AMERICAN ACTION
FORUM

An "Out-of-the-Box" Policy Playbook and the Bush Tax Cuts

Douglas Holtz-Eakin
President, American Action Forum

and

Allen Sinai
Chief Global Economist, Decision Economics, Inc.

November 2010

The authors thank Paul Edelstein and Chip Curran of DE for help in simulations with the Sinai-Boston (SB) Macroeconometric Model of the U.S. Economy and Cameron Smith for valuable comments. This paper is based, in part, on testimony by Doug Holtz-Eakin, "Aspects of the Sunset of EGTRRA and JGTRRA," United States Senate, Committee on Finance, July 14, 2010.

Executive Summary

Extending the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) – collectively known as the "Bush tax cuts" is not about counter-cyclical "stimulus." The U.S. economy is growing and needs stronger pro-growth policies in order to continue to do so. A permanent and full extension in the context of responsible budget policy is shown to have better macroeconomic implications than a temporary and limited extension, although leaving still for the future a permanent resolution of the U.S. budget deficits and debt problem.

The Decision Economics, Inc. SB Model of the U.S. Economy documents that ending the Bush tax cuts at this time would be a serious mistake for the economy, given the fragility of the uptrend currently in-place. Expiration of the income, capital gains, and dividend tax rate reductions and a return to pre-Bush Administration levels would move fiscal policy much tighter and could restrain the economy enough to push it back into recession.

Our analysis "stacks the deck" by using a model that embodies large short-run multiplier responses to changes in government spending. Despite this, we demonstrate that a deficit-neutral extension of the Bush tax cuts and a reduction in federal government outlays delivers improved economic performance over the 2011-2015 period. (See Summary Table 1.) A corollary is that whatever improvement in the federal budget deficit obtained from a full or partial sunset of the tax cuts would be significantly offset by the tax revenues lost after feedback from a much weaker U.S. economy.

The federal budget is on a dangerous and unsustainable course. The problem stems from federal government spending and fixing it should focus on increasing economic growth and reducing growth in outlays. Relying on near-term tax increases may even undercut efforts to rein in spending.

The distributional implications of these Acts have been poorly understood and discussions ignore channels by which tax burdens are shifted. In particular, the well-documented impacts of higher individual tax rates on entrepreneurial and small businesses will tend to shift the real burden of higher taxes toward workers and other suppliers.

The U.S. income tax system desperately needs reform. Viewing extensions of aspects of EGTRRA and JGTRRA from this perspective places a premium on extending low marginal tax rates, low and equal rates on the cash-flow returns to innovation and investment, and allowing anti-growth, tax-based subsidies to consumption to sunset.

Summary Table 1
Macroeconomic Impacts of Tax Policies
(Deviations from Baseline)

	2011	2012	2013	2014	2015
GDP Growth (percent growth rate)					
Permanent Extension, Deficit-Financed, Everyone	0.9	0.7	0.3	0.1	unch.
1-Year Extension, Under $250k/$200k Only	1.1	-0.4	-0.4	0.1	unch.
Permanent Extension, Financed With Equivalent Reductions in Government Outlays, Everyone	-0.6	0.7	0.2	0.1	unch.
Employment (thousands of jobs)					
Permanent Extension, Deficit-Financed, Everyone	598	1171	1387	1443	1393
1-Year Extension, Under $250k/$200k Only	702	629	227	201	152
Permanent Extension, Financed With Equivalent Reductions in Government Outlays, Everyone	164	663	901	968	937
Unemployment Rate (percent)					
Permanent Extension, Everyone	-0.2	-0.5	-0.5	-0.5	-0.5
1-Year Extension, Under $250k/$200k Only	-0.2	-0.3	-0.1	unch.	unch.
Permanent Extension, Financed With Equivalent Reductions in Government Outlays, Everyone	0.2	0.0	-0.1	-0.1	-0.1

*Simulations with the SB Model of the U.S. economy. Accommodative monetary policy, no change in the federal funds rate or Federal Reserve balance sheet.

I. Introduction

In the aftermath of the 2007-09 economic and financial crises, some very difficult and serious economic problems confront the United States—stagnant economic growth, sticky-high unemployment, and unsustainably high federal budget deficits and debt. These problems are largely legacies of the recent financial crisis and great recession.[1]

A U.S. economic recovery of sorts is underway, having begun in mid-2009.[2] But its upward momentum has been subpar. Downside risks going forward are considerable. And, the kind of gains that might normally occur from easier monetary policy and large fiscal stimulus have yet to appear.

Real GDP growth of about 3 percent for 2010:2 over 2009:2, the first year of the Recovery, compares with an average increase of 6 percent to 7 percent for ten comparable previous post-W.W.II episodes. However, the depth and duration of this last recession was far greater than the "mild" recessions of 1990-91 and 2001 so that the recovery to date relatively is the weakest in the post-World War II era.

Decision Economics, Inc. (DE) is forecasting average growth of 1.5 percent to 2 percent for real GDP in the second half of 2010 and 2 percent to 2.5 percent for 2011. Such growth would not produce sufficient aggregate demand to materially and significantly lower the unemployment rate, currently at 9.6 percent. Indeed, in coming months, with anywhere near normal labor force growth, the unemployment rate could move even higher while the underemployment rate stays near 17 percent or more.

This situation exists despite massively stimulative monetary and fiscal policies over the past few years. Federal Reserve monetary policy has been aggressively easy and extraordinarily accommodative, taking short-term interest rates to essentially zero on a reduction of 5.5 percentage points in the federal funds rate from late 2007 to Spring 2008 and hugely expanding its balance sheet, from $900 billion to nearly $2.5 trillion between Summer 2008 and April 2010 with an additional $600 billion planned by June 2011.

Over the course of the past several years, Administrations and Congresses have engaged in a number of counter-cyclical fiscal measures, or in the parlance of the political world, "stimulus":

---

[1]See Allen Sinai, "Macroeconomic Policy Challenges and Choices in a Time of Crises," Part I: "Responses to Economic Crisis," *Challenge,* March-April 2009, pp. 4-35 and Part II: "Fiscal Policy and Policies for 'Recovery'," *Challenge,* July-August 2009, pp. 53-93; also Allen Sinai, "U.S. Recovery, Prospects, and Legacies From the Crises," *Economic Outlook and Issues*, May 6, 2010, Decision Economics, Inc. and *Aspenia,* Aspen Institute-Italy, May 2010, pp. 122-43.

