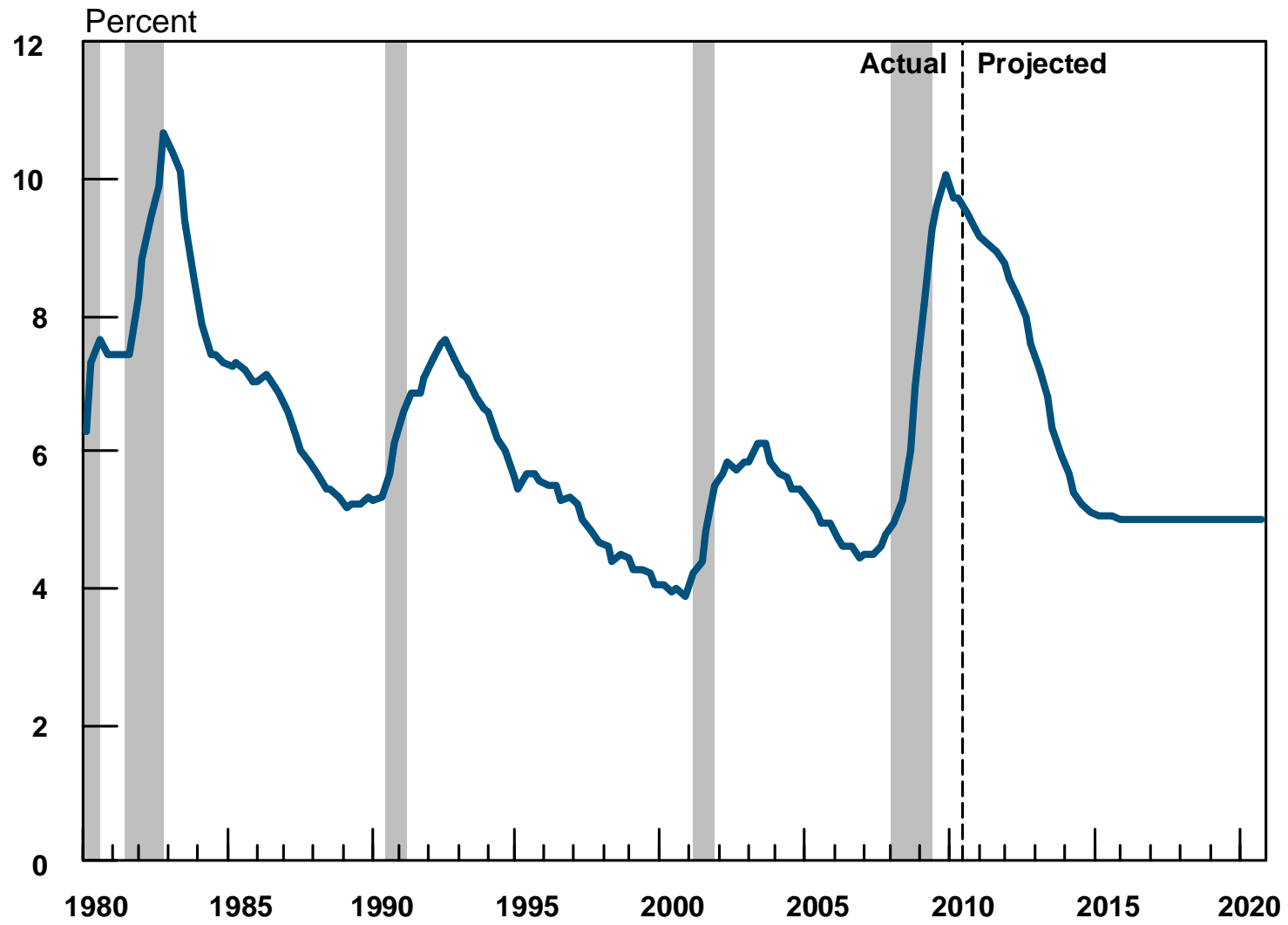


Introduction

- CBO expects that the economic recovery will proceed at a modest pace, leaving the unemployment rate above 8 percent until 2012.
- There are monetary and fiscal policy options that, if applied at a sufficient scale, would increase output and employment during the next few years (but not overnight).
- Such options would have costs as well. Expansionary fiscal policy would increase federal budget deficits and debt relative to current baseline projections. Policymakers need to address those trade-offs.

