U.S. Macro Outlook: Compromise Boosts Stimulus

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- The Obama administration and congressional Republicans have agreed to a wide range of tax cuts and benefit extensions.
- The proposals will boost growth in 2011, likely ensuring enough new jobs to measurably reduce unemployment by this time next year.
- Of the package's provisions, extending unemployment insurance benefits provides the biggest economic bang for the buck.
- The plan to continue current marginal tax rates at all income levels is prudent, given the current economic environment.
- The deal lessens pressure on the Federal Reserve to engage in additional quantitative easing.
- The federal deficit will grow this year and next, but debt markets should take this in stride as the recovery accelerates.

The fiscal policy compromise reached this week by the Obama administration and congressional Republicans will be good for the economy next year. The planned temporary tax cuts and spending increases will provide a substantial boost to growth in 2011, ensuring that the still-fragile economic recovery evolves into a self-sustaining economic expansion.

The deal's surprisingly broad scope meaningfully changes the near-term economic outlook. Real GDP growth in 2011 will be nearly 4%, approximately 1 percentage point greater than previously anticipated. Job growth will be more than twice as strong, with payrolls growing by 2.6 million. Unemployment will be more than a percentage point lower; instead of hovering near 10% through the year, it will end 2011 well below 9%.

Improving the odds of recovery

In all likelihood, the economy would have made it through next year without falling back into recession, but this compromise improves those odds significantly. The deal also reduces pressure on the Federal Reserve to engage in more aggressive monetary easing, which even supporters don't think would substantially boost growth.

There are some downsides to the deal. There will be little progress in reducing the budget deficit in the current fiscal year; the deficit appears set to come in near $1.3 trillion in fiscal 2011, equal to 9% of GDP. This is about the same as in fiscal 2010. While the impact on long-term interest rates should be limited, there is risk of a backlash by global debt investors rightly nervous about the U.S. fiscal outlook.

It is also important to note that growth will be slower in 2012 than previously anticipated, as the fiscal drag expected in 2011 is pushed off another year. The deal will also encourage businesses to pull investment forward into 2011, to the detriment of investment in 2012. The economy will end up in about the same place—as measured by GDP, jobs and unemployment—by mid-2013.

The mixture of tax and spending policies in the tax compromise could have been better designed to maximize the economic impact. The deal includes a wide range of tax cuts for households and businesses, some of which don't deliver much bang for the buck. Not unexpectedly, political factors significantly shaped the package. Nonetheless, the compromise has more pluses than negatives. All in all, this is a good deal for the U.S. economy.

The economic context

While the recovery would likely have continued without the additional fiscal stimulus, it remains fragile, and odds that it could falter are uncomfortably high. This is most evident in the job market. Job growth resumed at the start of 2010 but has been insufficient to keep the unemployment rate from drifting higher; it now seems likely to breach 10% again in the next few months.

High unemployment weighs heavily on the national mood. Sentiment surveys indicate that households and businesses feel better than they did during the depths of the Great Recession, but they are still very nervous. Confidence remains below levels experienced at the bottom in all previous recessions.

The economy thus remains vulnerable to further setbacks, and there are plenty of risks to worry about. The European debt crisis threatens to boil over, with policymakers there apparently unable to contain it. U.S. house prices are falling again and could resume the downward spiral of more foreclosures, banking system problems, and more price declines. China and other emerging economies are working hard to slow their own growth to forestall inflation and ease speculative pressures. Engineering a soft landing in these economies could prove difficult, particularly when many manage their currency exchange rates.

Prudent and effective

If the U.S. economy were to stumble, it is unclear how policymakers would respond. The Fed's efforts have come under severe criticism, and their success has been limited as is clear from the recent increase in long-term interest rates. A renewed recession would also cause the federal budget deficit to balloon, making it difficult for Congress and the administration to respond.

In this context, it is prudent for policymakers to initiate an additional fiscal stimulus. The stimulus policies of the past three years were very effective. It is no coincidence that the Great Recession ended in the summer of 2009 when the Recovery Act provided its maximum economic benefit. The stimulus was never intended to power economic growth over the long term; rather, it was designed to jump-start the recovery, and did so. The intent of additional stimulus in 2011 would be to ensure the recovery evolves into a self-sustaining expansion, with enough job growth to generate the income and consumer spending gains needed to convince businesses to hire even more. The economy is not there yet, but additional stimulus would get it there.