[2]The National Bureau of Economic Research (NBER) has dated the beginning of the Recovery as June 2009 (2009:2). Measures traditionally used by the NBER had been signaling an economic recovery except for nonfarm payroll employment which declined, ex-Census workers, in most months after June 2009 and when positive, was generally less than 100,000. 100,000-or-so nonfarm payroll jobs is at least what is needed to bring down the unemployment rate on normal gains in the workforce.

checks to households and temporary increases in federal government outlays (the Economic Stimulus Act of 2008), the gargantuan stimulus bill in 2009 (American Recovery and Reinvestment Act), "cash for clunkers" (the Car Allowance Rebate System) and tax credits for homebuyers (the Federal Housing Tax Credit). The total fiscal stimulus has been well over $1 trillion, split 70 percent-or-so in federal government outlays and 30 percent-or-so in temporary tax reductions.

But despite this, an anemic economic recovery and continuing rising unemployment have occurred, perhaps described as "deficits" in growth and in jobs—there is another deficit, that of the federal budget, ranging from about 10 percent of GDP in FY2009 to near 9 percent in FY2010, record highs, and approximately double the deficit-to-GDP ratios of the late 1980s. There is no doubt that the fiscal stimulus of $1 trillion has been a main contributor. And, on current policies and prospects, the ratio of gross public debt-to-GDP seems headed to over 100 percent within the next few years.[3] For various reasons, although a number of other debt-ridden countries have begun to do so, the U.S. has made no real attempt to deal with its outsized deficits and debt and the potential for a U.S. sovereign debt crisis.

This is indeed a discouraging scorecard on the current state-of-play of U.S. economic performance, especially given how much macroeconomic policy stimulus has been put into place. It can justifiably be said that the policies used have failed to deal with the three legacy "deficits" of the crises—growth, jobs, and the federal budget—at least on current results.

The question now is what is next for macroeconomic policy? Macroeconomic policies must be designed to stimulate growth and new jobs and, depending on how costly, also be set to reduce the cyclical and structural federal budget deficits.

This time the policy challenge for the United States is one never before faced—how to grow the economy faster, increase jobs, reduce unemployment and reduce the budget deficit—all at the same time. The fiscal policies used in 2008 and 2009-10 represented a kind of "sequencing" approach, reliance on government outlay-centric fiscal stimulus to first restore and revive the economy and then dealing with cyclical and structural federal budget deficits and debt later. They do not appear to have worked for the problems at-hand. The evidence is pretty conclusive. Real economic growth is running at a 1.5 percent to 2 percent rate and is expected to be only 2 percent to 2.5 percent in 2011. The potential rate of growth of the economy is probably about 2.5 percent, well below what it used to be. The current "output gap," as estimated by DE, stands at 6

[3]See A. Sinai (2010), p. 17.

percent to 6.5 percent of potential real GDP, a record-high. The unemployment rate was 9.6 percent in October 2010 and compares with an unemployment rate of 9.8 percent one year ago, 9.5 percent in June 2009 when the economic recovery began, and 7.7 percent in January 2009 (one month prior to passage of the American Recovery and Reinvestment Act). Inflation, as measured by the Consumption Price Deflator, is currently 1.4 percent year-over-year and ex-food and energy is 1.2 percent. In June 2009, the corresponding figures were 1.3 percent. Nonfarm payroll jobs, ex-Census, have averaged 69,000 per month year-to-date. Since June 2009, the net change in nonfarm payroll jobs, ex-Census workers, has been 691,000, or only 46,000 per month. And, finally, the federal budget deficit for FY2010 was $1.35 trillion, or 9.2 percent of estimated GDP; in 2009, the corresponding figures were $1.417 trillion or about 10 percent of GDP—all record highs by huge margins.

Given these results, going forward a new "out-of-the-box" approach seems to be called for that no longer relies upon huge deficit-financed federal government outlays that fail to stimulate the economy and the private sector in response, and then the design and implementation of a bona fide deficit reduction plan. Instead, a budget deficit-neutral pro-growth program that combines federal government outlay restraint with growth-stimulating tax policy should be considered.

This paper takes a look at the current situation and assesses macroeconomic policy choices in the context of the tasks at-hand—increasing economic growth, generating more jobs and a lower unemployment rate, and reducing the federal budget deficit and growth of debt relative to GDP. The "out-of-the-box" policy framework is looking at all three problems simultaneously rather than thinking about macroeconomic policy choices in the "sequencing" framework generally used in most macroeconomic policy deliberations and implementation. The paper also revisits tax policy as the principal means of dealing with the triple deficits of growth, jobs and the federal budget, suggesting a tax-centric, rather than outlay-centric, focus. It includes quantitative estimates of the effects from macroeconomic policies that address the problems of too little growth, too high unemployment, and too high federal budget deficits and debt.

The organization of the paper is as follows. Section II outlines the need for pro-growth fiscal policies that would not worsen the federal budget deficit and growing debt burden of the United States. Too much federal government spending is noted as the main problem in a pessimistic federal budget outlook. Section III discusses the drivers of growth that provide the focus for policy changes, notably fixed investment and exports. Sections IV, V and VI outline pro-growth tax policies with a discussion of fiscal multipliers, centering on pro-growth balanced-budget

stimulus in the context of the triple deficits in growth, jobs, and unsustainably high federal budget deficits and debt. Using tax policy as stimulus with cutbacks in the growth of federal government spending as a source of funding is suggested. Section VII examines the effects on the economy from extending the so-called "Bush Tax Cuts," rather than letting them expire, assessed using the SB Model of the U.S. Economy. Sections VIII and IX discuss related issues and provide some concluding perspectives.

