



# Unemployment: Issues in the 112<sup>th</sup> Congress

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## Summary

The longest and deepest recession since the Great Depression ended and an expansion began in June 2009. Although output started growing in the third quarter of 2009, the labor market was weak in 2010, with the unemployment rate averaging 9.6% for the year. Despite showing greater improvement toward the end of 2011, the unemployment rate averaged a still high 8.9% for the year. The labor market has continued to slowly strengthen in 2012, with the unemployment rate in September measuring 7.8%—the first time it has been below 8% since January 2009.

Several policy steps were taken after the economy entered the Great Recession, including stimulus bills in 2008 (P.L. 110-185) and 2009 (P.L. 111-5), an unprecedented expansion in direct assistance to the financial sector by the Federal Reserve, and the Troubled Asset Relief Program (TARP; P.L. 110-343). In December 2010, P.L. 111-312 extended the 2001 and 2003 “Bush” income tax cuts through 2012 as well as other expiring tax provisions and emergency unemployment benefits through 2011. The Tax Relief, Unemployment Reauthorization, and Job Creation Act also cut the payroll tax by two percentage points through 2011 as well.

Continued high unemployment has led to concerns about the need for additional policies to promote job creation. The President proposed a stimulus package in September 2011—the American Jobs Act—which was introduced by request in the House (H.R. 12) and Senate (S. 1549). The two percentage point payroll tax cut that was due to expire at the end of 2011 was extended into early 2012 as part of the Temporary Payroll Tax Cut Continuation Act (P.L. 112-78). The payroll tax cut and emergency unemployment benefits were extended through 2012 as part of the Middle Class Tax Relief and Job Creation Act (P.L. 112-96).

More recently, attention has focused on the upcoming significant increase in taxes and decrease in spending popularly referred to as the “fiscal cliff.” Economic projections have suggested that these policies will dramatically slow growth and perhaps lead to a recession in the first part of 2013. Proposals have been made to extend some of the expiring tax cuts (H.R. 8, S. 3412, S. 3413, S. 3521) although there is disagreement about which cuts to extend.

This report considers three policy issues: whether to take additional measures to increase jobs, what measures might be most effective, and how job creation proposals should be financed. Most proposals discussed as part of a potential additional macroeconomic jobs bill are traditional fiscal stimulus policies. Their objective is to increase total spending in the economy (aggregate demand) either through direct government spending on programs or by providing funds to others that they will spend (through tax cuts, transfer payments, and aid to state and local governments). Proposals for employment tax credits are different from traditional fiscal policies in that their objective is to directly increase employment through a subsidy to labor costs.

To be effective, fiscal stimulus is generally deficit financed. Although a stimulus measure could be paid for by cutting other spending or raising other taxes, these financing options will offset the stimulative effects on aggregate demand. It is possible to choose a deficit-neutral package of tax and spending changes that would stimulate aggregate demand if some types of measures induce more spending per dollar of cost than others, but such an effect would likely not be very large. The choice of financing affects both the macroeconomic impact and the cost-benefit tradeoff of the policy proposal. If such an effective stimulus package could be designed, it would have the advantage of not exacerbating the challenges of a growing debt.

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In response to the slow pace of improvement in the labor market after the end of the 2007-2009 recession, some Members of the 112<sup>th</sup> Congress and the Administration have proposed additional fiscal stimulus or job creation legislation. These bills follow several policy steps taken since the economy entered a recession in December 2007, including stimulus bills in 2008 (P.L. 110-185) and in 2009 (P.L. 111-5), unprecedented expansion in direct assistance to the financial sector by the Federal Reserve (Fed), the creation of the Troubled Asset Relief Program (TARP; P.L. 110-343), and a two-year extension of the 2001 and 2003 (popularly referred to as “Bush”) tax cuts as well as initiation of a temporary two percentage point cut in the payroll tax (P.L. 111-312). In addition, several extensions of emergency unemployment benefits have been signed into law since 2008.<sup>1</sup> More recently, Congress passed and the President signed the Middle Class Tax Relief and Job Creation Act of 2012. P.L. 112-96 extends the payroll tax cut and emergency unemployment benefit program through 2012.

Most recently, attention has focused on the significant increase in taxes and decrease in spending at the end of 2012, popularly referred to as the “fiscal cliff.” Economic projections have suggested that these policies will reduce spending and dramatically slow growth in 2013, most likely leading to a recession in the first part of 2013. Proposals have been made to extend some of the expiring tax cuts (H.R. 8, S. 3412, S. 3413) although there is disagreement about which cuts to extend.

This report briefly reviews the situation in the labor market, expands on the above-mentioned policy steps taken to date, and analyzes policy issues that typically arise during consideration of stimulus legislation. Three policy issues are examined: whether to take additional measures to increase jobs, what measures might be most effective, and how job creation proposals should be financed.

## **The Labor Market Situation**

From December 2007 to June 2009, the economy experienced the longest and deepest recession since the Great Depression. At the onset of the so-called “Great Recession,” the unemployment rate was 5.0%. It more than doubled, peaking at 10.1% in October 2009, before starting to very slowly decline. This marked the first time that unemployment topped 10% since the 1981-1982 recession. The 2007-2009 recession also was characterized by the biggest percentage point increase in the unemployment rate of any postwar recession.

Since the third quarter of 2009, economic output has grown, but not quickly enough to much reduce the unemployment rate.<sup>2</sup> The labor market remained weak in 2010, with the unemployment rate averaging 9.6% for the year. Although the rate fell during 2011, it nonetheless was a still high 8.9% for the year. The labor market has continued to slowly improve in 2012. In September, the unemployment rate fell to 7.8%—the first time it has been below 8% since January 2009.<sup>3</sup>

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<sup>1</sup> For a legislative history of unemployment benefit extensions, see CRS Report RL33362, *Unemployment Insurance: Programs and Benefits*, by Julie M. Whittaker and Katelin P. Isaacs.

<sup>2</sup> For more information on the relationship between the two variables see CRS Report R42063, *Economic Growth and the Unemployment Rate*, by Linda Levine.

<sup>3</sup> The latest news release of the Bureau of Labor Statistics is at <http://stats.bls.gov/news.release/pdf/empst.pdf>.

