A FISCAL OBSTACLE COURSE, NOT A CLIFF

Economic impacts of expiring tax cuts and impending spending cuts, and policy recommendations

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The focus of economic policy debate has turned to what has been called the "fiscal cliff"—the impact of tax cuts set to expire and spending cuts due to take effect at the end of calendar year 2012. For various reasons, "fiscal cliff" is a poor metaphor, most importantly because there is no single cliff but rather a series of separable tax and spending provisions that can be extended or ended. We thus propose a different metaphor—the fiscal obstacle course—with the obstacles in question standing in the way of rapid economic recovery and lower unemployment. After we identify the obstacles, we can examine which are particularly daunting to overcome and which are easy to surmount.

Given that the fiscal policy debate over the past few years has been misdirected, focusing too much on projected medium- and long-term deficits and too little on the immediate problem of joblessness, this concern about the fiscal obstacle course marks a return to sensible discussion. If all of the tax increases and spending cuts currently set to kick in at the beginning of next year actually take effect, the economy will surely reenter a recession. It would be wise for policymakers to keep this from happening.

However, avoiding a contractionary turn in fiscal policy (i.e., a decrease in the growth of economic output resulting from targeting smaller budget deficits through policy

changes) in the near term does not require that Congress mechanically extend all of the tax cuts set to expire and prevent all of the scheduled spending decreases from taking effect. Instead, the fiscal obstacle course just ahead should be taken as an opportunity to reorient policy to provide the maximum boost to the economy and jobs in coming years, and as a chance to discard those expiring provisions that are neither supportive of jobs in the near term nor economically useful in the long run. Continuing certain provisions, notably the upper-income Bush-era tax cuts, would have negligible economic benefit but would sharply worsen the fiscal outlook over the next decade if continued indefinitely.[1] Expiration of other policies, especially those passed to provide near-term fiscal support to the still-weak economy, poses significant risks to economic growth. Lastly, it is important to note that any fiscal headwinds that arise from allowing temporary tax cuts to expire on schedule could be overcome at a fraction of the cost with more cost-effective, targeted fiscal support.

This paper provides information for policymakers looking to spur economic growth, create jobs, and bring down the high unemployment rate, all without committing themselves to measures that are particularly harmful to achieving long-run fiscal sustainability. It estimates the impact on employment and gross domestic product (GDP) of each policy in question, thereby allowing policymakers to make informed "à la carte" choices for successfully navigating the fiscal obstacle course, and it recommends a policy response that would provide the maximum boost to near-term economic growth while also locking in policies that would contribute to long-term fiscal sustainability as the economy returns to full capacity. This paper finds that:

- The single largest projected economic drag posed by federal fiscal policy is the expiration of the remaining temporary *ad hoc* stimulus measures (extensions of emergency unemployment compensation, payroll tax cuts, and other measures described in more detail

in this paper), which is projected to slow real GDP growth by 1.4 percentage points and lower nonfarm payroll employment by over 1.6 million jobs by the end of 2013, relative to current budget policies.

- The second-largest headwind comes from spending cuts scheduled under the 2011 debt ceiling deal, which threaten to shave 1.1 percentage points from GDP growth and reduce employment by more than 1.3 million jobs by the end of 2013, relative to prior law. Over a third of this drag comes from discretionary spending caps largely ignored in the fiscal cliff discussion.

- Continuing all of the Bush-era tax cuts would boost GDP growth by just 0.5 percentage points and nonfarm payroll employment by 613,000 jobs by the end of 2013, relative to current law.

- Extending just the upper-income Bush tax cuts would boost GDP growth by 0.1 percentage point, increasing nonfarm payroll employment in 2013 by only 102,000 jobs—far less than one-tenth the impact of continuing the temporary *ad hoc* stimulus measures.

- Extending the 10 percent tax bracket as well as the enhanced Earned Income Tax Credit (EITC) and Child Tax Credit (CTC) that were part of the Bush tax cuts, and also extending the American Recovery and Reinvestment Act (ARRA) expansions of refundable tax credits, would boost GDP growth by 0.3 percentage points and support roughly 380,000 jobs.

- Extending just the Bush-era tax cuts and other annually renewed budget policies (patching the alternative minimum tax, preventing Medicare reimbursement cuts, and continuing expiring business tax cuts) would boost growth by just 1.2 percentage points by the end of 2013, relative to current law, and growth in the first half of the year would likely be insufficient to avoid an economic contraction.

- A better-targeted fiscal stimulus package that let some of these less-effective tax cuts expire could produce the same economic boost for $318 billion (43.4 per-

cent) less than the $732 billion cost of clearing all of the obstacles outlined in this paper.

The American economy today

The U.S. economy remains depressed, having never fully recovered in the three years since the Great Recession officially ended in June 2009. The key barrier to full recovery is the same as it has always been: insufficient spending by households, businesses, and governments to create enough jobs to bring down the unemployment rate and restore higher levels of labor force participation. The primary source of this demand shortfall is not particularly mysterious: the huge decline in household wealth and residential construction investment caused by the bursting housing bubble. During the peak effectiveness of ARRA at the end of 2009 and the beginning of 2010, government spending, particularly federal spending, provided an effective counterweight (if not sufficient to spur full recovery) to the reduced spending by households and businesses (Bivens 2011a).

However, since the recovery officially began, and after the fade-out of ARRA's economic boost, the public sector (particularly state and local governments) has been a key source of demand weakness. For example, once the substantial aid to state and local governments provided for in ARRA ran out, employment there fell significantly, with 449,000 jobs lost in the state and local government sectors since June 2010.

This pullback in fiscal support has coincided not only with falling public-sector employment, but also with a marked slowdown in the pace of overall recovery. Growth in real GDP in 2011 averaged just 2.0 percent, down from 2.4 percent in 2010 and 2.7 percent in the last six months of 2009 (the first half-year of official recovery).[2] Growth has further decelerated to a 1.8 percent annualized rate in the first half of 2012.