II. Post-Crises Performance, the Need for Pro-Growth Policies, and the Problem of Deficits and Debt

The pace of the U.S. economic upturn remains muted. Real GDP rose only 3 percent during the first year of recovery, the third weakest for the first year out of eleven such episodes since World War II. On a real final sales basis, real GDP-less inventories, the pickup has been only 1.1 percent, far below the 3 percent to 4 percent average across all previous post-W.W. II recoveries. And, given the recession that occurred, the longest and deepest in 70 years, the upturn might be seen as more a "dead cat" bounce than a sustained and sustainable recovery and expansion.

In many ways this is not surprising. As documented in Rogoff and Reinhart (2009) and Reinhart and Reinhart (2010), economic expansions in the aftermath of severe financial crises tend to be more modest and drawn out than recoveries from a conventional recession.[4] Under current policies, this appears to be the prospect for the United States.

To break with historical patterns and their verdict, it is imperative that macroeconomic policies be designed to generate the maximum possible pace of economic growth. More rapid growth is essential to the labor market futures of the millions of Americans without work. More rapid growth will be essential to minimizing the difficulty of slowing the explosion of federal debt to a sustainable pace. More rapid growth will generate the resources needed to meet our obligation to provide a standard-of-living for the next generation that exceeds the one this generation inherited.

Consider the federal government budget. Over the next ten years, according to Congressional Budget Office (CBO) analysis of the President's Budgetary Proposals for Fiscal Year 2011, the deficit will never fall below $700 billion. Ten years from now, in 2020, the deficit will be 5.6

[4]See Carmen M. Reinhart and Kenneth Rogoff, *This Time Is Different: Eight Centuries of Financial Folly,* Princeton University Press, September 2009; also the recent Reinhart-Reinhart paper, "After the Fall," presented at the Federal Reserve Bank of Kansas City Symposium, *Macroeconomic Policy Challenges for the Next Decade,* Jackson Hole, Wyoming, August 2010.

percent of GDP, roughly $1.3 trillion, of which over $900 billion will be devoted to servicing debt on previous borrowing.[5]

The dire long-term federal budget outlook is not the result of a revenue shortfall. The CBO projects that over the next decade the economy will fully recover, back to full employment, and that revenues in 2020 will be 19.6 percent of GDP—over $300 billion more than the historic norm of 18 percent. The problem is government outlays. By 2020, federal government outlays are expected to be 25.2 percent of GDP—about $1.2 trillion higher than the 20 percent that has been business as usual in the postwar era.

As a result of the embedded outlay increases as estimated by the CBO, in 2020 public debt will have more than doubled from its 2008 level to 90 percent of GDP and will still be on an upward trajectory. Gross public debt as a percent of GDP could be nearly 115 percent. Traditionally, a debt-to-GDP ratio of 90 percent-or-more has been associated with risk of a sovereign debt crisis. Indeed, there are warning signs even now that the U.S. debt situation is eating into the U.S. condition, its prospect, and standard-of-living.

As outlined in recent reports, the credit rating agency Moody's looks at the fraction of federal revenues dedicated to paying interest as one key metric for retaining a triple-A rating. On this dimension, large creditworthy sovereign borrowers are expected to devote less than 10 percent of their revenues to paying interest. Moody's grants the U.S. extra wiggle room based on its judgment that the U.S. has a strong ability to repair its condition after a negative shock. The upshot—on this dimension, no downgrade until interest equals 14 percent of revenues. This is small comfort as the CBO analysis shows 2015 as the year when the federal government crosses the threshold with interest as a percent of revenues reaching 14.8 percent, then 20.1 percent in 2020.

The federal government needs to reduce outlay growth, control public debt, and to do so dramatically. No sensible long-run growth strategy can be built around greater federal government spending until this happens. Long-run growth stimulus for the economy therefore needs to center on the private sector with more thought going to the federal government as a

[5]Very likely, under current prospects and policies actual federal budget deficits will be much greater than indicated in the CBO calculations. Assumptions of the law under which these projections are made must incorporate a return to full employment in the outyears. This raises revenues in the projections and reduces federal government outlays. Another example is the assumption that the Alternative Minimum Tax (AMT) will extend to many more families than now. This generates estimated revenues that may not be realized because of what has been called the "AMT patch," a yearly postponing of the AMT extension by the Congress. Realistic federal budget deficit projections, for example, Sinai (2010, p. 17, Table 10) and others, provide much higher estimates for the deficits.

partner and provider of incentives and inducements to private sector growth rather than as the primary driver, or engine, of growth.

III. Drivers of Economic Growth

Policies focused on more rapid economic growth should be the most important priority. In light of this, it is useful to reflect on four basic sources of growth; households, businesses, governments, and international partners.

Consumers are caught in a bind of badly damaged balance sheets, deteriorated household financial conditions, and weak growth in real disposable income. As is well-known, the bursting of the U.S. housing and stock market price bubbles left many households in financial distress with mortgage credit and residential real estate values below loan amounts for many families, vastly diminished household net worth, an extreme deterioration of household financial conditions, and immense damage to consumer sentiment. At one point, household net worth had fallen $15 trillion, year-over-year, from its peak, which on DE estimates took down aggregate consumption by nearly $900 billion.[6] Over the past year, household net worth has risen some from its trough, but still stands $11 trillion below its 2007 level. Because of recurring joblessness, there has been hardly any growth of real disposable income, just 0.3 percent since 2009:2, quantitatively the most significant determinant of aggregate consumer spending.

It would be surprising, or perhaps even undesirable, therefore, for households to be a robust source of final demand growth. Instead, just the opposite might be the case. For the longer-run, increased saving, debt reduction, and the rebuilding of household balance sheets is a positive. But, in the short-term, consumption spending will be less unless other sources of funds become available, as was previously the case from funds generated, or borrowed, on robust household balance sheets.

The best course for households is to repair badly damaged balance sheets as quickly as possible. Policies that support the ability of households to do so while otherwise maintaining consumption patterns would be beneficial. One-time "stimulus" in the form of tax cuts, or transfers, contributes little to this. Permanent tax reductions for the household sector, beyond mere extension of the Bush tax cuts, would support the process of building a solid financial foundation for stronger growth in consumer spending.

