Unemployment: Issues in the 112th Congress

Jane G. Gravelle
Senior Specialist in Economic Policy

Thomas L. Hungerford
Specialist in Public Finance

Marc Labonte
Specialist in Macroeconomic Policy

January 11, 2011

Congressional Research Service
7-5700
www.crs.gov
R41578

CRS Report for Congress
Prepared for Members and Committees of Congress

Summary

Following the longest and deepest recession since the Great Depression, the National Bureau of Economic Research (NBER) has declared the U.S. economy to be in expansion since June 2009. The unemployment rate in December 2007 was 4.9%; by October 2009, the unemployment rate was above 10%. Although economic output began to grow in the third quarter of 2009, the labor market remained weak into 2010. For the year, unemployment averaged 9.6%, and showed no improvement in the second half of the year.

In response to high unemployment, some members of Congress proposed job creation bills, following several policy steps taken since the economy entered the 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, the President signed into law (P.L. 111-312) a package that reinstated an estate tax until the end of 2012, extended all other parts of the 2001 and 2003 ("Bush") tax cuts until the end of 2012, extended alternative minimum tax relief and various other expiring tax provisions until the end of 2011, extended emergency unemployment benefits, and cut the payroll tax by two percentage points until the end of 2011. Nevertheless, the Blue Chip consensus forecast has the unemployment rate remaining above 9% throughout 2011 and near 9% in 2012. The 112th Congress is likely to be faced with developing legislation to foster job creation.

Most of the proposals discussed as part of a potential additional macroeconomic jobs bill are traditional fiscal stimulus policies. That is, 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). Fiscal stimulus is only effective when the policy options actually increase aggregate demand.

Some argue that employment tax credits are different from traditional fiscal policies in that their objective is to directly increase employment through a subsidy to labor costs. Studies that examined the 1977-1978 incremental jobs tax credit found mixed results—some conclude that the tax credit was responsible for creating a significant number of jobs, while others conclude that it was ineffective.

The choice of financing affects both the macroeconomic impact and the cost-benefit tradeoff of the policy proposal. Policy measures can be financed by cutting other spending, raising other taxes, or increasing the budget deficit. Economic theory indicates that a deficit-financed policy proposal would have the maximum impact on employment in the short term. If proposals are financed by cuts in other spending or increases in other taxes, then those cuts or tax increases would lead to declines in total spending that would offset the effects of the initiative on aggregate demand in part or whole. Policy changes that increase the deficit, however, move the budget further from long-term sustainability.

Contents

Contacts

In response to high unemployment, some members of Congress have proposed fiscal stimulus or job creation legislation. This follows several policy steps taken since the economy entered a recession in December 2007, 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, 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 (P.L. 111-312). In addition, several temporary extensions of emergency unemployment benefits have been signed into law since 2008.[1]

This report discusses the current unemployment outlook, gives an overview of the policy steps taken to date, and analyzes policy proposals likely to be before the 112th Congress to address the issue and options for financing proposals.

The Unemployment Problem

From December 2007 to June 2009, the economy experienced the longest and deepest recession since the Great Depression. At the onset of the recession in December 2007, the unemployment rate climbed steadily from a rate of 4.9%, topping 10% in October 2009. This marked the first time since 1982 that unemployment topped 10%; prior to that, unemployment had not topped 10% since the Great Depression. This recession was characterized by the biggest percentage point increase in the unemployment rate of any recession since World War II.

Since the third quarter of 2009, economic output has grown, but not quickly enough to reduce the unemployment rate. Unemployment fell slightly in the first half of 2010, and was flat, averaging 9.6%, during the second half of 2010. Most forecasters do not anticipate a large decrease in unemployment in 2011.

The duration of unemployment has also been rising. Since mid-2009, over half of those unemployed had been so for 15 weeks or longer. While long-term unemployment has consistently trended upward in past recessions since 1970, the long-term unemployment rate was higher in this recession than it has been at any point in the post-World War II period.