The recent slowdown in the pace of recovery has occurred even as the Federal Reserve has kept short-term interest rates at extremely low levels. Absent a radical—though merited—break with monetary policy precedent (e.g., announcing a higher target inflation rate or nominal GDP targeting), the pace of recovery going forward will surely be determined almost exclusively by the stance of fiscal policy. Current law for 2013 is for fiscal policy to be strongly contractionary—so much so that the Congressional Budget Office (CBO) has indicated that the current law budget baseline will cause the U.S. economy to reenter recession in 2013 if it is not changed (CBO 2012a; CBO 2012b).

Given perpetual (and often misplaced) concern that federal budget deficits are failing to decline rapidly enough, it is important to be clear about the precise danger the fiscal obstacle course presents: It is simply that the budget deficit would shrink *too quickly*—that is, public debt would *stop rising fast enough*—to maintain economic growth, let alone an adequate pace of growth to lower the unemployment rate. Deficits falling too quickly may sound like a counterintuitive problem given the very loud chorus of voices decrying rising deficits in recent years, but expanded budget deficits—increased both by "automatic stabilizers" (such as increased unemployment benefits when joblessness rises) and deliberate fiscal stimulus—have provided a huge boost to economic growth since mid-2009. As the European experience has demonstrated, rapid fiscal contraction can push a struggling economy into a double-dip recession, whereas in the United States today's largely cyclical federal budget deficit has kept us out of one (Bivens 2011b; DeLong and Summers 2012).

The implied pivot back toward promoting job creation and away from the undue obsession with deficit reduction that is inherent in declaring that the fiscal obstacle course must be dismantled soon has actually put policymakers on a more productive course than they were on since the beginning of 2011, when federal fiscal policy moved toward austerity.

Overview of impending fiscal obstacles

The tax cuts set to expire and the spending cuts set to go into effect at the end of 2012—the fiscal obstacle course—can be grouped into six broad categories. This section describes them and estimates the budget impact of maintaining the tax cuts and avoiding the spending cuts. Note that the *budget impact* and the *economic impact* are not necessarily the same. Some policies that are expensive in budgetary terms have only modest economic impacts (for example, the 2001 and 2003 tax cuts aimed at high-income households are costly but do not have much economic impact). Conversely, other policies with small budgetary costs have big economic impacts (for example, extended unemployment insurance benefits). The next section goes into these differences in detail.

The ad hoc fiscal stimulus supports following ARRA

The 2009 Recovery Act arrested a sharp economic contraction and jumpstarted growth (raising employment by 3–4 million jobs), but was insufficient by itself to restore full employment (CBO 2012c). Since the enactment of ARRA, Congress has passed a number of much smaller stimulus measures, a handful of which are still in effect.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (hereafter the Tax Relief Act of 2010) continued through December 31, 2012, the ARRA expansions of the refundable Earned Income Tax Credit (EITC), the Child Tax Credit (CTC), and the American Opportunity Tax Credit, or AOTC (for college tuition). Maintaining these refundable tax credit expansions, as proposed in the president's budget request for fiscal year 2013, would cost $276 billion over fiscal 2013–2022 (CBO 2012d). The act also replaced ARRA's Making Work Pay refundable tax credit with a larger, less-well-targeted 2 percentage-point employee-side Social Security payroll tax cut for 2011 (Fieldhouse 2011) and

continued the Emergency Unemployment Compensation (EUC) program for 2011.

Without this extra fiscal support as ARRA began winding down, the economy would have contracted in the first quarter of 2011 instead of growing, though annualized growth was still an anemic 0.1 percent. Both the payroll tax cut and the EUC program were subsequently extended through the end of 2012 by the Middle Class Tax Relief and Job Creation Act of 2012 (hereafter the Tax Relief Act of 2012), although the extension lowered the maximum duration of unemployment insurance (UI) in states with particularly high jobless rates from 99 weeks to 73, despite sustained high levels of long-term unemployment.[3] Collectively, expiration of these relatively well-targeted policies poses the largest economic drag relative to current fiscal policies. The payroll tax cut is projected to cost $114 billion in 2012 and the EUC program another $38 billion, but there is little talk of extending them into 2013.[4]

The Budget Control Act

While many components of the fiscal obstacle course reflect the expiration of temporary tax and spending provisions, one of the largest economic drags stems from spending cuts scheduled by the Budget Control Act of 2011 (BCA), i.e., last summer's debt ceiling deal. The first phase of the BCA cut primary spending (excluding net interest) by $761 billion over fiscal 2012–2021, $756 billion of which stemmed from cutting and capping discretionary spending (CBO 2011a).[5] The second phase created a Joint Select Committee on Deficit Reduction (JSC), tasked with finding between $1.2 trillion and $1.5 trillion in savings (including net interest), and established an automatic "sequestration" spending cut mechanism that would be triggered if the JSC failed to reach bipartisan agreement. The JSC indeed failed to reach such an agreement, and $972 billion of primary spending cuts—roughly split between defense spending and non-exempt domestic programs over fiscal 2013–2021—are slated to be allocated by the Office of Management and

Budget (OMB) and ordered into effect by the president on January 2, 2013.[6]

Bush-era tax cuts

The most expensive provisions of the Tax Relief Act of 2010 were those extending all of the Bush-era individual income tax cuts for two years, notably individual income marginal tax rate reductions, marriage penalty relief, expansion of refundable tax credits, the lowered 15 percent preferential rate on long-term capital gains and qualified dividends, and the elimination of the personal exemption phaseout (PEP) and the limitation on itemized deductions. The 2010 act also reinstated estate and gift taxes—which the Bush tax cuts had temporarily eliminated for 2010—but at levels that taxed large inheritances even more lightly than the already low rates of 2009. These temporary tax policies are all slated to expire after December 31, 2012. These components of the fiscal obstacle course have the largest *budgetary* cost but by no means pose the largest economic drag if they are allowed to expire. If the AMT patch were continued, extending the Bush-era tax cuts and maintaining the current estate and gift tax parameters would reduce revenue by $3.7 trillion over fiscal 2013–2022 (CBO 2012b).[7] Further, the Bush-era tax cuts are separable into subgroups that are roughly targeted to lower-, middle-, and upper-income households.