The duration of unemployment remains long by postwar standards. More than three years after the recession's end, the average length of time a worker has been unemployed is about 40 weeks. Long-term unemployment continues at historically high levels. Two of every five workers unemployed in September 2012, for example, had not held a job in over six months.<sup>4</sup>

The rise in unemployment during the Great Recession was driven by a steep decline in employment. The number of employees on nonfarm employer payrolls plummeted by almost 7.5 million between December 2007 and June 2009.<sup>5</sup>

Job losses have decreased since the recovery began, and employment at private- and public-sector employers has risen by almost 3 million between June 2009 and September 2012. Within this period, total employment increased substantially from March to May 2010 because the federal government hired temporary workers to assist it in conducting the decennial census.<sup>6</sup> After May 2010, employment fell as the temporary workers were let go upon completion of the 2010 census. Private-sector employment began increasing in March 2010, according to data from the U.S. Bureau of Labor Statistics' monthly survey of employers in the nonfarm sector of the economy. From October 2010 through July 2012, job gains in the private sector more than offset losses in the public sector—chiefly at state and local governments. The public sector began contributing to the net increase in nonfarm payroll employment in the second half of 2012. In September 2012, for example, the 114,000 job growth at nonfarm employers was due to the combination of 104,000 private-sector jobs and 10,000 public-sector jobs.

A “hands off” policy approach would counsel for patience. In this view, a decrease in unemployment is inevitable. Every recession since World War II except the 1980 recession was followed by a period of sustained job creation.<sup>7</sup> Historical experience confirms that strong economic growth is the most important factor for reducing unemployment after a recession.<sup>8</sup> Nevertheless, because the unemployment rate is so high, even if the economy grew at a healthy pace, it would take a significant amount of time for unemployment to reach more normal levels. For example, after the unemployment rate peaked at 10.8% in November and December 1982, it had fallen less than three percentage points one year later; it took about six years for the rate to fall by half. This gradual decline from a recession-elevated level happened when economic growth averaged an unusually high rate of 4.5% annually. During the current recovery, the rate of economic growth has been well below that level.

Another argument in favor of patience is that the government has already taken extraordinary steps to stabilize the economy through the creation of the TARP, the Fed's unconventional policy actions, and fiscal stimulus in 2008 and 2009, the latter of which contained significant outlays through 2011. (These programs will be discussed in greater detail in the following section, entitled “Policy Steps Taken Through 2010.”) Proponents of this approach are likely to argue that

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<sup>4</sup> For more information, see CRS Report R41179, *Long-Term Unemployment and Recessions*, by Gerald Mayer and Linda Levine.

<sup>5</sup> CRS Report R41434, *Job Growth During the Recovery*, by Linda Levine.

<sup>6</sup> Emily Richards, “The 2010 Census: the Employment Impact of Counting the Nation,” *Monthly Labor Review*, March 2011.

<sup>7</sup> In the case of the 1980 expansion, the economy slid back into recession in 1981. Employment then began sustained growth in 1983 following the end of the 1981-1982 recession.

<sup>8</sup> See CRS Report R42063, *Economic Growth and the Unemployment Rate*, by Linda Levine.

stimulus faces diminishing returns and, with these policies already in place, it is unlikely that further policy steps could sharply hasten the anticipated decline in unemployment.

A more interventionist policy approach could be justified on at least three grounds. First, the loss in output caused by high unemployment is very costly in economic and non-economic terms in the short run. If policy steps to reduce unemployment can be taken at relatively low costs, then the cost-benefit tradeoff would be favorable. An ongoing major policy debate, discussed later in the report, examines how costly financing these additional policy steps would be at a time of large budget deficits.

The second rationale depends on whether high unemployment has any permanent effects. Mainstream economic theory suggests that the business cycle has no lasting effect on the *natural rate of unemployment*—busts and booms temporarily move the unemployment rate up and down, but it always gravitates back toward its long-term equilibrium rate. In this view, policy steps could hasten the return to the natural rate, but market forces would eventually have caused unemployment to return to the same long-run level on its own. In other words, policy steps would result in temporary (but not permanent) improvements in well-being. Some economists have offered a competing theory called “hysteresis.” In this view, bouts of high unemployment can lead to permanent increases in the natural rate of unemployment, so that unemployment never falls as low in the subsequent recovery as it had been at the previous peak.<sup>9</sup> Hysteresis could result from workers losing some of their skills in long bouts of unemployment that reduce their subsequent employability. If hysteresis effects are significant, then policy steps that successfully reduce unemployment sooner than later could avoid some permanent loss in economic well-being.<sup>10</sup>

Third, a more interventionist approach might be pursued in case the economic recovery stalls. Fear has periodically been expressed that the economy could experience a so-called “double-dip” recession, meaning a return to economic contraction in the near term. By historical standards double dips are rare. In the 20<sup>th</sup> century, there were two cases where the economy emerged from a recession, only to be quickly followed by another recession (beginning in 1920 and 1981).<sup>11</sup> In 1981, a large tightening of monetary policy is seen as playing a key role in the economy’s return to recession. For the current expansion to similarly be knocked off course, some new “shock” to the economy would likely be needed. Arguably, the economic crisis now engulfing Europe could provide such a large shock as could the so-called “fiscal cliff” (i.e., implementation of tax increases and spending decreases scheduled to occur in early 2013). The fiscal cliff is hands-off in terms of the law but not in terms of economic policy, as the combination of tax increases and spending cuts is projected to be 5% of output.<sup>12</sup>

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<sup>9</sup> Olivier Blanchard and Lawrence Summers, “Hysteresis and the European Unemployment Problem,” in Stanley Fischer, ed., *NBER Macroeconomics Annual*, vol. 1 (Cambridge: MIT Press, 1986), p. 15.

<sup>10</sup> For additional information, see CRS Report R41785, *The Increase in Unemployment Since 2007: Is It Cyclical or Structural?*, by Linda Levine.

<sup>11</sup> The economy experienced two recessions during the Great Depression. The first ended in 1933 and the second began in 1937. The Great Depression experience is not comparable to current fears of a double-dip recession because the two recessions were over four years apart, and output grew very rapidly during the expansion between the two recessions. For more information, see CRS Report R41444, *Double-Dip Recession: Previous Experience and Current Prospect*, by Craig K. Elwell.