In the other direction, the prospect of a tax increase would force households to undertake even more balance sheet repair in anticipation of higher taxes and lower growth of future

[6]Sinai and Edelstein, pp. 15-17.

income. For example, if the so-called Bush tax cuts are allowed to sunset, the Congressional Budget Office ("CBO") projects a reduction in GDP growth of about 1.4 percent in 2011. Empirical results obtained with the SB Model of the U.S. Economy indicate over a 1 percentage point decline in real economic growth in 2011 and 0.7 percentage points in 2012 on a sunset; more, as much as 1.5 percentage points next year, if there is no AMT "patch." The stock market surely would correct and decline if such a tax increase were to occur. Consumer sentiment might tumble as well.

With households repairing and reliquefying balance sheets, this leaves business sector spending and net exports as potential points of focus for badly-needed pro-growth fiscal policies. The federal and state and local government sectors can hardly engineer an outlay-driven push, given their financial condition. Policies toward international trade are not the focus of this paper. But it should be noted that the United States has been on the sidelines of international trade agreements for far too long. Pro-trade, pro-export polices should be part of a bipartisan approach to raising economic growth and increasing jobs.

IV. Tax Policies to Promote and Achieve More Rapid Economic Growth

To be effective, tax policy should support not only household consumption but also household saving and household balance sheets to lay the foundation for permanent gains. Now well-known is that a large swath of U.S. economic activity is organized in sole proprietorships, partnerships, and other pass-thru entities that are directly affected by the individual income tax. Tax policy can also support business expansion in the form of spending for innovation, workers and their compensation, repairs, and new plant and equipment.

The Joint Committee on Taxation projects that $1 trillion in business income will be reported on individual income tax returns in 2011. Notably, of that $1 trillion, nearly one-half, $470 billion, will be reported on returns that will be subject to the top two rates of 36 percent and 39.6 percent if the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) – collectively known as the "Bush tax cuts" – are allowed to sunset.[7]

This has direct effects on employment. According to the Small Business Administration, there are almost 120 million private sector workers in the United States. Slightly more than half those workers, 60 million, work for small business. About two-thirds of the nation's small

[7]The Joint Committee on Taxation does not take into account the impact on small, non-publicly-traded "C" corporations. There are several million of these entities, which likely will be adversely affected by marginal tax rate increases on ordinary and capital income.

business workers are employed by businesses with 20 to 500 employees. According to Gallup Survey data conducted for the National Federation of Independent Business (NFIB), half the small business owners in this group fall into the potential 36 percent and 39.6 percent tax brackets of 2011. This means there is a pool of more than 20 million workers in those firms directly affected by looming prospective higher marginal income tax rates. This is likely a conservative estimate as it ignores flow-through entities with one-to-19 workers. The future of EGTRRA and JGTRRA thus is central to business sector spending as a key driver of growth.

One consideration is uncertainty over the future course of the tax law itself. It has been widely noted that uncertainty about the policy environment may be contributing to businesses hoarding cash instead of spending. A particularly vivid expression of this appears in the June 2010 NFIB Small Business Economic Trends:

> "*But Congress continues to pass and propose legislation that increases the cost of running a business and creates huge uncertainty about future costs. The small business sector of the economy is improving, there is a pulse, but it is weak. Washington is applying leeches and performing blood-letting as a cure*."[8]

A temporary extension of EGTRRA and JGTRRA will merely defer resolving the uncertainty over the tax policy outlook. In the other direction, a permanent extension would set expectations, permit long-range business planning, and support long-term economic growth. At the same time, there would be immediate economic benefits as businesses stepped up spending to match an improved long-run outlook.

In thinking about the permanent extension of EGTRRA and JGTRRA, it is useful to recognize that not all the components are equal from an economic growth perspective. Innovation, investment, and saving decisions are directly affected by the structure of marginal income tax rates, the taxation of returns to equity investment in the form of dividends and capital gains, and provisions for capital cost recovery (e.g., Section 179 expensing). In contrast, provisions for refundable tax credits, marriage penalty relief, and other targeted incentives make no contribution to growth incentives.

Indeed, the impact of phase-outs of refundable credits may have even more perverse growth consequences. As noted in Brill and Holtz-Eakin (2010), some provisions, exacerbated by the phase-outs in the recently-passed Patient Protection and Affordable Care Act (PPACA),

---

[8]See http://www.nfib.com/Portals/0/PDF/sbet/sbet201006.pdf.

contribute to higher marginal tax rates.[9] The effect is to raise to as high as 41 percent the effective marginal income tax rate on some lower-income U.S. workers. This has implications for the ability of families to rise from the ranks of the poor, or to ascend toward the upper end of the middle class. This growth and mobility goes to the heart of the American dream and is a pressing issue at this time.

In addition, a broad spectrum of provisions creates more complexity that is costly for small businesses and individuals. In some other cases, they effectively raise marginal tax rates. House Ways and Means GOP tax staff calculate that the net effect of these non-rate provisions is to raise effective marginal income tax rates by two percentage points.

A picture emerges in which preserving permanently certain aspects of the tax code—low marginal income tax rates, low taxation of dividends and capital gains, and some others—is central to a successful economic growth strategy. In contrast, making permanent other provisions in EGTRRA and JGTRRA is less central to economic growth imperatives—they are present for other policy objectives—and may even diminish incentives for jobs and growth. In light of the clear need for more rapid economic growth and increased jobs, an issue facing policymakers is resolving the tradeoffs among multiple policy objectives and instruments.

What is at stake? If the top income tax rates are permitted to rise, marginal tax on the return to small business will rise to roughly 42 percent (39.6 percent plus the roughly two percent from the hidden marginal rates. Note that this excludes the 3.8 percent tax in the PPACA). This will diminish incentives to expand payrolls and establishment size, as well as tilt the playing field in favor of corporate investments that will face a 35 percent tax rate. Less dramatic effects but in the same direction are posed by higher tax rates on capital gains. However, the most striking blow on growth-oriented investment possibilities would be the increase in taxation of equity returns in the form of dividends from 15 percent to a top effective rate of 42 percent.