Alternative minimum tax

Congress routinely "patches" the alternative minimum tax (AMT) by upwardly adjusting its exemptions and brackets for inflation, as the AMT parameters are not automatically indexed for inflation (unlike the individual income tax parameters).[8] The Tax Relief Act of 2010 patched the AMT for 2011 but the patch has since lapsed, although Congress commonly patches the AMT retroactively. If Congress does not patch the AMT for 2012, the adverse impact on disposable income will largely occur in calendar year 2013 as households file their 2012 returns (CBO 2012a). The cost of patching the AMT grows

exponentially, not just through "bracket creep"—nominal incomes growing faster than inflation, thus pushing filers into higher tax brackets and liability—but also with inflation itself, which increases the expansion of the exemption relative to current law. There is a sizable interaction between the AMT patch and the Bush tax cuts, which reduced income tax liability without adjusting the AMT correspondingly (thereby pushing more households into the AMT). This paper attributes the entirety of that interaction effect to the Bush-era tax cuts. Excluding this interaction effect, continuing to patch the AMT will cost $864 billion over fiscal 2013–2022 (CBO 2012b).[9]

Business tax extenders

Congress routinely extends a bundle of temporary business tax credits and preferences scheduled to expire (or retroactively extends already expired provisions), commonly known as the "business tax extenders." CBO's August 2012 baseline showed 84 temporary tax provisions scheduled to expire over the next decade (excluding the Bush tax cuts, AMT patch, temporary estate and gift tax cuts, and the payroll tax cut). A number of these provisions were extended through 2011 as part of the Tax Relief Act of 2010 and 50 expired at the end of 2011, with another 11 scheduled to sunset by December 31, 2012 (CBO 2012d). The costliest of these provisions include accelerated expensing of investment property, the Subpart F active financing exception, the research and experimentation credit, and the alcohol fuel tax credit.[10] Extending all of the business tax extender provisions would cost $890 billion over fiscal 2013–2022 (CBO 2012d).[11]

Medicare physician reimbursement rates

Since 2003, Congress has annually prevented the Medicare Sustainable Growth Rate (SGR) formula—established by the Balanced Budget Act of 1997—from making scheduled cuts to Medicare physician reimbursement rates (Van de Water 2010). Like

the AMT patch, the cost of the "doc fix" compounds every year as the scheduled SGR cut being prevented increases. Congress most recently extended the doc fix through December 31, 2012, as part of the Tax Relief Act of 2012. Maintaining the doc fix would increase primary spending by $245 billion over fiscal 2013–2022 (CBO 2012b).[12]

Economic impacts of the fiscal obstacles

Table 1 presents the economic impacts of addressing the major components of the fiscal obstacle course, measured for calendar year 2013 relative to CBO's August 2012 current law baseline (see the Appendix for detailed methodology). Cumulatively, continuing these expiring budgetary provisions and reversing the BCA spending cuts would boost GDP growth by 3.7 percentage points and nonfarm payroll employment by nearly 4.4 million jobs by the end of 2013, relative to the current law baseline.[13] To put this in economic context, CBO projects annualized real GDP contraction of 0.5 percent for 2013 if current law is followed—with annualized growth of 1.9 percent in the second half of the year, which would be insufficient to exert sustained downward pressure on the unemployment rate.[14] Further, the CBO's current law economic projection is for an economic contraction of a 2.9 percent annualized rate in the first six months of 2013 (CBO 2012a)—meaning that unemployment would rise and the economy would likely fall into a double-dip recession (as a rule of thumb, two consecutive quarters of negative growth is considered a recession).[15]

The estimates of the fiscal drag potential in Table 1 are consistent with CBO's two alternatives for economic growth with greater spending than scheduled under current law from their report *Economic Effects of Reducing the Fiscal Restraint That Is Scheduled to Occur in 2013* (CBO 2012a). CBO's central estimate for real GDP growth was 3.9 percentage points above current law projections without *any* fiscal restraint—i.e., maintaining current

budget policies for zero reduction in the structural budget deficit—and 1.6 percentage points above current law projections under its "alternative fiscal scenario" (CBO 2012a), which assumes that all temporary tax provisions except the payroll tax cut will be continued, the doc fix will be continued, and the BCA sequester will not take effect. Our economic projections show a comparable 1.9 percentage-point increase in real GDP growth from a continuation of these policies.[16] Mitigating *all* fiscal restraint would additionally take into consideration policies not considered in this paper, including winddown of some ARRA outlays and new taxes from the Affordable Care Act taking effect in 2013. Note that nearly 60 percent of the difference between CBO's growth forecast with no fiscal restraint versus current law results from deviations from current budget policies outside of CBO's alternative fiscal scenario (notably excluding the Bush tax cuts). This provides more evidence that despite their outsized role in public debates, the real danger to economic growth from the fiscal obstacle course is not the Bush tax cuts. These estimates of the fiscal obstacle course's economic impact are also consistent with Moody's Analytics Chief Economist Mark Zandi's estimate that the fiscal cliff would shave 3.6 percentage points from real GDP growth relative to current fiscal policies (Zandi 2012).