<sup>12</sup> Congressional Budget Office, *Economic Effects of Reducing the Fiscal Restraint That Is Scheduled to Occur in 2013*, May 2012, at [http://www.cbo.gov/sites/default/files/cbofiles/attachments/FiscalRestraint\\_0.pdf](http://www.cbo.gov/sites/default/files/cbofiles/attachments/FiscalRestraint_0.pdf).

Another scenario is that the economy neither re-enters recession nor experiences its usual steady return to full employment and normal growth rates. Instead, it experiences long-term stagnation, sometimes referred to as a deflationary or liquidity trap, where overall spending does not grow quickly enough to significantly reduce the slack in the economy.<sup>13</sup> Evidence in favor of this scenario is the weakness of the expansion to date and the fact that businesses and consumers are “deleveraging” (increasing saving, and in some cases selling assets, to reduce debt).

Although the United States has not experienced such stagnation in the post-World War II period, Japan’s experience since its equity and real estate bubbles burst in the early 1990s illustrates that this scenario is possible in a modern economy. From 1980 to 1991, gross domestic product (GDP) growth in Japan averaged 3.8%. Since 1991, GDP growth has never exceeded 2.9% in a year. From a low starting point, Japan’s unemployment rate rose each year from 1991 to 2002. From 1995 to 2009, Japan experienced 10 years of deflation (falling prices) and low inflation in the other years, which indicates that Japan’s slow growth was in part due to inadequate aggregate demand. Although the central bank reduced overnight interest rates to low nominal levels and budget deficits were large (5.6% of GDP on average from 1993 to 2009), Japan was not able to break out of its deflationary trap. Some economists believe that Japan’s deflationary trap was prolonged by the government’s sporadic attempts to withdraw fiscal and monetary stimulus prematurely.<sup>14</sup> Balance sheet growth was withdrawn in 2006 when inflation was still below 1% and economic growth was about 2%; prices and output began shrinking again following the 2008 financial crisis. In addition to inadequate stimulus, many economists believe Japan’s liquidity trap was prolonged by its failure to address problems in its financial system after its financial crash.

## Policy Steps Taken Through 2010

Numerous policy actions have already been taken to contain damages spilling over from housing and financial markets to the broader economy. These policies include traditional monetary and fiscal policy as well as federal interventions into the financial sector.

### 110<sup>th</sup> Congress

In February 2008, shortly after the recession began, an economic stimulus package of approximately \$150 billion was adopted.<sup>15</sup> A provision that was considered (but not included) in the Economic Stimulus Act of 2008 (P.L. 110-185) was a 26-week extension of unemployment benefits. The extension was eventually enacted.<sup>16</sup>

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<sup>13</sup> For more information, see CRS Report R40512, *Deflation: Economic Significance, Current Risk, and Policy Responses*, by Craig K. Elwell.

<sup>14</sup> Robert J. Samuelson, “Japan’s Lost Decade—and Possibly Ours,” *The Washington Post*, March 12, 2012, p. A17.

<sup>15</sup> A second stimulus plan (H.R. 7110) passed the House on September 26, 2008, but was not passed by the Senate before the 110<sup>th</sup> Congress ended. It included \$36.9 billion on infrastructure (\$12.8 billion highway and bridge, \$7.5 billion water and sewer, \$5 billion Corps of Engineers); \$6.5 billion in extended unemployment compensation; \$14.5 billion in Medicaid; and \$2.7 billion in food stamp and nutrition programs.

<sup>16</sup> For a discussion of the tax, housing, and unemployment legislation adopted in the 110<sup>th</sup> Congress, see CRS Report RS22850, *Tax Provisions of the 2008 Economic Stimulus Package*, by Jane G. Gravelle; CRS Report RS22172, *The Conforming Loan Limit*, by N. Eric Weiss and Sean M. Hoskins; and CRS Report RS22915, *Temporary Extension of Unemployment Benefits: Emergency Unemployment Compensation (EUC08)*, by Katelin P. Isaacs and Julie M. Whittaker.

A number of financial-sector interventions also were undertaken before and after financial market conditions worsened significantly in September 2008. In October 2008, legislation was enacted granting the Treasury Department authority to purchase up to \$700 billion in assets through TARP (P.L. 110-343).<sup>17</sup> A number of programs were created under TARP, including programs to inject capital into banks, aid automakers and troubled financial firms, provide funds to private investors to purchase troubled assets, and modify mortgages. Other policies enacted in response to the financial crisis were an FDIC guarantee of debt issued by banks, a Treasury guarantee of money market mutual funds, and Treasury support of the government-sponsored enterprises (GSEs).<sup>18</sup>

## 111<sup>th</sup> Congress

As the recession deepened, congressional leaders and President Obama proposed much larger stimulus packages early in 2009. The American Recovery and Reinvestment Act of 2009 (ARRA), which was signed into law on February 17, 2009 (P.L. 111-5), was a \$787 billion package with \$286 billion in tax cuts and the remainder in spending.<sup>19</sup> The wide-ranging act included infrastructure spending, revenue sharing with the states, middle class tax cuts, business tax cuts, unemployment benefits, and food stamps. The Congressional Budget Office (CBO) projected that the largest budgetary effects of P.L. 111-5 would occur in FY2010 (equaling 2.2% of GDP, compared with 1.3% in 2009). Some of the stimulus spending was expected to occur in FY2011 as well; CBO projected that P.L. 111-5 could increase the deficit by 0.7% of GDP in FY2011.

On February 24, the Senate adopted S.Amdt. 3310 to H.R. 2847 (Hiring Incentives to Restore Employment), which contained payroll tax credits equal to the employer's share of OASDI (payroll taxes of 6.2% that finance Social Security) for hiring those who have been unemployed for at least 60 days and a \$1,000 income tax credit for employers after these employees had been retained for 52 weeks. This provision was the principal one in the package based on its cost of \$13 billion, with \$7.6 billion for the payroll tax relief and \$5.3 billion for the retention credit; the costs for the credit occurred in 2010 and 2011.<sup>20</sup> Other provisions included an option to convert tax credit bonds to Build America Bonds (\$2.5 billion), an extension in the small business expensing provision through 2010 (\$35 million), and an extension of the highway bill that provided transfers between the general funds and trust funds. S.Amdt. 3310 also contained offsets related to foreign tax compliance (a gain of \$8.7 billion)<sup>21</sup> and a further two-year delay in the worldwide interest allocation for the foreign tax credit (\$7.9 billion).<sup>22</sup> The House subsequently passed the bill as amended. It was signed by the President on March 18, 2010 (P.L. 111-147).