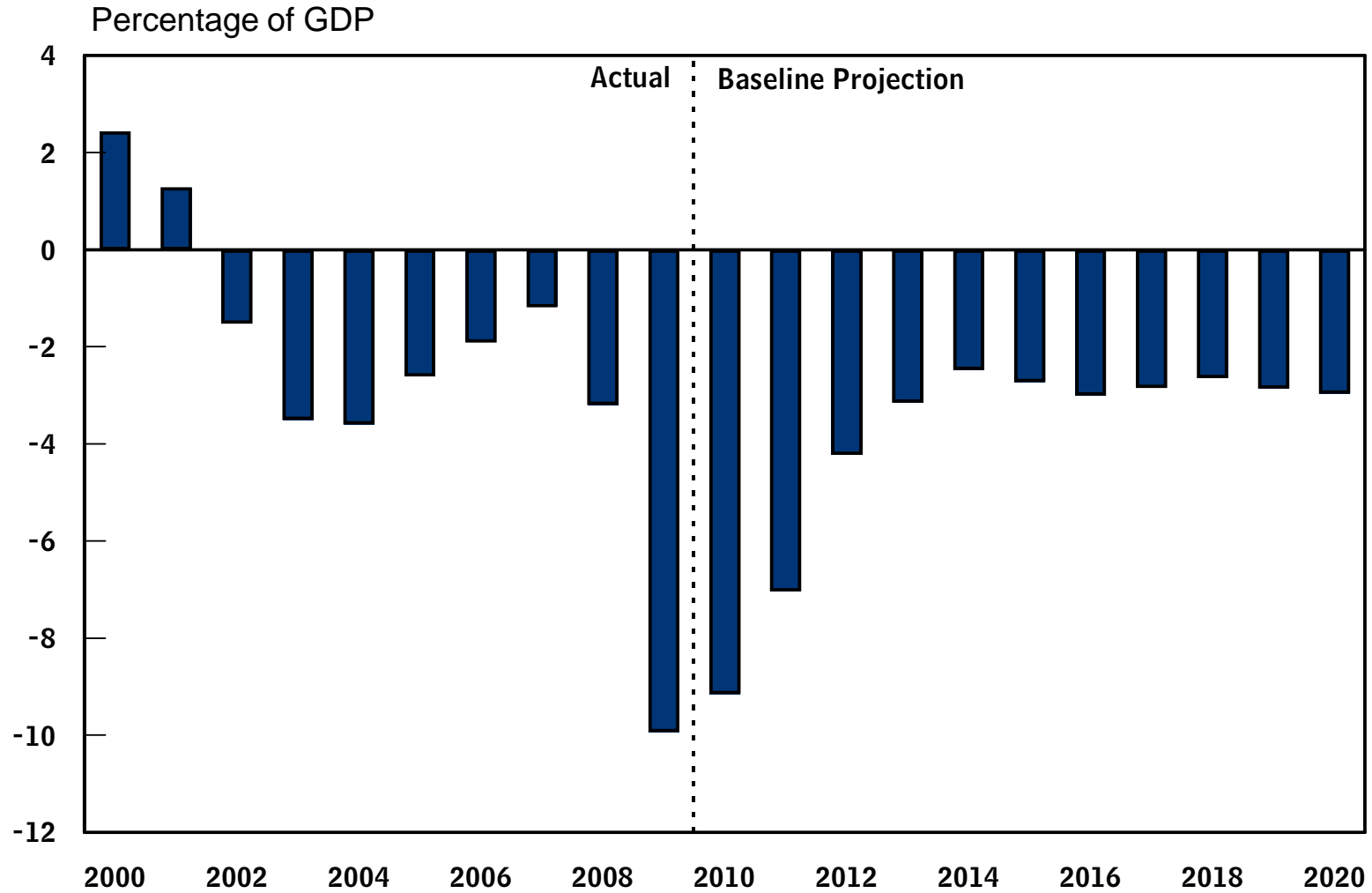


Unemployment Rate



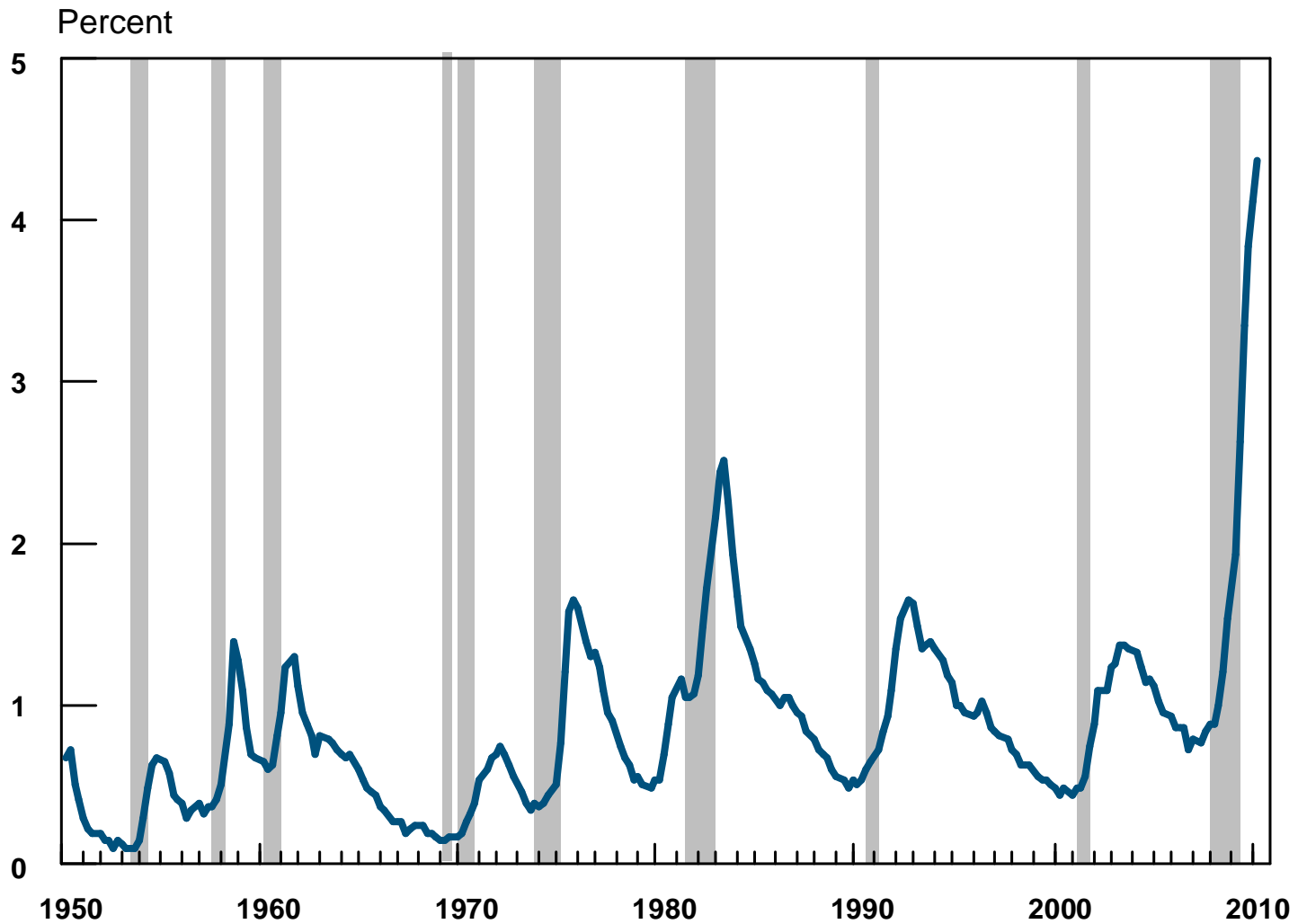


Federal Budget Deficit or Surplus





Long-Term Unemployment Rate



Note: The long-term unemployment rate is the percentage of people in the labor force who have been unemployed for longer than 26 weeks.



Monetary Policy Options

- The traditional tool of lowering the federal funds rate is not available.
- Other possible tools:
 - Purchase additional longer-term securities.
 - Ease financial conditions through communications about future policy.
 - Reduce the interest rate paid on excess reserves.
 - Raise the medium-term inflation goal.
- Use of those tools has potential costs as well as benefits.