Economic impact of continued fiscal stimulus support

The single largest projected economic drag posed by federal fiscal policy is the expiration of the temporary stimulus, all elements of which demonstrate relatively high fiscal multipliers (meaning that the economic activity generated within a year per dollar of spending increase or tax decrease is high).[17] Relative to the current law baseline, continuing this stimulus would boost GDP by 1.4 percentage points and nonfarm payroll employment by over 1.6 million jobs by the end of 2013. If this boost to growth were evenly sustained throughout the year, it would roughly halve the contraction projected for the first

TABLE 1

Economic impact of the "fiscal obstacle course" relative to current law, 2013

Fiscal obstacles	Budgetary cost (billions)	Multiplier	Economic impact (billions)	Economic impact (% GDP)	Employment impact (thousands)
Fiscal support following ARRA					
Continue the payroll tax cut	$115	1.25	$144	0.9%	1,090
Continue EUC (UI) program	39	1.52	59	0.4	448
Continue ARRA expansion of refundable credits	10	1.19	12	0.1	92
Subtotal	165	1.31	216	1.4	1,631
Budget Control Act					
Deactivate sequestration	$78	1.40	$110	0.7%	829
Undo phase one discretionary spending caps	50	1.40	70	0.4	529
Subtotal	128	1.40	180	1.1	1,357
Bush-era tax cuts					
Continue upper-income Bush tax cuts	$52	0.26	$14	0.1%	102
Continue middle-income Bush tax cuts	84	0.35	29	0.2	223
Continue lower-income Bush tax cut and credits*	55	0.69	38	0.2	288
Continue estate and gift tax cuts**	12	0.00	0	0.0	0
Subtotal	202	0.40	81	0.5	613
Other expiring (current policy) provisions					
Continue the AMT patch	$114	0.53	$60	0.4%	455
Continue the business tax extenders	109	0.27	29	0.2	222
Continue the Medicare "doc fix"	14	1.01	14	0.1	106
Subtotal	237	0.44	104	0.7	784
Fiscal obstacle course total	$732	0.79	$581	3.7%	4,385

* Includes the 10% tax bracket and modifications to the Child Tax Credit

** Estate tax cuts as modified by the Tax Relief Act of 2010

Source: Authors' analysis of Congressional Budget Office (2011a, b; 2012b, d, e, f) and Moody's Analytics (Zandi 2011a, b)

half of the year and keep year-over-year growth in positive territory.

Economic impact of the Budget Control Act

The second-largest projected economic drag results from the BCA. Deactivating the sequestration cuts and undoing the first-phase spending caps would boost GDP growth by 1.1 percentage points and nonfarm payroll employment by over 1.3 million jobs by the end of 2013. In terms of fiscal multipliers, with the exception of curtailing emergency unemployment benefits (which yield an even higher multiplier of 1.52), the BCA is the most economically damaging component of the various fiscal drags projected under current law (Zandi 2011a; Zandi 2011b). While the automatic sequester poses the greater risk to near-term growth, the phase-one spending caps by themselves account for 39.0 percent of the overall GDP impact of the BCA cuts.

Economic impact of the Bush-era tax cuts

Continuation of the Bush-era tax cuts would have the largest budgetary impact of the major components of the fiscal obstacle course but a relatively low impact on economic growth—even lower than the collective impact of other annually renewed budget policies that are not intended as fiscal stimulus. Continuing all of the Bush-era tax cuts would boost GDP growth by just 0.5 percentage points and nonfarm payroll employment by 613,000 jobs by the end of 2013, relative to current law. Extending just the upper-income Bush tax cuts would boost growth by a meager 0.1 percentage point, increasing nonfarm payroll employment in 2013 by only 102,000 jobs.

Conversely, the Bush-era tax cuts that enhanced the CTC and introduced the 10 percent tax bracket account for 27.1 percent of the budgetary impact of the Bush tax cuts, but account for nearly half (47.0 percent) of their economic impact. As policymakers consider which of these tax cuts to preserve while the economy remains depressed, from a macroeconomic perspective these findings indicate that it surely makes sense to work from the "bottom-up."

This weak impact of the overall package of Bush-era tax cuts is not surprising, as they were not designed to provide fiscal support. While fortuitous timing meant that they were enacted when the economy actually did need stimulus in the aftermath of the 2001 recession, for a couple of reasons they were uniquely ill-suited to boost economic recovery. They were phased in over a decade, instead of being front-loaded to address that recession. They were disproportionally targeted toward upper-income households, who are more likely than low- and moderate-income households to save rather than spend temporary income gains (Fieldhouse and Pollack 2011a; Zandi 2011b). And they included provisions such as cuts in the estate and gift taxes, cuts that most economic models show have no impact on near-term growth. Because of their poor design, the Bush tax cuts failed to generate even mediocre economic results: The 2001–2007 economic expansion over which they were the dominant economic policy produced the worst growth in GDP, nonresidential fixed investment, employment, and compensation of any post-World War II expansion (Bivens and Irons 2008).

Cumulatively, letting the Bush tax cuts expire would inflict just over one-third (37.6 percent) the damage of letting the stimulus expire and under half (45.1 percent) the damage of implementing the BCA spending cuts. Of the major fiscal obstacle course components analyzed in Table 1 that Congress can choose to extend or discard for 2013, the upper-income Bush tax cuts account for 7.1 percent of the total cost but only 2.3 percent of the economic benefit (measured in terms of GDP or employment). The combined upper- and middle-income Bush tax cuts account for 18.6 percent of the total cost but only 7.4 percent of the economic benefit (see **Figure A**).[18]

Policy recommendations

A sensible policy response to the looming obstacle course of tax and spending hurdles would consider each com-