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<sup>17</sup> CRS Report R41427, *Troubled Asset Relief Program (TARP): Implementation and Status*, by Baird Webel.

<sup>18</sup> CRS Report R41073, *Government Interventions in Response to Financial Turmoil*, by Baird Webel and Marc Labonte.

<sup>19</sup> For a discussion of the American Recovery and Reinvestment Act of 2009, see CRS Report R40104, *Economic Stimulus: Issues and Policies*, by Jane G. Gravelle, Thomas L. Hungerford, and Marc Labonte.

<sup>20</sup> Cost estimates are at <http://www.cbo.gov/ftpdocs/112xx/doc11230/hr2847.pdf> and further tax details are included in the Joint Committee on Taxation, JCX-5-10 at <http://www.jct.gov/publications.html?func=startdown&id=3649>.

<sup>21</sup> These proposals involve a variety of additional information reporting, disclosure, and related penalties associated with foreign banks and trusts, an increase in the statute of limitations for foreign matters, and clarifications regarding foreign trusts and dividend equivalent securities. For general background on matters of individual tax evasion with foreign investments, see CRS Report R40623, *Tax Havens: International Tax Avoidance and Evasion*, by Jane G. Gravelle.

<sup>22</sup> See CRS Report RL34494, *The Foreign Tax Credit's Interest Allocation Rules*, by Jane G. Gravelle and Donald J. (continued...)

The Small Business Jobs Act of 2010 (H.R. 5297) was signed into law on September 27, 2010 (P.L. 111-240). It created a “Small Business Lending Fund” that allowed Treasury to purchase up to \$30 billion of preferred stock in small banks, along with some limited tax cuts (e.g., a one-year extension of bonus depreciation through 2010).

In December 2010, the President signed into law (P.L. 111-312) a package that reinstated an estate tax until the end of 2012 and extended all other parts of the 2001 and 2003 (“Bush”) tax cuts until the end of 2012. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act also extended through the end of 2011 the alternative minimum tax relief and various other expiring tax provisions, and it extended and expanded bonus depreciation while also extending emergency unemployment benefits through 2011. In addition, the act cut the employee portion of the payroll tax by 2 percentage points until the end of 2011. Relative to current law, CBO estimated that the legislation would increase the deficit by a total of \$797 billion in 2011 and 2012. Aside from the payroll tax cut, the other provisions of the legislation could be considered to prevent policy from becoming contractionary in 2011 (by allowing the deficit to decrease through the expiration of existing policy), rather than generating additional fiscal stimulus.

## **Federal Reserve**

The Fed has used both conventional and unconventional tools to stimulate the economy. By December 2008, it had reduced short-term interest rates to near zero in a series of steps. It also pursued “quantitative easing,” which can be defined as actions to further stimulate the economy through growth in the Fed’s balance sheet once the federal funds rate has reached the “zero bound.”<sup>23</sup> In 2008, it introduced a number of emergency lending facilities, providing direct assistance to the financial system that would eventually surpass \$1 trillion (those facilities have since expired).<sup>24</sup> From the spring of 2009 to the spring of 2010, the Fed completed purchases of \$1.25 billion of mortgage-backed securities, \$175 billion in GSE debt, and \$300 billion of long-term Treasury debt. On November 3, 2010, the Fed announced that it would further increase the size of its balance sheet by purchasing an additional \$600 billion of Treasury securities at a pace of about \$75 billion per month.<sup>25</sup>

## **The President’s September 2011 Proposal**

President Obama proposed a new set of tax cut and spending programs on September 8, 2011. The proposed package totals \$447 billion, with slightly over half in tax cuts. This package is considerably larger than the 2008 stimulus but smaller than the 2009 stimulus. At the President’s request, the American Jobs Act was subsequently introduced in the House (H.R. 12) and Senate (S. 1549). Since then, other measures have been introduced that contain parts of the President’s

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<sup>23</sup> See CRS Report R41540, *Quantitative Easing and the Growth in the Federal Reserve’s Balance Sheet*, by Marc Labonte.

<sup>24</sup> See CRS Report RL34427, *Financial Turmoil: Federal Reserve Policy Responses*, by Marc Labonte.

<sup>25</sup> For additional information, see CRS Report RL30354, *Monetary Policy and the Federal Reserve: Current Policy and Conditions*, by Marc Labonte.

proposal, including the Fix America's Schools Today Act (H.R. 2948/S. 1597), Teachers and First Responders Back to Work Act (S. 1723), and Rebuild America Jobs Act (S. 1769).

## **Tax Provisions**

The largest single provision in the American Jobs Act would cut the employee's share of the Social Security payroll tax by 50% for 2012. At a cost of \$175 billion, it is 39% of the total. The bill also would provide tax cuts, largely employment incentives, to employers. One provision would cut the employer payroll tax in half for the first \$5 million in wages, a proposal targeting small business. Another provision would eliminate the payroll tax for growth in employer payrolls, up to \$50 million. These two provisions together would cost \$65 billion, slightly under 15% of the total. An additional \$5 billion would be spent on extending the 100% expensing (which allows firms to deduct the cost of equipment immediately rather than depreciating it) through 2012 (where 50% expensing is currently allowed). The bill also has a \$4,000 tax credit for hiring the long-term unemployed (\$8 billion) and tax credits from \$5,600 to \$9,600 for hiring unemployed veterans (at a negligible cost). The effectiveness of these types of tax incentives is discussed in the following section.