The compromise

The compromise between the administration and Congress is significant. Some aspects were widely anticipated and fully incorporated into Moody's Analytics' baseline outlook. This includes those tax provisions that had bipartisan support such as holding marginal tax rates unchanged for taxpayers earning less than

$250,000 annually, the annual patch to the alternative minimum tax, restoration of the estate tax, and extensions of various business tax breaks such as the tax credit for research and development.

Budget Cost of Tax and Spending Compromise

$ bil

Calendar Year	2010	2011	2012	2010-2012
Total	4	592	388	984
Republican Proposals	0	54	50	103
High-income tax cuts	0	42	38	79
Estate tax	0	12	12	24
Democratic Proposals	4	266	66	336
1-yr of unemployment benefits	4	46	0	50
1-yr of refundable credits				
CTC @ $3,000 (ARRA)	0	0	10	10
EITC MP (ARRA)	0	0	2	2
EITC 3rd tier	0	0	2	2
AOTC	0	1	6	7
Payroll tax holiday	0	120	0	120
Accelerated depreciation	0	99	47	146
Bipartisan Proposals	0	272	272	544
Middle income tax cuts	0	140	140	280
AMT	0	70	70	140
Estate tax	0	22	22	44
Business tax extenders	0	40	40	80

Sources: CBO, Tax Policy Center, Treasury Department, Moody's Analytics

Much controversy surrounded a House Republican proposal to hold tax rates unchanged for taxpayers earning more than $250,000 annually. The administration and many congressional Democrats argued the economic benefits were not worth the cost to the Treasury. Despite the heated debate, our baseline outlook assumed policymakers would extend these tax cuts, at least for a year. The compromise goes further, extending them for two years. The plan also includes a higher estate tax than that anticipated in the baseline.

The big surprises came from the administration's contributions to the deal, particularly a payroll tax reduction of 2 percentage points for all workers during 2011. This replaces the Making Working Pay tax credit, which will expire at the end of 2010. The credit was targeted to lower-income taxpayers, while the payroll tax break will include all workers and is measurably larger.

Less surprising, but not included in our baseline, were the Democrats' proposals to extend emergency unemployment insurance through 2011 and expensing of all business investment during the year. Our baseline assumed an extension of jobless benefits through March 2011 and did not include the expensing provision.

(Because the deal still requires congressional approval, it has not been formally incorporated into the Moody's Analytics December baseline forecast. If enacted it will become the new baseline in the January forecast.)

Budget costs, economic impact

Compared with current law, we estimate the compromise will cost the Treasury nearly $600 billion in 2011 and an additional $400 billion in 2012, for a total cost of $1 trillion. Compared with current policy, including the current marginal tax rates and various provisions in the Recovery Act, the cost to the Treasury is approximately $300 billion in 2011 and less than $100 billion in 2012, equal to $400 billion in total. Compared with our baseline economic outlook, the cost to the Treasury is almost $250 billion in 2011 and $125 billion in 2012, a total of $375 billion.

The deal's economic benefit is substantial. Of all its provisions, the extension of emergency unemployment insurance provides the largest economic multiplier or bang for the buck. For every dollar in additional UI, real GDP increases $1.60. 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.

Fiscal Stimulus Multipliers

As of 2010q2

	Bang for the Buck
Tax Cuts	
Refundable lump-sum tax rebate	1.22
Nonrefundable lump-sum tax rebate	1.01
Temporary tax cuts	
Child tax credit, ARRA parameters	1.38
Job tax credit	1.30
Earned income tax credit, ARRA parameters	1.24
Making Work Pay	1.17
Payroll tax holiday, workers	1.09
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.

Small-business tax concerns

In the current uncertain environment, allowing tax rates on higher-income households to rise in 2011 would be taking an unnecessary 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. 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.

Taking all the provisions of the compromise together will result in meaningfully stronger economic growth in 2011. Real GDP is now expected to expand 3.9% in 2011, compared with the previous baseline forecast of 2.8%. Payroll employment is projected to increase by 2.6 million compared with 1.3 million in the previous baseline, and the unemployment rate will average 8.7% in 2011 compared with 9.9% in the previous baseline. The implication of these numbers is that the economy will grow measurably faster than its potential, defined as the rate of growth consistent with a stable unemployment rate. As unemployment falls, confidence should improve and the recovery will evolve into a self-sustaining expansion.