Budgetary cost versus economic impact, as a share of the "fiscal obstacle course," of Bush-era tax cuts, 2013
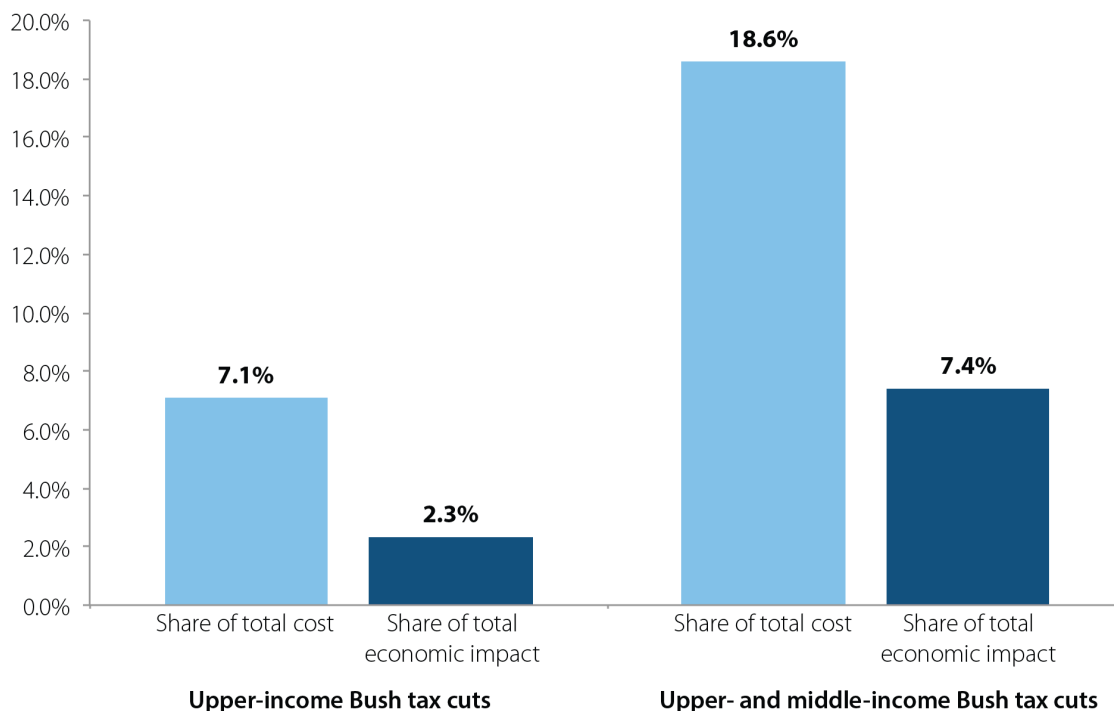
Source: Authors' analysis of Congressional Budget Office (2011a, b; 2012b, d, e, f) and Moody's Analytics (Zandi 2011a, b)

ponent's effects on economic recovery. That would mean taking the following actions:

First, disengage the BCA sequester and phase-one discretionary spending caps. The rapid cutback in spending required by the BCA will harm near-term job creation and threaten longer-term economic growth because of the disproportionate cuts to the non-security discretionary budget and the public investments contained within (Fieldhouse and Pollack 2011b; Bivens 2012).

Second, enhance the temporary fiscal stimulus to not just dodge an economic drag in the coming years but to provide a substantial boost to growth in the near term. The highest "bang-per-buck" stimulus set to expire in 2013 is the EUC program, which has already been scaled down by the Tax Relief Act of 2012 despite persistently

high long-term unemployment. Restoring the EUC program to support up to 99 weeks of unemployment compensation in distressed states would be an improvement, and replacing the payroll tax cut with more-effective infrastructure spending and/or fiscal aid to states would be a significant improvement for near-term economic support.[19]

Avoiding the economic harm posed by the BCA and enacting more-effective temporary stimulus of an equal dollar amount to the temporary stimulus provisions that are expiring would boost growth by 2.5 percentage points and sustain real GDP growth of 2.0 percent for 2013—a faster year-over-year growth rate than has been experienced since the start of 2012. These two actions would also close over 30 percent of the "output gap" (the gap between what the economy is producing today versus

what it could produce with unemployment closer to 5 percent), projected at $1.3 trillion under current law for 2013 (CBO 2012b).

By contrast, merely continuing the Bush tax cuts, the AMT patch, the doc fix, and the business tax extenders would boost growth by just 1.2 percentage points by the end of 2013, relative to current law, and growth in the first half of the year would likely be insufficient to avoid an economic contraction.

Given this disparity, there is no good economic reason to extend the upper-income Bush-era tax cuts or the recently expanded estate and gift tax cuts; they fail any reasonable cost-benefit analysis for economic stimulus. Allowing them to expire would shave a meager 0.1 percentage point from real GDP growth in 2013 relative to current policy, but revenue would rise by $1.2 trillion (0.6 percent of GDP) over fiscal 2013–2022 (CBO 2012d). The case for extending the middle-income Bush tax cuts is also thin, and expiration would increase revenue by another $1.4 trillion (0.7 percent of GDP) relative to current policy over fiscal 2013–2022 (CBO 2012d).

However, the provisions in these tax cuts that actually have a large economic impact—expansions of refundable tax credits, for example—should be reinstated, along with the subsequent ARRA expansions of these credits.

Moreover, any fiscal drag from expiration of most of the Bush tax cuts could be overcome with well-targeted fiscal stimulus of much smaller dollar value. For example, just $58 billion in well-targeted stimulus in 2013 could provide the same fiscal boost to the economy that the $202 billion worth of Bush-era income tax cuts and estate and gift tax cuts would provide.[20] Alternatively, dedicating the cost of a one-year extension to high bang-per-buck stimulus would add 1.8 percentage points to growth (1.3 percentage points more than the Bush tax cuts and estate tax cuts). Coupled with extending the *ad hoc* stimulus or deactivating the BCA, a double-dip recession could likely be averted in the first half of the year.

In all, deactivating the BCA and maintaining the remaining stimulus, the Bush tax cuts, the AMT patch, the doc fix, and the business tax extenders would increase the primary budget deficit by $732 billion relative to current law but would boost GDP by only $581 billion (3.7 percent) in 2013 (not enough to close 45 percent of the output gap projected under current law). The same economic benefit could be achieved with just $415 billion of well-targeted stimulus, for budgetary savings of $318 billion, or 43.4 percent. And if Congress were willing to take the full cost of addressing our existing obstacle course and instead use it to finance high-value fiscal projects, it is likely that nearly four-fifths (78.4 percent) of the output gap could be erased by the end of 2013 (or at least by mid-2014).