## **Spending and Transfer Provisions**

The plan contains \$140 billion of spending, including grants to states to retain teachers and first responders (\$35 billion), modernizing schools (\$30 billion), spending on surface transportation (\$50 billion), an infrastructure bank (\$10 billion), and rehabilitation of vacant property (\$15 billion). The plan also includes \$49 billion for unemployment insurance expansion and reform (e.g., allowing benefits for job sharing) and \$5 billion for worker training.<sup>26</sup>

## **Congressional Proposals in December 2011 and in Early 2012**

With the payroll tax cut slated to expire at the end of 2011, several proposals related to it and other issues were proposed in November and December. S. 1917, S. 1931, and S. 1944 were defeated on the Senate floor in December 2011.

- S. 1917, proposed by Senate Democrats, would have continued the 2 percentage point payroll tax cut through 2012, would have increased the reduction to a percentage point, and would have extended the benefit to employers for compensation up to \$5 million for a cost of \$241 billion for FY2012 and FY2013, most of it for the employee benefit. An additional \$24 billion loss would have been associated with a temporary hiring credit. The revenue loss would have been offset by a permanent 3.25% surtax on incomes more than \$1 million, raising \$268 billion over the 10-year budget horizon (FY2012-FY2021).

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<sup>26</sup> For additional information on these among other provisions, see CRS Report R42033, *American Jobs Act: Provisions for Hiring Targeted Groups, Preventing Layoffs, and for Unemployed and Low-Income Workers*, coordinated by Karen Spar.

- S. 1931, proposed by the Senate Republicans, would have extended the current employee's payroll tax cut through 2012, at a cost of \$120 billion. The revenue loss would have been largely offset by a cutback of spending on federal employment (a reduction in hiring and an extension of the pay freeze) of \$246 billion over the 10-year budget period (FY2012-FY2021). It would also have eliminated unemployment and supplemental nutritional assistance for millionaires and increased Medicare supplemental insurance payments for those with \$750,000 of income or more. These provisions, along with allowing a space on the tax return for donations to the government (donations can already be made), would have raised a small amount (\$9.3 billion over 10 years).
- S. 1944, proposed by the Senate Democrats, would have extended the payroll tax cut for employees through 2012 and reduced it by an additional percentage point, at a cost of \$188 billion for FY2012 and FY2013. Like S. 1917, the cost would have been offset in part by a (smaller 1.9%) surtax on income more than \$1 million. Like S. 1931, it would also have eliminated unemployment and supplemental nutritional assistance for millionaires.

H.R. 3630, the House Republican proposal, passed on December 13, 2011. It would have extended the 2 percentage point employee-side tax cut (\$124 billion in FY2012-FY2013) and the 100% expensing for depreciation (bonus depreciation) through 2011. It also would have allowed an alternative minimum tax offset as an option instead of expensing and included extensions for unemployment compensation and welfare. In addition, the bill would have extended the "doc fix" (a provision to delay a scheduled decrease in Medicare payments to doctors). Revenue losses and spending cuts would have been more than offset by extending the freeze on federal employee pay and increasing their retirement contributions, by additional limits to discretionary spending, by revisions in Medicare (including spending changes and requiring high-income individuals to contribute more), by restrictions on unemployment benefits and welfare payments, and by eliminating some health provisions. The offsets would have been spread out into the future. Other provisions in the bill would have eliminated certain changes in corporate estimated tax payments and pertained to abuses and tax administration (e.g., requiring a Social Security number for children to claim the child credit).

The Senate did not adopt H.R. 3630 as passed by the House. On December 17, 2011, the Senate adopted an amended version that extended the payroll tax by two months. The House on December 20 proposed a conference. A few days later (December 23), the Temporary Payroll Tax Cut Continuation Act of 2011 (H.R. 3765) was introduced in and passed by the House. It included the two-month extension among other provisions. That same day the Senate passed the bill and the President signed it into law (P.L. 112-78).

On February 16, 2012, the conference announced a compromise for H.R. 3630 that extends the payroll tax cut and unemployment benefits as well as provides for the "doc fix" through 2012. The cost of the bill is offset by spectrum auctions, an increase in pension contributions for new federal employees, and some reductions in health spending. On February 22, 2012, the House and Senate enacted the Middle Class Tax Relief and Job Creation Measure Act of 2012 into law (P.L. 112-96).

## The Fiscal Cliff and Related Proposals

As a result of prior legislative decisions, a number of tax increases and spending cuts will take place at the end of 2012 or start of 2013, absent congressional action.<sup>27</sup> The Congressional Budget Office (CBO) and other forecasters have predicted dramatic reductions in the rate of economic growth, than would be otherwise expected, due to reductions in the budget deficit. CBO, for example, projects a reduction in growth of 3.9% and an expected recession in 2013. Out of a projected fiscal restraint of \$607 billion in FY2013, CBO estimates that \$502 billion (83%) is policy related and the remainder is due to economic changes.<sup>28</sup> Of the policy-related items, 80% is tax increases, primarily the expiration of the 2001, 2003, and part of the 2009 tax cuts and the alternative minimum tax (AMT) “patch” (44% of the policy-related cliff). The AMT patch largely prevents the AMT exemption, which has not been indexed for inflation, from falling significantly. Other tax provisions include expiration of the temporary two-percentage-point reduction in the employees’ Social Security payroll tax (19%); the expiration of other tax cuts, including depreciation and the “extenders” (13%),<sup>29</sup> and taxes scheduled to come into effect as a part of health reform (4%). Spending reductions include the automatic largely across-the-board spending cuts under the Budget Control Act (13%),<sup>30</sup> the expiration of extended unemployment insurance benefits (5%); and the “doc fix” that will lower Medicare payments (2%).

Legislative proposals thus far have focused on expiring tax provisions other than the payroll tax cut. Most of these provisions expire at the end of 2012, although the AMT patch and most extenders expired at the end of 2011. The proposals include the following:

- H.R. 8 and S. 3412, the Republican tax proposal, that would extend the 2001 and 2003 tax cuts for a year and the AMT patch for two years;
- S. 3412, the Democratic tax proposal, that would extend the 2001 and 2003 tax cuts, except for high income individuals, and the parts of the 2009 tax cuts that expire at the end of 2012, along with a one-year AMT patch; and
- S. 3521, approved by the Senate Finance Committee, that would extend the AMT for two years, most of the “extenders” for a year, and provisions allowing increased expensing of small business for a year.