Fiscal Policy Options

- Options include changing many different types of federal spending and taxes.
- Two key questions:
 - What sorts of fiscal policies would encourage greater economic activity and more employment?
 - How can short-term fiscal stimulus be reconciled with the imperative to put fiscal policy on a sustainable medium-term and long-term path?
- CBO has done a substantial amount of analysis on both of those questions.



What Sorts of Fiscal Policies Would Encourage More Economic Activity?

- Policies can work through several channels, such as changing:
 - Demand for goods and services directly;
 - Current and/or expected income;
 - The payoff from extra work and saving;
 - The cost of investment.
- Many policies work through more than one channel.
- Predicting the effects of particular policies is difficult, and estimates are quite uncertain.



The American Recovery and Reinvestment Act (ARRA)

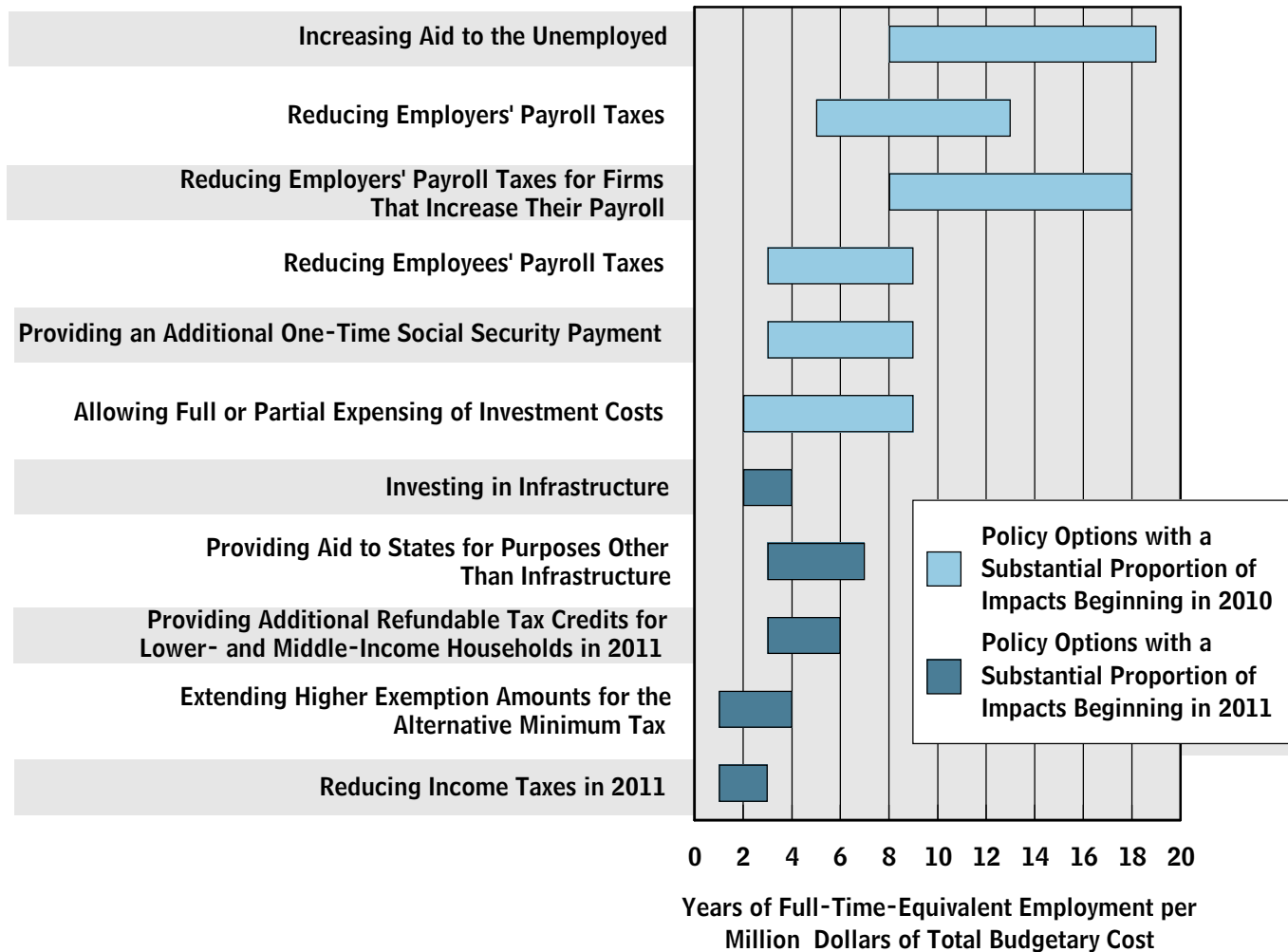
- In CBO's assessment, ARRA has boosted output and employment relative to what would have occurred otherwise. The alternative cannot be observed, so any assessment must be inferred indirectly.
- Some concerns have been expressed about CBO's approach—but we have either accounted for them or believe they have little impact under current economic circumstances:
 - People saved, rather than spent, some of the tax cuts.
 - Jobs are shifting to different sectors of the economy and regions of the country.
 - Interest rates might be pushed up by the extra borrowing.
 - Other economic activity was crowded out by the stimulus.
- Our estimates of the effects of legislation like ARRA would be different under different economic circumstances.