Replacing ineffective policies with cost-effective fiscal support would also reduce the budget deficit through cyclical effects. In short, true deficit hawks who also seek to alleviate persistently high unemployment would be extraordinarily vigilant in ensuring that only very effective fiscal support measures were preserved in upcoming negotiations over the fiscal obstacle course and that cost-effective economic policies replace ineffective policies.

Conclusion

Policymakers and economic commentators should stop talking about the upcoming "fiscal cliff" and talk more plainly about what is needed: a plan to ensure that the budget deficit is not reduced so quickly that it harms the economy and worsens unemployment. Such plain talk would show that there is clear recognition that the rapid fiscal contraction baked into current law must be avoided.

This paper makes some policy recommendations for navigating the separable barriers to continued recovery. First, letting the upper-income Bush tax cuts and estate and gift tax cuts expire will pose negligible harm to the near-term economic outlook, yet expiration of both would produce substantial savings over the coming decade or could finance much more cost-effective fiscal support.

Second, the expiration of temporary, targeted stimulus and implementation of Budget Control Act spending cuts will pose substantial impediments to growth.

Third, any economic drag that follows from raising taxes can be offset with efficient, temporary fiscal support that trades bigger near-term deficits and greater economic growth for medium- and long-run deficit reduction relative to current budget policies.

The current path leads to a recession in 2013. We can fall right into it, barely avoid it, or sail past it, depending on how nimbly we navigate the fiscal obstacle course.

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Appendix

The baseline for economic comparisons is projected nominal GDP for calendar year 2013 from CBO's August 2012 baseline economic forecast (CBO 2012f). All budgetary costs of spending provisions reflect outlays rather than budget authority, and all provisions' costs exclude associated debt service (which has a negligible near-term macroeconomic impact). All fiscal multipliers are adopted or modeled from fiscal multipliers published by Moody's Analytics Chief Economist Mark Zandi (Zandi 2011a; Zandi 2011b). While even the multipliers for specific provisions used in the various reports by Zandi change trivially over time, it is useful to note that these fiscal multipliers are comparable in scale and (even more importantly) relative ranking to the midpoint estimates of the multipliers used by CBO in evaluating the efficacy of ARRA (CBO 2012c), as well as those used by the Council of Economic Advisors in its quarterly reports on ARRA (CEA 2011). Similarly, the relative ranking of these multipliers is consistent with the implicit multipliers in Zandi's more recent analysis of the fiscal obstacle course, which shows the expiration of EUC and the sequester posing the largest drag on growth per dollar (Zandi 2012). In short, the relative ranking and the scale of impact of avoiding various drags set to begin in January 2013 are robust to a range of estimates of the multipliers.

The budgetary cost of each policy is multiplied by its related fiscal multiplier for the projected dollar impact on GDP at the end of calendar year 2013. The change in nonfarm payroll employment is calculated based on the percent increase in nominal GDP that would be associated with each component of the fiscal obstacle course. See Bivens (2011c) for detailed methodology.

Fiscal stimulus programs after ARRA

The budgetary cost of continuing the payroll tax cut is extrapolated by indexing the cumulative cost of both extensions for calendar year 2012 ($114 billion) for CBO's projections of wage and salary growth between 2012 and 2013 (CBO 2011b; CBO 2012e; CBO 2012f). A fiscal multiplier of 1.25 is applied—Zandi's multiplier for an employee-side payroll tax holiday (Zandi 2011b). The budgetary cost of continuing the EUC program is extrapolated by indexing the cumulative cost of both extensions for calendar year 2012 ($38 billion) for CBO's projections of consumer price index (CPI-U) growth between 2012 and 2013 (CBO 2011b; CBO 2012e; CBO 2012f). The budgetary cost of continuing the

ARRA expansion of refundable tax credits is calculated as 100 percent of the fiscal 2013 cost and 25 percent of the fiscal 2014 cost of several provisions from CBO's *Expiring Tax Provisions—August 2012 Baseline* (CBO 2012d): reducing the earnings threshold for the refundable portion of the CTC to $3,000, extending the AOTC, and EITC modifications. ARRA-specific multipliers of 1.38 and 1.23 are used for the CTC and EITC provisions, respectively (Zandi 2011b). A multiplier of 1.09 is used for the AOTC, which is the weighted average of a 1.22 multiplier for refundable lump-sum tax rebates (40 percent) and a 1.01 multiplier for non-refundable lump-sum tax rebates (60 percent), reflecting that up to 40 percent of the AOTC is refundable.

The Budget Control Act

The budgetary cost of deactivating the sequester is taken from Table 1-5 of CBO's August 2012 budget baseline (CBO 2012b), calculated as 100 percent of the fiscal 2013 spending increase and 25 percent of the fiscal 2014 increase. (As the cuts are scheduled to be ordered in January 2013, all the fiscal year 2013 impact is assumed to occur in calendar year 2013, while approximately a quarter of the fiscal year 2014 impact would occur in the fourth quarter of calendar year 2013.) The budgetary impact of the phase-one BCA discretionary spending caps is taken from Table 1 of CBO's analysis of the BCA (CBO 2011a), calculated as 75 percent of the fiscal 2013 spending cut and 25 percent of the fiscal 2014 cut. A fiscal multiplier of 1.4—Zandi's most recent general government spending multiplier (Zandi 2011a)—is applied to each.