The treatment of the other major expiring tax cut (the payroll tax) and the spending cuts has not been addressed in major legislation.

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<sup>27</sup> See CRS Report R42700, *The “Fiscal Cliff”: Macroeconomic Consequences of Tax Increases and Spending Cuts*, by Jane G. Gravelle for a more detailed discussion of the fiscal cliff components and projected economic effects.

<sup>28</sup> Congressional Budget Office, *Economic Effects of Reducing the Fiscal Restraint That Is Scheduled to Occur in 2013*, May 2012, at [http://www.cbo.gov/sites/default/files/cbofiles/attachments/FiscalRestraint\\_0.pdf](http://www.cbo.gov/sites/default/files/cbofiles/attachments/FiscalRestraint_0.pdf).

<sup>29</sup> The extenders are a series of tax provisions that are normally enacted temporarily and usually extended.

<sup>30</sup> For information on how spending cuts under the Budget Control Act might affect employment in the near term see CRS Report R42763, *Sequestration: A Review of Estimates of Potential Job Losses*, by Linda Levine.

## **Economic Effects of Broad Policy Options**

Both monetary and fiscal policy can be used to stimulate the economy. Fiscal policy options include direct spending by the government; transfers to state and local governments (for either infrastructure spending, Medicaid, or other purposes); direct transfers to individuals (such as unemployment compensation); tax cuts for individuals; and tax incentives aimed at businesses, including jobs tax credits. Jobs subsidies differ from policies aimed at increasing aggregate demand, in that they are intended to be supply-side subsidies. That is, the initial effect is not aimed at inducing spending that will then encourage firms to expand output and hire workers (although it may do so), but is aimed at reducing the cost of hiring workers, so as to induce more hires. The first section below discusses traditional fiscal policies; the second discusses incentives aimed at jobs.

### **Spending, Transfers, and Tax Cuts**

The objective of traditional fiscal stimulus is to increase total spending (aggregate demand) either through direct spending on programs or by providing funds to others that will spend (through transfer payments, tax cuts, and aid to state and local governments). The issues surrounding these fiscal instruments are the same as those relating to the previous stimulus, except that it is later in the business cycle and there is a greater possibility that the provisions may come later than is desirable.<sup>31</sup> Moreover, growing concerns about the magnitude of the debt and deficit may make such policies less viable.

Economists judge the effectiveness of fiscal stimulus based on how much it increases aggregate demand. The size of the proposal and financing are the most important determinants of its effect on aggregate demand. Generally, proposals that are small relative to GDP are unlikely to have a large impact on GDP. As discussed below, standard macroeconomic theory indicates that only deficit-financed proposals would have a significant and positive effect on aggregate demand.

Many economists view fiscal policy as less effective than monetary policy in an open economy. With a goal of increasing aggregate demand, fiscal expansion can cause a series of reactions that provide offsetting decreases in demand. When fiscal expansion raises the deficit and drives up interest rates, capital is attracted from abroad. The purchase of U.S. dollars by foreigners to buy U.S. assets drives up the price of the dollar, causing export demand to decline. This reduction in the demand for exports offsets in part (perhaps in large part) the initial increase in demand induced by the stimulus. The more mobile international capital flows are, the larger the offsetting effect. There are currently questions among economists, however, about how much more stimulus can potentially be delivered through monetary policy now that the Fed has lowered interest rates to zero and undertaken quantitative easing.

Fiscal stimulus can involve tax cuts, government spending increases, or a combination of both. Tax cuts may be less effective at stimulating overall spending than spending increases because

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<sup>31</sup> See CRS Report R40104, *Economic Stimulus: Issues and Policies*, by Jane G. Gravelle, Thomas L. Hungerford, and Marc Labonte for a more extensive discussion of the issues surrounding the 2009 stimulus. See CRS Report RS22790, *Tax Cuts for Short-Run Economic Stimulus: Recent Experiences*, coordinated by Jane G. Gravelle for evidence on the effectiveness of recent policy options.

some of the tax cut may be saved, and not spent.<sup>32</sup> Some argue that tax cuts that are aimed at higher-income individuals are more likely to be saved.<sup>33</sup> Transfer payments have a similar effect on aggregated demand as tax cuts, but tend to be received by lower-income individuals who are more likely to spend them. Evidence generally suggests that tax subsidies for business tax cuts are not very effective.<sup>34</sup> CBO, for example, has suggested the following multipliers (the dollar increase in real output for each dollar of stimulus) for various policy options:

- income tax cuts range between 0.1 and 0.4,
- payroll tax cuts range between 0.3 and 1.2,
- expensing for investment spending ranges between 0.2 and 1.0,
- transfers to state and local governments range between 0.4 and 1.1,
- expanded unemployment benefits range between 0.7 and 1.9, and
- infrastructure ranges between 0.5 and 1.2.<sup>35</sup>

These multipliers are estimated for the cumulative effect on GDP over five years, and CBO notes that some of the proposals would have a faster effect than others.

Relative multipliers for one year indicated by Mark Zandi, a private forecaster for Moody's Analytics for elements of the fiscal cliff, are as follows:<sup>36</sup>

- extension of unemployment benefits at 1.5,
- automatic spending cuts under the Budget Control Act at 1.1,
- Bush tax cuts for those below \$250,000 and the payroll tax at 0.9,
- Bush tax cuts for those above \$250,000 and the AMT at 0.5, and
- taxes imposed under health care, depreciation, "extenders" and doc fix at 0.2.

These multipliers indicate that increased unemployment benefits have the largest effects, followed by spending, and tax cuts and payments to high income individuals and businesses the smallest effects.

The challenge for spending programs is that there may be a lag time for planning and administration before the money is spent (although this issue does not apply in the case of the fiscal cliff where changes would prevent cuts from taking place). Some analysts suggest that aid

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<sup>32</sup> See CRS Report RS21136, *Government Spending or Tax Reduction: Which Might Add More Stimulus to the Economy?*, by Marc Labonte.

<sup>33</sup> CRS Report RS21126, *Tax Cuts and Economic Stimulus: How Effective Are the Alternatives?*, by Jane G. Gravelle.