V. EGTRRA, JGTRRA, and Fiscal Multipliers

Many will choose to frame the extension of EGTRRA and JGTRRA as an issue of "stimulus." This is deeply misplaced. The focus should be on an economic growth strategy that gives strong incentives for sustainable gains in household consumption, business spending, and net exports. In that setting, expectations and uncertainty regarding future tax rates are part of the

---

[9]Alex Brill and Douglas Holtz-Eakin, "Another Obama Tax Hike." *Wall Street Journal,* February 4, 2010. See also Douglas Holtz-Eakin and Cameron Smith, "Labor Markets and Health Care Reform," 2010. http://americanactionforum.org/files/LaborMktsHCRAAF5-27-10_0.pdf.

calculus of current business hiring and investment decisions. It is a false dichotomy to suggest that long-term tax incentives are unrelated to current economic activity.

One can expect, nevertheless, a discussion of tax versus spending "multipliers" in the debate over fiscal policy stimulus. For some, there will be an argument for more federal government spending, or at least not to cut spending growth, on the grounds that the negative multiplier effects will outweigh the benefits of stimulative tax policy. These arguments are often couched within the context of a formal economic model, such as that used by Administration officials Christina Romer and Jared Bernstein to support the ARRA. It is important to note that in basic Keynesian models, spending multipliers are larger than tax multipliers. As a result, adopting these models presumes this result. But the models often are simple and static and do not fully capture lags in effects, nor the full array of the determinants of consumption, nor effects on financial asset prices, saving, and the economy. Recent empirical work on both sides of the budget suggest that tax impacts are larger—perhaps much larger—than spending impacts especially over the longer-run.[10]

In Sinai (2009, Part II), various federal government spending and tax multipliers are presented using the SB Macroeconometric Model of the U.S. Economy. The fiscal multipliers assume accommodative monetary policy, a standard procedure in these kinds of exercises, and are presented for a number of categories of federal government outlays and tax changes. The results indicate a sharp and large short-run impact for federal government purchases but then a fading over time and later a move into negative territory. Tax multipliers for permanent tax reductions, particularly for individuals, show smaller and slower initial impacts on real GDP but a higher and longer-lasting positive path than for government purchases multipliers. Permanent tax cuts are shown to have permanently longer effects than temporary tax reductions, suggesting that for lasting improvement in growth, permanent reductions in taxes are to be preferred. Balanced budget changes of increased federal government outlays and permanent reductions in taxes indicate a longer-lived net positive effect on the economy from the tax reductions than from the increased spending, especially for employment.[11]

Now, because this business cycle episode is so different from previous ones, it may well be that the government spending and outlay multipliers shown in Sinai (2009) could be overstated. Numerous impediments to the current fiscal stimulus exist that did not in most of the sample

---

[10]Greg Mankiw discusses these issues. Also Sinai (2009, Part II).
See http://nationalaffairs.com/publications/detail/crisis-economics.

[11]Sinai (2009: Part II, Figures 2, 3, 7 and especially 11).

period history, e.g., the extraordinary "deleveraging" and "reliquefication" going on in the household sector; severely deteriorated household finances; disintermediation, rather than intermediation, in the financial system for both bank and nonbank financial intermediaries; and a "jobless" recovery that is producing a different set of reactions by consumers and businesses than embodied in the data and averages of history.

For these reasons, model-based predictions for the impacts of alternative budget policies this time must be treated with the proverbial "grain of salt." It is equally important to be skeptical of the use of these same models to show that any fiscal stimulus has "worked," or is "working."

VI. Federal Fiscal Perspectives

The fiscal outlook for the federal government is dire. In these circumstances, some argue that it is imperative to permit EGTRRA and JGTRRA to sunset, thereby reducing federal budget deficits. However, as noted above, the fundamental budgetary problem is excessive spending, not a paucity of tax receipts. Receipts are projected to rise to 19.6 percent of GDP—above historic norms—only to be offset by spending at 25 percent of GDP. Too much federal government spending is the fiscal problem.

Thus, focusing on the sunsets in EGTRRA and JGTRRA as the top budgetary priority is misplaced as a matter of priorities. It is true that sunsets of the Acts would reduce deficits in the near and long-term and perhaps could ameliorate any emerging financial market distress from the budgetary outlook. But, unfortunately, any such fiscal progress would be quickly unwound due to rising federal spending. When that happens, would Congress be tempted simply to raise taxes again? If so, then a sunset to the Acts may actually undercut incentives to rein in excessive federal spending.

Just as tax policy must be focused on growth, fiscal policy generally should be oriented to a private sector pro-growth philosophy. To grow more quickly, the Nation must be willing to forego current consumption to finance innovation, additional education and skills, and investment in plant and equipment. To the extent that budget deficits are driven by consumption subsidies, trimming the growth in these programs will shift the balance of expenditures toward greater growth and prosperity.

Lastly, it is important to gauge budgetary impacts inclusive of growth feedbacks. Based on the CBO January estimates, the budget impact of extending both the EGTRRA and JGTRRA for 2011 is roughly $115 billion; over the next 10 years it is more than $2.5 trillion. Based on the macroeconometric model simulations of extending the Acts permanently as reported below, the

positive growth effects reduce the deficit impact by roughly 10 percent for a one-year extension, meaning the dynamic deficit effect is roughly $100 billion. In contrast, the feedbacks from growth reduce the deficit impact by 22 percent over six years, thus lowering the deficit impact to $1.95 trillion.

VII. Large-Scale Macroeconometric Model Results—Quantitative Evidence on Near-Term and Longer-Run Effects of Tax Policies

The American Action Forum (AAF) paired with Decision Economics, Inc. (DE) to produce large-scale structural macroeconometric model simulations of several fiscal policy options for the short- and longer-term. In doing so, a large-scale structural macroeconometric model was employed where short-run federal government spending multipliers generally are larger than short-run tax multipliers. But, this is not so longer-term. Also, in the model, the SB Model, forward-looking expectations related to federal budget deficits have significant effects, particularly on financial market asset prices and then the transmission of those asset prices into the economy through various channels and mechanisms.[12]

Three scenarios involving the Bush tax cuts were examined:

1. Extend EGTRRA and JGTRRA permanently, deficit-financed with accommodative monetary policy;
2. Extend EGTRRA and JGTRRA for one year, but only for those earning less than $250,000 (families) or $200,000 (individuals), deficit-financed with accommodative monetary policy;
3. Extend EGTRRA and JGTRRA permanently, financed by reductions in federal government purchases and accommodative monetary policy.