Bush-era tax cuts

The budgetary cost of continuing the lower-income Bush-era tax cuts reflects the cost of maintaining the 10 percent bracket and the CTC at $1,000, both from CBO's *Expiring Tax Provisions* (CBO 2012d). The upper-income Bush tax cuts follow the Obama administration's definition (single filers with AGI above $200,000 and joint filers with AGI above $250,000), and their cost is imputed from CBO's Table 1-5 as line 51 less line 58 (CBO 2012b). The budgetary cost of the middle-income Bush tax cuts is calculated as the residual of the 2001, 2003, and 2010 tax cuts and interaction with the AMT patch (CBO 2012d) less the ARRA expansion of refundable tax credits, lower-income Bush tax cuts, upper-income Bush tax cuts, and estate and gift taxes. The calendar year 2013 cost for each of these provisions is calculated as 100 percent of the fiscal 2013 revenue loss in addition to 25 percent of the fiscal 2014 loss. (As the Bush tax cuts expire December 31, 2012, all the fiscal year 2013 impact is assumed to occur in calendar year 2013, while approximately a quarter of the fiscal year 2014 impact would occur in the fourth quarter of calendar year 2013.)

Constructing the correct multipliers for various portions of the Bush income tax cuts is a bit challenging. The aggregate multiplier for the entire package is 0.35 (Zandi 2011b). We know that the multiplier of those tax cuts aimed at lower-income households should be higher—the Zandi multiplier for refundable lump-sum tax rebates is 1.22, for example (Zandi 2011b). Since the CTC and EITC provisions in the Bush tax cuts are refundable, we apply this higher 1.22 multiplier to them.

Next, we want to apply a plausible multiplier to the elimination of the 10 percent tax bracket. Because much more of this provision's benefits are aimed at moderate-income households with lower propensities to save, it should have a higher multiplier than the overall package. The highest multiplier (besides the refundables) scored for a specific portion of the Bush tax cuts provided directly is the 0.53 multiplier for permanently extending the AMT patch (Zandi 2011b). Because the marginal effect of the AMT patch is on high-income households, but not the highest income (because the highest-income households are already being scooped up by the AMT regardless of whether or not it is patched), we believe it is safe to apply the AMT multiplier to the 10 percent bracket elimination. The 0.35 aggregate multiplier is applied to the

middle-income tax cuts, which can reasonably be expected to have roughly an average impact on economic activity.

The Zandi multiplier for making dividend and capital gains tax cuts permanent (0.39) is applied to that portion of the upper-income tax cuts which is broken out in CBO's *Expiring Tax Provisions* (Zandi 2011b; CBO 2012d). The multiplier for the *remainder* of the Bush tax cuts (i.e., the top two marginal income tax rate reductions and repeal of PEP and the itemized-deduction limitation—aimed squarely at higher-income households) is imputed so that the 0.35 aggregate multiplier for the Bush-era income tax cuts (all provisions except for refundable credits, the estate and gift tax cuts, and AMT patch, but including the AMT interaction effect) is preserved, using the average weights of various provisions over the entire fiscal 2013–2022 period. This calculation implies a multiplier of 0.17 for the remaining upper-income tax cuts. When these multipliers are applied to their respective budgetary costs over the decade, they produce a weighted multiplier of 0.84 for the lower-income tax cuts and 0.25 for the upper-income tax cuts.

Other expiring (current policy) provisions

The budgetary cost of continuing the AMT patch is taken from Table 1-5 of CBO's August 2012 budget baseline (CBO 2012c), calculated as 100 percent of projected fiscal 2012 and 2013 revenue loss and 25 percent of fiscal 2014 revenue loss. As noted previously, this cost estimate excludes interaction effects with the Bush tax cuts identified in Table 1-5, which are entirely attributed to the Bush tax cuts themselves. A multiplier of 0.53 is applied—Zandi's multiplier for permanently extending the AMT patch.

The budgetary cost of continuing the business tax extenders is taken from Table 1-5 of CBO's August 2012 budget baseline (CBO 2012c), calculated as 75 percent of projected fiscal 2013 revenue loss and 25 percent of

fiscal 2014 revenue loss. A multiplier of 0.27 is applied, which is the average of Zandi's multipliers for the accelerated depreciation (0.29) and loss carryback (0.25) temporary business tax cuts.

The budgetary cost of continuing the "doc fix" is also from Table 1-5 of CBO's August 2012 budget baseline (CBO 2012c). The doc fix budgetary cost is calculated as 100 percent of projected fiscal 2013 outlays and 25 percent of fiscal 2014 outlays. A multiplier of 1.01—Zandi's multiplier for non-refundable lump sum transfers—is assigned to the doc fix, which intuitively should have a smaller multiplier than general government spending as doctors are assumed to have a relatively high marginal propensity to save.

Endnotes

1. The Bush-era tax cuts generally refer to the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 and the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) of 2003, although there were a number of tax changes over 2001–2008. Subsequent tax changes primarily accelerated the implementation of provisions in the 2001 and 2003 tax cuts. The upper-income Bush tax cuts follow the definition in the Obama administration's budget request for fiscal year 2013, that is, tax cuts for households with adjusted gross income over $200,000 for single filers and $250,000 for joint filers.

2. Real GDP growth is measured from the fourth quarter of the year relative to the fourth quarter of the previous year (or from the second quarter when measuring growth in the second half of 2009).

3. Both the payroll tax cut and EUC were first extended for two months by the Temporary Payroll Tax Cut Continuation Act of 2011 as Congress struggled to negotiate a full-year deal.

4. Treasury Secretary Timothy Geithner has explicitly stated that the payroll tax cuts should not be continued past 2012 (Sparshott 2012), and the *current policy baselines* used by the Economic Policy Institute and CBO assume that both the payroll tax cut and EUC program are not continued, even

though their expiration would drag greatly on growth relative to *current fiscal policies*. (GDP growth in the National Income and Product Accounts reflects changes relative to *current fiscal policies*.)