<sup>34</sup> See CRS Report RL31134, *Using Business Tax Cuts to Stimulate the Economy*, by Jane G. Gravelle and CRS Report R41034, *Business Investment and Employment Tax Incentives to Stimulate the Economy*, by Thomas L. Hungerford and Jane G. Gravelle.

<sup>35</sup> Congressional Budget Office, *Policies for Increasing Economic Growth and Employment in 2010 and 2011*, January 2010. Also see CRS Report R40104, *Economic Stimulus: Issues and Policies*, by Jane G. Gravelle, Thomas L. Hungerford, and Marc Labonte for a list of multipliers. This report also discusses the effects of alternative tax and spending policies in more detail.

<sup>36</sup> See CRS Report R42700, *The "Fiscal Cliff": Macroeconomic Consequences of Tax Increases and Spending Cuts*, by Jane G. Gravelle, for a derivation of these multipliers.

to state and local governments may be spent more quickly because these governments are likely to cut back on spending in downturns due to balanced budget requirements, and the aid may forestall these cuts. The receipt of tax cuts can also be delayed, if they are delivered through changes to withholding or through a delayed refund. If a stimulus is considered or enacted as the economy is beginning to recover, its benefits may be limited given these lags.

Subsidies to business investment are, like other policies, aimed at increasing aggregate demand (through increased investment spending). Although a temporary subsidy should be the most effective investment stimulus in theory, evidence from prior investment subsidies suggests that such subsidies are not very effective.<sup>37</sup> The lack of effectiveness may occur in part because businesses with losses cannot take advantage of the provision and in part because firms may already have excess capacity. In other words, businesses may not respond to the incentive because there is lack of demand for their products. The small business investment subsidies suffer from the same problems confronting business subsidies for investment in general. The extension of the expensing provision for small business, however, has mixed effects because firms in the phase-out range have a marginal disincentive to invest. In any case, the potential effect on spending is limited by the fact that these provisions have relatively small effects on revenue.

## **Employment Tax Credits**

Some argue the employment tax credits are different from traditional fiscal policies in that their objective is to directly increase employment through a subsidy to labor costs. A general subsidy to labor (such as a forgiveness of the employer's share of payroll taxes) would significantly reduce tax revenue. (In the short run, a forgiveness of the employee's share of payroll taxes would be similar to an individual income tax cut while forgiveness of the employer's share would be similar to a job credit.) The tax code has for some time contained permanent tax credits targeted at certain types of workers, and the target groups were expanded somewhat in 2009.<sup>38</sup> These credits are applicable to newly hired workers from the targeted groups but without requiring an increase in a firm's total employment. As noted above, an employment credit was included in P.L. 111-147.

A proposal that has been circulating for some time, and that might be considered as a small business hiring incentive, is an incremental jobs tax credit.<sup>39</sup> This type of credit would provide benefits for hiring employees in excess of a base amount. The United States had one historical experience with this type of credit in 1977 and 1978 (the New Jobs Tax Credit).<sup>40</sup> Two proponents of this policy, Bartik and Bishop, have argued that the proposal will be successful in creating a significant number of jobs.<sup>41</sup> Their estimates were done by assuming a labor demand elasticity of 0.3, which indicates that a 10% reduction in the cost of labor would increase employment by 3%. Their estimates, however, did not rest on a study of the 1977-1978 credit, but rather they predicted the effect on jobs based on the average labor demand elasticity.<sup>42</sup> Note that this estimate

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<sup>37</sup> See CRS Report RL31134, *Using Business Tax Cuts to Stimulate the Economy*, by Jane G. Gravelle.

<sup>38</sup> For more information, see CRS Report RL30089, *The Work Opportunity Tax Credit (WOTC)*, by Christine Scott.

<sup>39</sup> A more detailed analysis of job tax credits is in CRS Report R41034, *Business Investment and Employment Tax Incentives to Stimulate the Economy*, by Thomas L. Hungerford and Jane G. Gravelle.

<sup>40</sup> See CRS Report 92-939, *Countercyclical Job Creation Programs*, by Linda Levine for a discussion.

<sup>41</sup> Timothy J. Bartik and John H. Bishop, *The Job Creation Tax Credit*, Economic Policy Institute Briefing Paper, October 20, 2009, <http://www.epi.org/publications/entry/bp248/>.

<sup>42</sup> See Daniel L. Hamermesh, *Labor Demand* (Princeton University Press: Princeton, NJ, 1993), for a survey: (continued...)

is a general demand elasticity, and might not necessarily be as high during a recession, when business is slack.

Studies that examined the 1977-1978 credit found mixed results. Bishop studied the construction, retailing, and wholesaling industries, accounting for the effect of the jobs credit, and found that the credit was responsible for 150,000 to 600,000 of the 1 million increase in employment during that period.<sup>43</sup> Perloff and Wachter compared firms who knew about the credit with those who did not and found employment growth to be greater among the former group, although they caution that this is not a random selection and there may be characteristics about firms with more knowledge that could independently affect growth. Overall, they seem to conclude that the credit did not work very well because many firms were not aware of it, and many firms did not have enough employment growth.<sup>44</sup> Tannenwald surveyed Wisconsin and New England firms.<sup>45</sup> He found that the effect was smaller than predicted. He indicated that most estimates of the labor demand response to a change in wages indicate that a 10% change in wages led to labor demand increases of 2%. These estimates are general estimates, not associated with a downturn. He found an increase of only 0.4%, less than a quarter of the projected effects. The major reason was the lack of product demand. For example, one quote from his survey was, "Orders determine levels of hiring, not tax gimmicks." The main reservation about a jobs tax credit is that it might not be effective in those industries that are experiencing slack demand, causing the labor demand elasticity, already low in normal times, to approach a very low level.<sup>46</sup>

While an incremental credit can have a larger "bang for the buck" by only providing subsidies for additional hiring, it is also much more complicated and the incremental feature can possibly be avoided (for example, firms may hire their contractors temporarily). The 1977-1978 credit was made incremental in Congress (presumably to increase bang for the buck), but an incremental subsidy was opposed by the Carter Administration because of complexity and unfairness. Sunley discusses a variety of distortions that arise from an incremental credit, depending on the design, such as hiring part-time workers instead of full-time, reducing overtime, and firing and replacing workers. Also, it automatically favors firms that are growing anyway, which leads to geographic differentials.<sup>47</sup>

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(...continued)

Hammermesh suggests a midpoint elasticity of 0.3 on p. 92.