Table 1 shows the results.

[12]See Sinai (1992, pp. 5-17; 43-46; p. 48; and the Appendix) for a discussion and examples of how forward-looking financial market expectations affect current asset prices, altering the responses of the economy to various exogenous policy shocks compared to a situation without such expectations and financial market asset price feedback.

Table 1
Extending the Bush Tax Cuts: Permanent, Temporary Deficit-Financed, Permanently Financed with Equivalent Reductions in Federal Government Outlays*
(Deviations from Baseline)

	2011	2012	2013	2014	2015
GDP Growth (percent growth rate)					
Permanent Extension, Deficit-Financed, Everyone	0.9	0.7	0.3	0.1	unch.
1-Year Extension, Under $250k/$200k Only	1.1	-0.4	-0.4	0.1	unch.
Permanent Extension, Financed With Equivalent Reductions in Government Outlays, Everyone	-0.6	0.7	0.2	0.1	unch.
Employment (thousands of jobs)					
Permanent Extension, Deficit-Financed, Everyone	598	1171	1387	1443	1393
1-Year Extension, Under $250k/$200k Only	702	629	227	201	152
Permanent Extension, Financed With Equivalent Reductions in Government Outlays, Everyone	164	663	901	968	937
Unemployment Rate (percent)					
Permanent Extension, Everyone	-0.2	-0.5	-0.5	-0.5	-0.5
1-Year Extension, Under $250k/$200k Only	-0.2	-0.3	-0.1	unch.	unch.
Permanent Extension, Financed With Equivalent Reductions in Government Outlays, Everyone	0.2	0.0	-0.1	-0.1	-0.1
Labor Force (thousands)					
Permanent Extension, Deficit-Financed, Everyone	125	368	530	687	858
1-Year Extension, Under $250k/$200k Only	148	271	174	219	226
Permanent Extension, Financed With Equivalent Reductions in Government Outlays, Everyone	-111	-15	160	321	485
Gross Private Domestic Investment (billions of 2000 dollars)					
Permanent Extension, Deficit-Financed, Everyone	4.5	19.5	31.2	36.5	36.7
1-Year Extension, Under $250k/$200k Only	5.3	15.4	11.2	8.8	7.3
Permanent Extension, Financed With Equivalent Reductions in Government Outlays, Everyone	-2.0	4.8	17.5	25.0	26.8
Household (NIPA) Saving (billions of dollars)					
Permanent Extension, Deficit-Financed, Everyone	240.1	132.1	103.2	76.7	44.9
1-Year Extension, Under $250k/$200k Only	304.1	-100.9	-22.3	-35.1	-40.0
Permanent Extension, Financed With Equivalent Reductions in Government Outlays, Everyone	115.4	43.5	4.3	-16.6	-41.9
Household (NIPA) Saving Rate (percent)					
Permanent Extension, Deficit-Financed, Everyone	1.9	0.9	0.6	0.4	0.1
1-Year Extension, Under $250k/$200k Only	2.4	-0.9	-0.2	-0.3	-0.3
Permanent Extension, Financed With Equivalent Reductions in Government Outlays, Everyone	0.9	0.3	unch.	-0.2	-0.3

*Source: Decision Economics, Inc. (DE). Simulations with the SB Model. Accommodative monetary policy, no change in the federal funds rate or Federal Reserve balance sheet.

Beginning with real GDP, a deficit-financed permanent extension of the Bush tax cuts for all families and individuals in all tax brackets is estimated to raise economic growth by just under one percentage point in the first year and 0.7 percentage points in 2012. In contrast, a limited one-year extension has a greater, 1.1 percentage point, impact in 2011, but then a reversal of real economic growth in 2012-13, to -0.4 and -0.1 percentage points, respectively, as the temporary stimulus is withdrawn.

These differences are mirrored in labor market outcomes as the limited and temporary extension for middle and lower income families and individuals creates fewer jobs over five years against the Baseline (382,000 per year versus 1,198,000) and reduces unemployment by

less (-0.1 percentage points per annum against -0.4 percentage points) compared with the Baseline. Not surprisingly, fewer discouraged workers return to the labor force, 208,000 a year rather than under a permanent deficit-financed extension, where the labor force is larger by an average of 514,000 workers per year.

When the tax cuts are offset by equal reductions in federal government purchases, the initial impacts generally are negative. This is because initially the federal purchases multipliers are larger than the tax multipliers. But, subsequently in this simulation, the path for economic activity turns positive relative to the Baseline, reflecting the longer-run positive effects of tax reductions against the fading effects of the fiscal restraint. This shows particularly in jobs and unemployment where an average of 727,000 jobs are created relative to the Baseline over the five years and the unemployment rate is down slightly. Under a one-year extension for middle and lower income families, 382,000 jobs per annum are created relative to the Baseline. If the one-year extension included higher-income families, net jobs creation would be higher but still below the results shown when the tax cuts are financed by reductions in federal government purchases.

Finally, there are important differences in the key drivers for economic growth. Under a temporary extension, business fixed investment is $5.3 billion greater in the first year and $15.4 billion higher in the second year. In the first year of a permanent extension, there is only $4.5 billion of additional investment but the effects are much stronger in the second and subsequent years. Over the longer-run, a permanent extension about triples the average per annum impact compared with the temporary one. Also, under the permanent extension, household saving (NIPA basis) rises $304.1 billion in the first year (in 2000 dollars) and the personal savings (NIPA) rate jumps 2.4 percentage points. But, subsequently, under a temporary extension the savings rate reverses. It stays higher permanently if a permanent extension of the Bush tax cuts is deficit-financed.

These results provide evidence that the permanent extension of EGTRRA and JGTRRA would permit households to save and repair household balance sheets, then to permanently raise consumption in the future. In contrast, in a temporary extension, there is only a short-run improvement in the overall saving rate and less carryover into consumption going forward.

Forward-looking expectations are reflected in weaker initial results on economic activity and jobs under permanent extension of the Bush tax cuts for everyone compared with the one-year temporary extension for just middle- and lower-income families.