CBO's Analysis of Some Specific Fiscal Options

- CBO addressed policy options in its January 2010 report, “Policies for Increasing Economic Growth and Employment in 2010 and 2011.”
- CBO studied temporary policy changes. In most cases, permanent changes would generate larger short-term stimulus, but would have substantially larger medium- and long-term budget and economic costs.
- CBO estimated the “bang for the buck” of different policies; the effect on the economy would also depend on the scale of the policies. Making a significant difference in an economy with output of nearly \$15 trillion would involve a considerable budgetary cost.
- CBO analyzed illustrative policies and provided ranges of estimates to reflect uncertainty.

Cumulative Effects of Policy Options on Employment in 2010 and 2011, Range of Low to High Estimates



Note: Assumes enactment early in 2010.

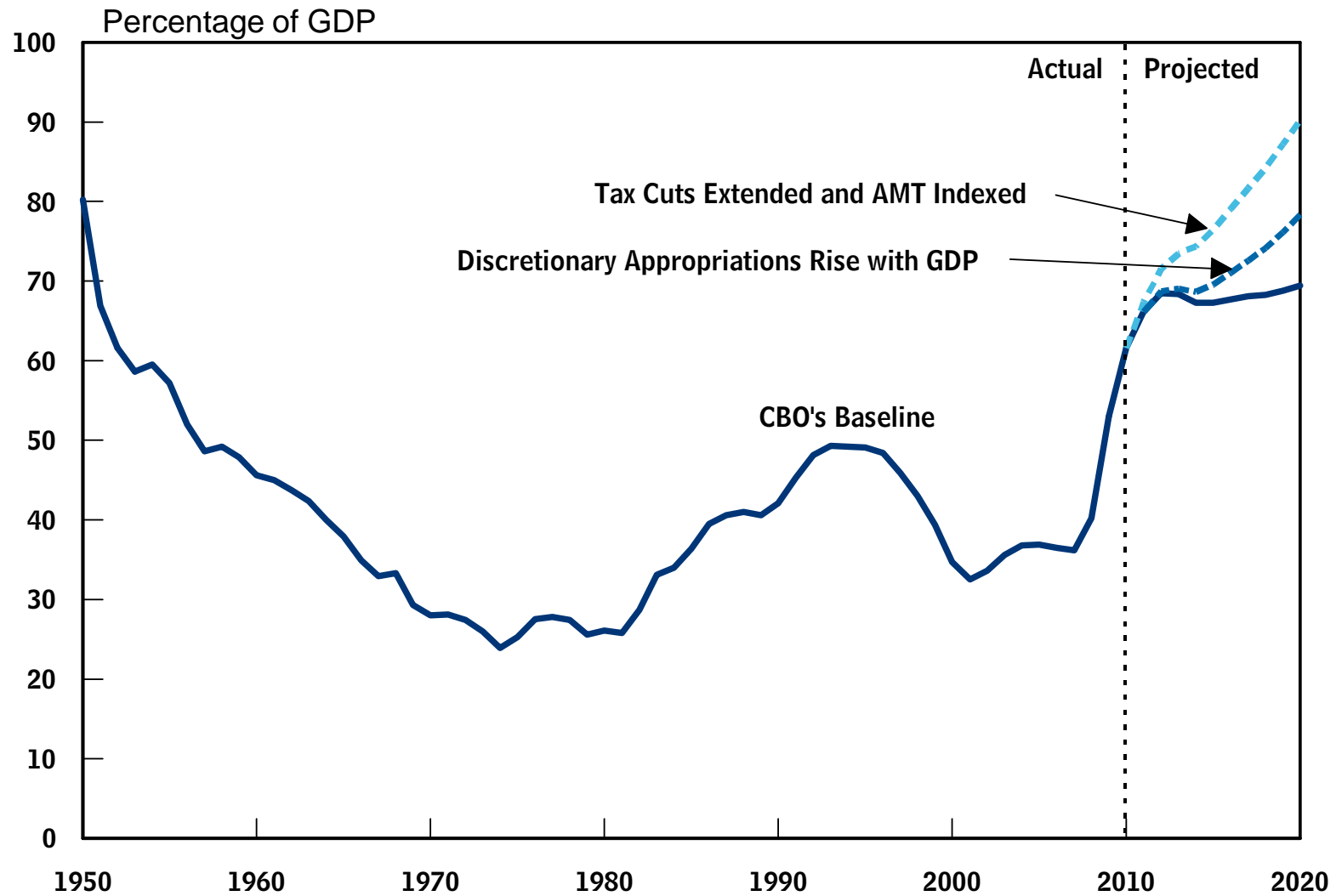


How Can Fiscal Stimulus be Reconciled with Putting Fiscal Policy on a Sustainable Path?

- 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.
- If taxes were cut permanently or spending increased permanently, that would worsen the fiscal outlook. Even if changes were temporary, the additional debt would weigh on the budget and the economy in the future.
- Achieving both stimulus and sustainability would require a combination of policies: 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.



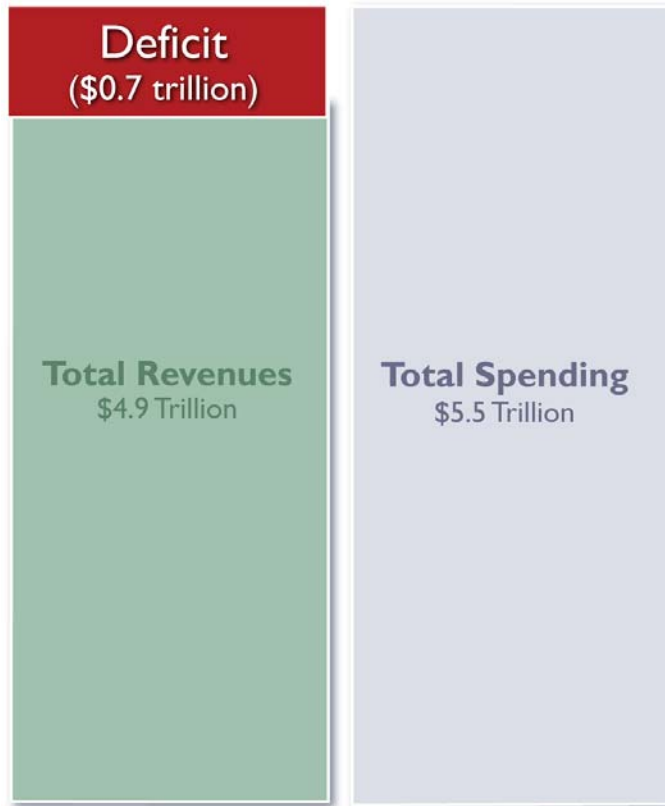
Rising Burden of Federal Debt Held by the Public





Projected Federal Revenue and Spending in 2020

Current Law (Baseline)