5. While both the first-phase spending caps and sequester are built into CBO's current law baseline, current policy baselines used by many budget analysts and macroeconomists assume that the sequester will be deactivated but that the spending caps will remain in effect. The absolute impact of the spending caps in 2013 analyzed in this paper is larger than the relative increase in the magnitude of the cut between 2012 and 2013, the number reflected in CBO's analysis (CBO 2012a). The adverse effect of the escalating spending caps is, however, reflected in CBO's -0.5 percent annualized real GDP growth forecast for 2013, and completely eliminating the caps would boost growth relative to CBO's current law baseline, irrespective of assumptions about current policy.

6. With net interest savings, the BCA reduced federal spending by $2.1 trillion—a dollar in spending reduction for every dollar increase in the statutory debt ceiling negotiated in July 2011. OMB would have to order sequestration for fiscal 2013 in early calendar year 2013, possibly rescinding balances from the first quarter of the fiscal year (which will start October 1, 2012), but the economic drag would be felt in 2013.

7. This cost includes mandatory outlay effects but excludes net interest, which would increase the cost by $587 billion for a total cost of $4.3 trillion. The interaction effect with the AMT patch attributed to the Bush tax cuts is $931 billion in revenue loss and an additional $142 billion with associated debt service costs. This total cost of the Bush tax cuts includes the EITC, CTC, and AOTC modifications included in the Tax Relief Act of 2010. Without the $276 billion cost of the ARRA expansion of refundable tax credits and the $388 billion revenue loss from continuing the 2010 estate and gift tax cuts, continuation of the Bush tax cuts would decrease revenue and increase primary spending by $3.0 trillion over a decade (a net cost of $3.5 trillion including debt service).

8. Without indexing the parameters for inflation, more upper-middle-class households would be pushed into the AMT as nominal incomes rise because the ordinary individual income tax code parameters are indexed for inflation (decreasing ordinary income tax liability relative to AMT tax liability without the patch).

9. This cost estimate excludes net interest, which would increase the cost by $130 billion for a total cost of $994 billion.

10. The "active financing" exception for foreign source income allows multinational firms to avoid tax on their worldwide income when they establish "captive" foreign financing subsidiaries (a subsidiary incorporated overseas providing financing for the parent company's products). Under Subpart F of the tax code, deferral of foreign source income repatriation is restricted in the case of income from passive investment (i.e., income earned from a limited partnership, rental property, or enterprise with which the parent firm is not actively involved). Specifically, Subpart F taxes controlled foreign corporations as if their foreign earnings were repatriated to the United States as dividends, regardless of whether earnings are kept abroad or repatriated. Thus the "active financing" exception to Subpart F allows captive foreign financing subsidiaries to delay repatriation of income—potentially indefinitely—rather than paying dividends taxes on their foreign income.

11. This cost estimate excludes net interest, which would increase the cost by $157 billion, for a total cost of $1.0 trillion. By far the most expensive component would be continuing the partial first-year "bonus" depreciation schedule for investment property over the next decade, which would reduce revenue by $341 billion. The Tax Relief Act of 2010 included 100 percent expensing of qualified capital investments for 2011 and 50 percent first-year bonus depreciation for 2012. The business tax extenders include continuation of the additional 50 percent first-year bonus depreciation beyond 2012. Without this provision, which was sold as fiscal stimulus despite an incredibly low 0.29 fiscal multiplier (Zandi 2011b), the revenue loss from maintaining the business tax extenders would fall to $549 billion over fiscal 2013–2022 (CBO 2012d).

12. This cost estimate excludes net interest, which would increase the cost by $36 billion for a total cost of $281 billion over fiscal 2013–2022.

13. See Bivens (2011c) for EPI methodology on translating fiscal impulses into GDP and employment impacts.

14. The historical relationship between the unemployment rate and real GDP growth—known as Okun's rule of thumb—shows that real GDP growth above 2–2.5 percent (roughly trend growth) is needed to exert downward pressure on the unemployment rate. This relationship does not hold with month-to-month volatility (especially with present swings in labor force participation rates) but is relatively stable over the long run. CBO's growth forecast for 2013 is measured as the change in real GDP between the fourth quarter of 2012 and the fourth quarter of 2013.

15. The National Bureau of Economic Research dates changes in the U.S. business cycle (i.e., recessions and expansions) on a monthly rather than quarterly basis and identifies recessions based on a "significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales" (NBER 2012). Two quarters of negative real GDP growth, however, is a common rule of thumb for identifying recessions.

16. CBO's midpoint fiscal multiplier for the AMT patch (0.35) is lower than the Zandi multiplier (0.53) used in our projections (CBO 2012c; Zandi 2011b). See Appendix.

17. Note that the possible continuation of accelerated bonus depreciation, which was also a provision of the Tax Relief Act of 2010, is treated as part of the business tax extenders rather than stimulus because of its exceptionally low fiscal multiplier. See endnote 11.

18. The middle-income Bush tax cuts are defined as those provisions proposed for extension under the Obama administration's budget request for fiscal year 2013 (i.e., households with adjusted gross income under $200,000 for single filers and $250,000 for joint filers) *except for* continuation of the 10 percent tax bracket and refundable tax credits, which are considered the lower-income Bush tax cuts.

19. Another important question is that of scale: Continuing the expiring stimulus programs would close only 16.5 percent of the output gap—the difference between projected potential GDP and actual GDP—estimated at just over $1.3 trillion for calendar year 2013 (CBO 2012f). Reasonable economic stabilization policy should *at minimum* seek to halve the output gap—which would require roughly $467 billion in well-targeted stimulus relative to current law for 2013—both for the sake of restoring full employment and reducing costly long-run economic scarring (Irons 2009; Fieldhouse 2012). Well-targeted stimulus is assumed to achieve a multiplier of 1.4, which could easily be achieved with infrastructure spending (1.44) or safety-net spending (Zandi 2011b). For more on cost-effective stimulus and assessing job creation measures see Eisenbrey, Mishel, Bivens, and Fieldhouse (2011).

20. Well-targeted stimulus is assumed to achieve a multiplier of 1.4—Zandi's most recent general government spending multiplier (Zandi 2011a).

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