The cost of a deficit-financed permanent extension is quite high, over five years a static loss of $2.2 trillion in tax receipts and, ex-post, an increased federal budget deficit of about $365 billion a year relative to the Baseline. *From the expectation of permanently higher federal budget deficits, current long-term U.S. Treasury interest rates rise sharply, and quickly, by 40 to 60 basis points, then feedback through other asset prices like stock prices and the dollar exchange rate to limit the increases in real economic growth*. In contrast, the temporary "stimulus" costs only $427 billion and has essentially no expectations effects on long-term interest rates and no negative effect on economic activity near-term. The higher long-term interest rates that occur on expected permanently higher federal budget deficits raise the discount rate on expected future earnings and prevent stock prices from rising as much as would be the case if there had been no permanent deficit financing. The effects on interest rates and the stock market produce weaker results in the first and second years of the permanent extension than in the temporary extension. Opposite effects can be seen on a balanced-budget financing of the permanent extension done with reduced federal government purchases. The effects on economic activity, jobs, the unemployment rate, gross private domestic investment, and household savings are all more positive, although not so much as in the deficit-financed extension. *These results are sufficient to give pause to implementing a purely deficit-financed permanent extension of EGTRRA and JGTRRA.*

VIII. Related Issues

Growth vs. Stimulus

The focus on the problems confronting the U.S. needs to be growth as opposed to stimulus. Objectives of fiscal policies should be to promote long-run maximum growth, full employment and price stability, the same objectives that exist for the Federal Reserve in monetary policymaking. The same objectives for both monetary and fiscal policy would help to encourage a coordinated approach in setting policies to achieve what is necessary for the U.S. economy.

Stimulus implies short- or long-run programs that would raise economic activity and move the U.S. economy to a better situation. But, the focus on stimulus takes away from the ultimate longer-run objectives of the U.S. economy to which probably should be added budget stability, along with price stability, as an objective of fiscal policy.

When viewed in this light, issues relating to the long-run effects of policies taken today and planned for tomorrow would move to the forefront and stimulate thinking, perhaps policies themselves, that would serve both short- and long-run purposes.

Monetary-Fiscal Policy Mix

Looking either at monetary policy or fiscal policy alone as a means for achieving policymaking objectives, in isolation, analytically, and in terms of practice, can lead to policies that could be deficient, operating at cross purposes; pro-cyclical rather than countercyclical.

Forward-looking monetary policy can hardly disregard the potential impacts on asset prices, the economy, jobs, unemployment and inflation of federal government fiscal actions. For example, a tax-centric pro-growth deficit-neutral fiscal policy combination, if put forward and analyzed, would suggest to the Federal Reserve "Easier Money" rather than "Tighter Money," taking account of the fiscal policy prospect. Not knowing the fiscal policy algorithm or confronting "Loose Fiscal Policy" would lead to monetary policy prescriptions that might be counterproductive.

It is well-known that in an open economy with flexible exchange rates an "Easy Money"-"Loose Fiscal" policy mix leads to more economic growth, more jobs, but also more inflation that ultimately can produce a boom, with price bubbles in asset markets, that later would prove to be counterproductive. Currency volatility is an implication with all that it implies for trade flows, and repercussions for the countries that are significant trading partners.

"Easy Money"-"Tight Fiscal" monetary-fiscal policy combinations suggest interest-sensitive activities as favored, along with a lower currency, that can shift the composition of demands away from the public sector to the private sector and particularly to business fixed investment and net exports, two drivers of growth in the current situation. Without an integrated policy viewpoint and implicit or explicit coordination of stabilization policies, it is hard to think that optimal results can be achieved with macroeconomic policies nor timed appropriately.

Comprehensive Tax Reform

The U.S. tax system is in need of fundamental reform. Existing corporation and individual income taxes are rife with phase-outs, carve-outs, and other distortions. The corporate profits tax is high relative to many other such countries who are competitors of the U.S. and the U.S. remains unique in its anti-competitive taxing of worldwide income for multinationals. The individual income tax provides subsidies for the excessive consumption of debt-financed housing, gold-plated health insurance, and myriad other activities. Its combination of refundable tax credits and phase-outs creates strikingly high effective marginal tax rates on working Americans of modest means. Income taxation in the United States is in desperate need of fundamental reform. We will simply assume that this need is widely recognized and focus on how the sunsets of EGTRRA and IGTRRA fit into the movement to a more efficient tax code.

The most important thing to recognize is that tax reform should be built around the objective of permanently lowering marginal tax rates while broadening the tax base to ensure sufficient revenues. Any plan that does not seek to permanently maintain or lower marginal tax rates is moving in the wrong direction. Specifically, permitting the EGTRRA and JGTRRA to sunset for those making more than $250,000 (families) or $200,000 (individuals) would raise substantial more revenues without broadening the base.

How should the base be broadened? A premium should be placed on base-broadeners that reduce subsidies to consumption. A consumption-oriented tax places burdens on the amount that individuals take out of the economy. In contrast, an income tax places the tax burden on the amount of labor hours, effort, skills, capital, and risk-taking that individuals supply. The former is ethically superior. A consumption-based tax would also equalize the effective tax on all forms of investment—investment in technologies, human skills, and innovation would compete equally with physical capital. Investment in small and large business would be on a level field.

The same insight applies to extensions of temporary, tax-based policies enacted as part of the American Reinvestment and Recovery Act. To the extent that permitting provisions to sunset lowers effective marginal tax rates (especially including those on lower-income workers) and reduces specific subsidies to consumption, it will be consistent with using tax policy to enhance the growth prospects for the U.S. economy.

A final point is that tax reform does not mean adding whole new tax systems on top of a broken U.S. income tax system. Some recent discussion has featured adding a value added tax (VAT) to the U.S. system, in part because of the putative efficiency of a VAT. But the efficiency effects of a free-standing VAT are quite different from the effects of a VAT that would be added onto the existing tax system. Indeed, because deadweight losses rise non-linearly, the total distortion associated with an add-on VAT would be worse than the sum of the two systems. In the context of the sunsets of the Acts, the key is to undertake effective reform of the existing system before contemplating new tax systems.