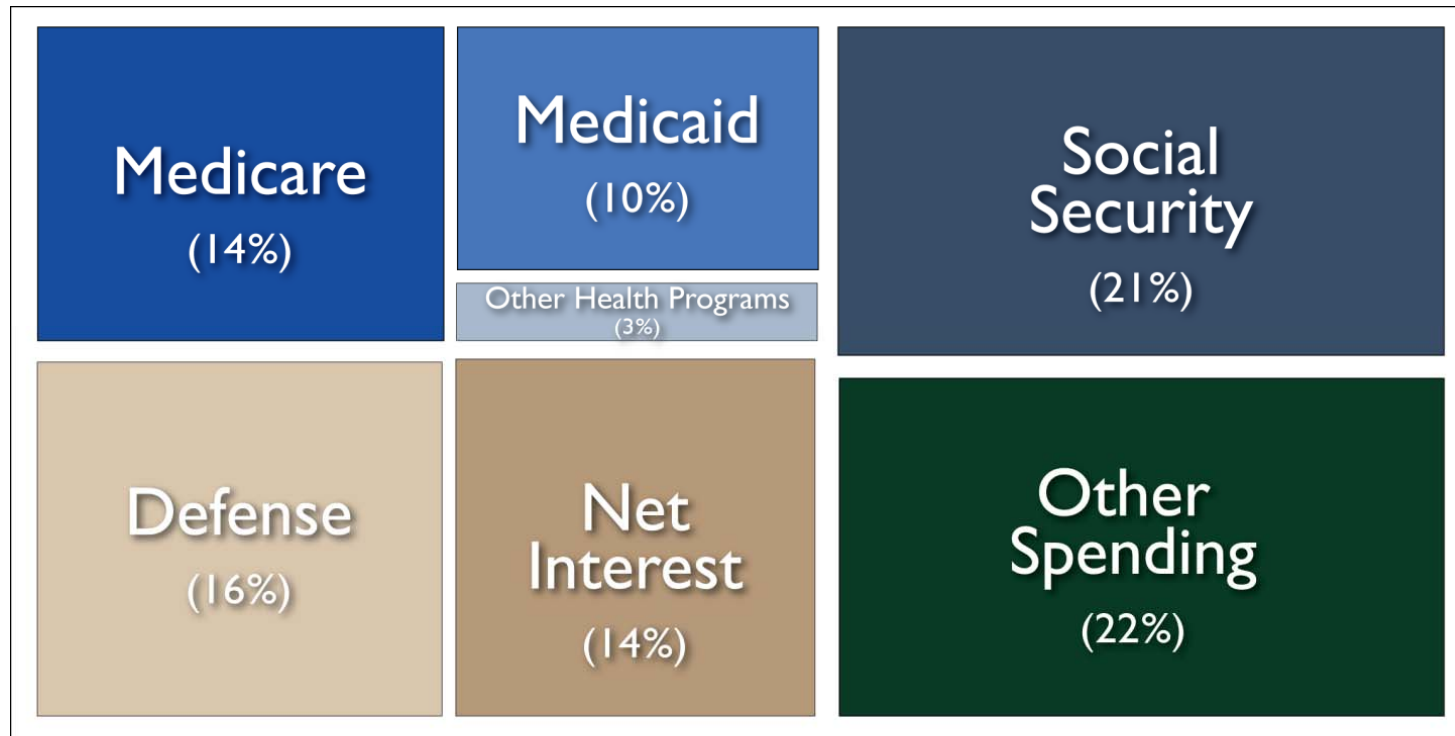


With Tax Cuts Extended and AMT Indexed





Shares of Federal Spending Projected for 2020 in CBO's August Baseline



“Other Health Programs” includes: Health insurance subsidies, exchanges, and related spending; Department of Defense Medicare-Eligible Retiree Health Care Fund (including TRICARE for Life); Children’s Health Insurance Program, and other programs.



Constructing a Combination of Policies

- If policies are enacted that widen the deficit in the near term, observers will be skeptical that the difficult actions to narrow the deficit later will be carried through. To overcome their skepticism, those later actions would probably need to be specified and enacted into law.
- Specificity about how the fiscal imbalance will be addressed would help reduce uncertainty about government policies, which probably represents a drag on current economic activity.



Conclusion

- The economic recovery will probably proceed at a modest pace—leaving total output well below its sustainable level, and the unemployment rate well above its sustainable level, for a number of years.
- In CBO’s judgment, the available monetary and fiscal tools, if applied at sufficient scale, would improve economic conditions during the next few years—though with costs and risks in the medium and long term. Policymakers need to address those trade-offs.
- To avoid worsening the medium-term and long-term imbalance between federal spending and revenue, any policies that widened budget deficits in the near term would need to be accompanied by specific policies to reduce spending or increase revenue over time.