Economic Impact of Tax and Spending Compromise

	2009	2010	2011	2012	2013	2014	2015
Real GDP							
Moody's Analytics Current Baseline							
2005 $ bil	12,881	13,226	13,593	14,170	14,803	15,268	15,642
% Change	-2.6	2.7	2.8	4.2	4.5	3.1	2.5
Republican Proposals							
2005 $ bil	12,881	13,226	13,583	14,168	14,804	15,271	15,645
% Change	-2.6	2.7	2.7	4.3	4.5	3.2	2.5
Democratic Proposals							
2005 $ bil	12,881	13,232	13,744	14,194	14,821	15,283	15,653
% Change	-2.6	2.7	3.9	3.3	4.4	3.1	2.4
Combined Proposals							
2005 $ bil	12,881	13,232	13,753	14,214	14,823	15,285	15,655
% Change	-2.6	2.7	3.9	3.4	4.3	3.1	2.4
Payroll Employment							
Moody's Analytics Current Baseline							
Mil	131	130	132	134	139	142	144
Change, mil	-5.9	-0.7	1.3	2.6	4.4	3.6	2.0
Republican Proposals							
Mil	131	130	131	134	139	142	144
Change, mil	-5.9	-0.7	1.2	2.7	4.4	3.7	2.0
Democratic Proposals							
Mil	131	130	133	134	139	142	144
Change, mil	-5.9	-0.6	2.6	1.4	4.4	3.6	1.9
Combined Proposals							
Mil	131	130	133	135	139	142	144
Change, mil	-5.9	-0.6	2.7	1.5	4.2	3.6	1.9
Unemployment Rate							
Moody's Analytics Current Baseline	9.3	9.7	9.8	8.7	6.9	5.9	5.7
Republican Proposals	9.3	9.7	9.9	8.7	6.9	5.8	5.7
Democratic Proposals	9.3	9.6	8.7	8.5	6.8	5.7	5.7
Combined Proposals	9.3	9.6	8.7	8.4	6.7	5.7	5.7
Federal Budget Deficit, FY							
Moody's Analytics Current Baseline							
$ bil	-1,415	-1,294	-1,080	-905	-806	-739	-692
% of GDP	-10.0	-8.9	-7.1	-5.7	-4.7	-4.2	-3.7
Republican Proposals							
$ bil	-1,415	-1,294	-1,095	-909	-807	-739	-690
% of GDP	-10.0	-8.9	-7.2	-5.7	-4.7	-4.2	-3.7
Democratic Proposals							
$ bil	-1,415	-1,298	-1,280	-920	-803	-737	-688
% of GDP	-10.0	-8.9	-8.4	-5.7	-4.7	-4.1	-3.7
Combined Proposals							
$ bil	-1,415	-1,298	-1,328	-921	-803	-736	-688
% of GDP	-10.0	-8.9	-8.7	-5.7	-4.7	-4.1	-3.7

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

Particularly opportune is that much of the economic benefit of the additional fiscal stimulus will be front-loaded into the first half of 2011, when the recovery will be most vulnerable. Incomes will receive a sizable boost from the payroll tax holiday. Growth should also benefit at the end of the year, as businesses rush to take advantage of the accelerated depreciation benefits.

Pressure off the Fed

One key implication of this more upbeat economic outlook is that it is unlikely the Federal Reserve will need to engage in additional quantitative easing. The Fed has announced its intent to purchase $600 billion in Treasury bonds through mid-2011 and will likely follow through, but with the economy growing above potential and unemployment falling, the need for more QE should quickly fade. This is desirable from the Fed's perspective given the questionable efficacy of QE and the withering criticism the central bank has received for restarting the policy. For this reason and others, Fed Chairman Bernanke has said on various occasions that he would like to see more fiscal stimulus.

Broadly speaking, the compromise ensures that fiscal policy will not become a significant headwind to growth next year. Yet even with the compromise, fiscal policy will not be a tailwind; rather it will simply be neutral with respect to economic growth. This implies that fiscal policy will become a measurable drag on growth in 2012, but by then, the economy should be in better shape to cope with it.

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 begins falling definitively, the recovery will not be on track toward a self-sustaining expansion. Moreover, while the nation's fiscal challenges are very serious, they will soon become overwhelming if the recovery does not gain traction.

In this context, it is encouraging that fiscal policymakers appear set to support the economy, or at least not allow policy to significantly drag on growth. The deal between the administration and Congress has yet to become law, but that appears likely. The nightmare of the financial panic and Great Recession will not easily fade, but policymakers’ actions this week ensure that it will.