IX. Some Conclusions and Perspectives

The U.S. economy is languishing, some 18 months into its 11th post-W.W.II economic recovery, at near 2 percent growth significantly less than potential, exhibiting a huge gap of over 6 percent between potential and actual output, an unemployment rate easily four percentage points above full employment unemployment, underemployment rate that is the highest in

measured history, and federal budget deficits and debt that are more than double previous record-highs. This, indeed, is a sorry performance record.

The legacies of the financial and economic crises of 2007-09—far too little economic growth, far too much slack and overcapacity, far too high an unemployment and underemployment rate and unacceptably high federal budget deficits and debt—present a macroeconomic policy challenge never before seen. The task is how to increase economic growth, generate net new jobs, reduce the unemployment rate, and lower the federal budget deficit and debt relative to GDP—all at the same time.

At this point, the ability of the federal government to increase government outlays for almost any reason is severely constrained. Identifying spending reductions in both discretionary and mandatory categories needs to be the first priority for fiscal stability and with consolidation focus the outlay side of the budget. Overhead savings, headcount reduction, limitations on spending growth through caps set by inflation, tax subsidies, and organizational redundancies and inefficiencies all should be targets. The central government apparatus is an anachronism, white elephant, an albatross, and should be overhauled. The federal budget deficit prospect is dire under current economic prospects if no changes in policy are made going forward.

But it is in the tax policy arena where a new thrust for pro-growth fiscal stimulus can be found, in one case the "Bush tax cuts," set to expire at the end of this year. Results obtained with the SB Model of the U.S. Economy suggest that expiration of the Bush tax cuts at this time would be a serious mistake, given the fragility of the economic uptrend currently in-place. Expiration of the income, capital gains, and dividend tax cuts put into place nearly a decade ago and a return to pre-Bush levels would move fiscal policy much tighter and could restrain the economy enough to push it back into recession. Model simulations show that expiration of the Bush tax cuts would be responsible for a loss of at least one percentage point of real economic growth in 2011 and 0.7 percentage points in 2012, high enough, depending on other factors, to raise the odds of a potential "Double-Dip" recession considerably. Whatever improvement in the federal budget deficit would be obtained from the tax revenues gained would be significantly offset by the tax revenues lost after feedback from a much weaker U.S. economy.

Tax-centric pro-growth deficit-neutral fiscal policy programs combining funds released through spending restraint and redeployed into the economy through gains in growth-stimulating tax reductions were found to provide a significant lift to the U.S. economy, a lower unemployment rate *and* a reduction, ex-post, in the federal budget deficit and in gross public debt relative to GDP.

In the SB Model, although the negative impact multipliers from reductions in federal government purchases exceed the initial gains in the economy from permanent reductions in income taxes, the intermediate- to longer-term effects show net gains in the path of real GDP relative to a Baseline, and in jobs creation. Interest rates decline on expectations of lower federal budget deficits, helping the stock market, in turn stimulating the economy through numerous channels, involving increased wealth and household savings flows, through to improved consumption, business fixed investment, new enterprise and jobs creation. A balanced budget financing of permanent income tax reductions financed by reduced federal government spending is net-stimulative and moves the performance of the economy simultaneously in the direction of increased growth, a lower unemployment rate, reductions in the federal budget deficit, and a lower ratio of debt-to-GDP.

The tax system can be a powerful means for dealing with today's macroeconomic problems of growth, jobs, budget deficits and federal debt. An "out-of-the-box" policy combination and mix approach should be utilized going forward. Numerous possible "solutions" to the problems at-hand for the U.S. are possible. Focus on policies, both fiscal and monetary, separately or together, that will raise economic growth, generate jobs, reduce unemployment, and lower the federal budget deficit – all at the same time – need to be explored and made part of the macroeconomic policy discussion that is bound to occur in coming months.

References

Blinder, Alan and Mark Zandi, "How the Great Recession Was Brought to an End," Moody's Analytics.com, July 2010.

Brill, Alex and Douglas Holtz-Eakin, "Another Obama Tax Hike." Wall Street Journal, February 4, 2010. See also, Douglas Holtz-Eakin and Cameron Smith, "Labor Markets and Health Care Reform, 2010.

Holtz-Eakin, Douglas, Testimony presented to the United States Senate, Committee on Finance, "Aspects of the Sunset of EGTRRA and JGTRRA," July 14, 2010.

Reinhart, Carmen M. and Kenneth Rogoff, "This Time Is Different: Eight Centuries of Financial Folly," Princeton University Press, September 2009.

Reinhart, Carmen M. and Vincent Reinhart, "After the Fall," Macroeconomic Policy Challenges for the Next Decade, Federal Reserve Bank of Kansas City Symposium, Jackson Hole, Wyoming, August 2010.

Romer, Christina D. and David H. Romer, "The Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks," American Economic Review, June 2010, pp. 763-801.

Sinai, Allen, "Macroeconomic Policy Challenges and Choices in a Time of Crises," Challenge, Part I: "Responses to Economic Crisis," March-April 2009, pp. 4-35 and Part II: "Fiscal Policy and Policies for "Recovery," July-August 2009, pp. 53-93.

Sinai, Allen, "Financial and Real Business Cycles." Eastern Economic Journal, Presidential Address, Winter 1992, pp. 1-54.

Sinai, Allen, "U.S. Recovery, Prospects, and Legacies From the Crises," Economic Outlook and Issues, May 6, 2010, Decision Economics, Inc.; also in Aspenia, Aspen Institute-Italy, May 2010, pp. 122-143.

Sinai, Allen and Paul Edelstein, "Macroeconomic Policies and the 'Great Recession' of 2007-09: Retrospect and Prospect," presented at the 2010 ASSA Annual Meetings IBEFA Session, "The Andrew Brimmer Policy Forum: National Economic and Financial Polices of President Barack Obama, Evaluations One Year on the Trail," Atlanta, Georgia, January 3, 2010.

Taylor, John, "Empirically Evaluating Economic Policy in Real Time," NBER Inaugural Martin Feldstein Lecture, July 2009.

Taylor, John, "Perspectives on the U.S. Economy: Fiscal Policy Issues," Testimony before the Committee on the Budget U.S. House of Representatives, July 1, 2010.