<sup>43</sup> John Bishop, "Employment in Construction and Distribution Industries: The Impact of the New Jobs Tax Credit," in *Studies in Labor Markets*, University of Chicago Press, 1981, pp. 209-246.

<sup>44</sup> Jeffrey J. Perloff and Michael L. Wachter, "The New Jobs Tax Credit," *American Economic Review*, vol. 69, May 1989, pp. 173-179.

<sup>45</sup> Robert Tannenwald, "Are Wage and Training Subsidies Cost-Effective? Some Evidence from the New Jobs Tax Credit," *New England Economic Review*, September/October 1982, pp. 25-34.

<sup>46</sup> Although the issues are somewhat different, studies of permanent targeted jobs tax credits that are aimed at disadvantaged workers have generally found limited effects. Daniel L. Hammermesh, *Labor Demand* (Princeton University Press: Princeton, NJ, 1993) reviews the evidence on the effects of several earlier jobs subsidies. For studies of the current work opportunity credit, see CRS Report RL30089, *The Work Opportunity Tax Credit (WOTC)*, by Christine Scott.

<sup>47</sup> These positions, as well as problems with the credit, were discussed by a Carter Administration official, Emil Sunley, in "Legislative History of the New Jobs Tax Credit," *The Economics of Taxation*, Edited by Henry J. Aaron and Michael J. Boskin, Washington, DC, The Brookings Institution, 1980. See also James Leigh Griffith, "A Critical View of the Complexity and Effect of the New Jobs Credit," *The Tax Lawyer*, vol. 32, fall 1978, pp. 157-179, and Roland L. Hjorth, "New Jobs Credit," *Taxes: The Tax Magazine*, vol. 55, November 1977, pp. 707-714, for further discussions of complexity issues.

## Should Fiscal Stimulus Be Deficit Financed?

Although policy measures can be financed by cutting other spending, raising other taxes, or increasing the budget deficit, fiscal stimulus is normally deficit financed. It is theoretically possible to design a stimulus package that would be deficit neutral by choosing a mix of stimulus proposals with high multipliers and offsets with low multipliers, but such a stimulus would be smaller than a deficit financed proposal. The choice of financing affects both the macroeconomic impact and the cost-benefit tradeoff of the policy proposal.

Economic theory indicates that a deficit-financed policy proposal would have the maximum impact on employment in the short term. In a deep recession, total spending (aggregate demand) in the economy is inadequate to fully employ labor and capital resources. In other words, lack of aggregate demand is the main cause of high unemployment. Increasing the budget deficit can increase total spending in the economy and bring some of those idle resources back into use. Deficit-neutral proposals would tend to neutralize the effects of job creation provisions on total spending in the economy by cutting other spending or lowering the spending of those whose taxes are raised. Deficit-neutral proposals could even be mildly contractionary. For example, if taxes are cut and financed by a spending reduction, the increase in consumption of recipients would not fully offset the contractionary effects of the decrease in government spending to the extent that the recipient saves part of the tax cut. Deficit-neutral policies might be designed to lower the cost of labor, but without any increase in demand for their products, employers may be unresponsive to incentives to increase their labor force.

In the context of a large output gap, the short-term economic cost of increasing the budget deficit may be quite low. The main economic costs of increasing the deficit come from its tendency to “crowd out” private investment spending or increase the trade deficit.<sup>48</sup> Deficits crowd out private investment spending because their financing requires scarce private saving. Increasing the demands on this private saving raises interest rates, making private investment spending less attractive. In the current context, investment spending has been greatly reduced by the recession, so there is less chance of it being crowded out by the larger deficit in the short run. Unusually low Treasury bond rates are evidence that the crowding out factor is not significant at present.<sup>49</sup> Deficits and domestic private investment spending can also be financed through foreign capital flows, however. An increase in net foreign capital inflows must be matched by an equal increase in the trade deficit.<sup>50</sup> With perfect capital mobility, the stimulus to total spending caused by the larger deficit could be entirely offset by the decline in total spending resulting from a larger trade deficit. Since the trade deficit has fallen significantly since the beginning of 2007, this drawback to increasing the deficit may also be less important at present.

While an economic argument can be made that increasing the deficit could have short-term benefits, that argument may presuppose that the increase in the deficit would be reversed when economic conditions return to normal. Political constraints may make that difficult, and could lead one to conclude that the short-term benefits of higher deficits would be outweighed by the

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<sup>48</sup> For more information, see CRS Report RL31775, *Do Budget Deficits Push Up Interest Rates and Is This the Relevant Question?*, by Marc Labonte.

<sup>49</sup> Although the credit crunch has increased the risk premium on borrowing rates and cut off access to credit for some risky borrowers, it has led to a general decline in interest rates.

<sup>50</sup> This relationship is due to the balance of payments accounting identity (i.e., dollars sold equals dollars bought).

long-term costs—namely, that if deficits are not reduced or are increased when unemployment falls, the negative effects on investment spending and the trade deficit would become greater. Indeed, any proposal to increase the deficit can be viewed in the broader context of an overall deficit that since 2009 has been larger relative to the size of the economy than all but a handful of previous wartime years. Current deficits are not sustainable in the long run in the sense that deficits of that size would cause the national debt to continually rise relative to output. A deficit of this size cannot be maintained indefinitely without eventually resulting in a fiscal crisis where investors refuse to continue financing it because they no longer believe that the government would be capable of servicing it. While there is no sign of investor unwillingness to hold federal debt at the present (since borrowing rates are so low), it is also difficult to predict at what point investors would refuse to hold more debt. Essentially, investors are willing to hold federal debt as long as they believe that the government will eventually reduce the deficit to the point where it becomes sustainable. Policy changes that increase the deficit place the deficit further from sustainability.<sup>51</sup>

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<sup>51</sup> For more information, see CRS Report R40770, *The Sustainability of the Federal Budget Deficit: Market Confidence and Economic Effects*, by Marc Labonte.