The rise in unemployment was driven by a steady decline in employment. The decline in employment during this recession can be separated into three phases. From January to August 2008, employment fell between 10,000 and 334,000 per month. From September 2008 to July 2009, employment fell between 458,000 and 779,000 per month. Since July 2009, job losses have tapered off and employment generally rose in 2010.[2] Employment rose significantly in March, April, and May 2010 because of the federal government hiring of temporary Census workers. After May, employment fell as the temporary workers were let go after the completion of the Census; private-sector employment, however, increased. By the fourth quarter of 2010, employment was rising again.

[1] For a legislative history of unemployment benefit extensions, see CRS Report RL33362, *Unemployment Insurance: Available Unemployment Benefits and Legislative Activity*, by Katelin P. Isaacs, Julie M. Whittaker, and Alison M. Shelton.

[2] The data described here are net figures from the Bureau of Labor Statistics' establishment survey. Despite the recession, gross job gains at firms averaged 7 million per quarter in 2008, down from 7.6 million per quarter in 2007. These gross job gains have been more than offset by gross job losses, however. Gross job losses at firms averaged 7.9 million per quarter in 2008, up from 7.4 million per quarter in 2007.

A "hands off" policy approach would counsel for patience—in this view, the fall in unemployment will be gradual, but it is also inevitable. Every recession since World War II except the 1980 recession was followed by a period of sustained job creation.[3] Historical experience confirms that strong economic growth is the most important factor for reducing unemployment after a recession.[4] Nevertheless, because the unemployment rate is so high, even if the economy grew at a healthy rate, 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 December 1982, the unemployment rate was 8.3% one year later, and it took almost five years for the rate to fall by half. This gradual decline happened over a five-year period when economic growth averaged an unusually high rate of 4.5% annually.

Another argument in favor of patience is that the government has already taken extraordinary steps to stabilize the economy through the creation of the Troubled Asset Relief Program (TARP), the Federal Reserve's unconventional policy actions, and fiscal stimulus in 2008 and 2009, the latter of which contains 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 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. A major policy debate at this time, discussed below, examines how costly financing these additional policy steps would be at a time of large and unsustainable 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," however. 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. This theory was developed to explain the failure of high unemployment to fall in Western Europe in the 1980s expansion.[5] Hysteresis could result from imperfections in labor markets or 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 now could avoid some permanent loss in well-being.

[3] In the case of the 1980 expansion, the economy slid back into recession in 1981. Employment then began sustained growth in 1983.

[4] See CRS Report R40925, *Unemployment and Economic Recovery*, by Linda Levine.

[5] See 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.

Third, should a more interventionist policy be pursued in case the economic recovery turns out to be weaker than expected? Most economic forecasters are predicting that the economy will continue to grow at a similar pace to 2010 through 2011, and that unemployment will continue to top 9% through the end of 2011.[6] But what if the economy performs worse than expected?

There are two downside risks to the consensus view on the economic outlook that can be considered unlikely, but not implausible. There is a fear the economy will experience "double dip" recessions, meaning a return to economic contraction in the near-term. By historical standards double dips are rare—in the 20th 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).[7] In 1981, a large tightening of monetary policy is seen as playing a key role in the economy's return to recession, unlike today. The usual pattern is that once the expansion takes root (as the NBER has determined has happened), it continues for some time. For the expansion to be knocked off course and the economy to return to recession, some new "shock" to the economy would likely be needed, such as economic crisis throughout Europe, perhaps following a sovereign default. By their nature, shocks are hard to foresee, but large shocks are relatively infrequent.

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.[8] 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).

While 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, GDP growth in Japan averaged 3.8%. Since 1991, GDP growth has never exceeded 2.9% in a year, and from 1992 to 2003, GDP growth was below 2% in all but two years. 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 low growth was in part due to inadequate aggregate demand. Although the central bank lowered 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. Further, some economists believe that Japan's deflationary trap was prolonged by sporadic attempts by the government to withdraw fiscal and monetary stimulus prematurely. 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 following its financial crash.

[6] See, for example, *Blue Chip Economic Indicators*, vol. 35, no. 11, November 11, 2010.

[7] 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.

[8] For more information, see CRS Report R40512, *Deflation: Economic Significance, Current Risk, and Policy Responses*, by Craig K. Elwell.

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.

110th Congress

In February 2008, shortly after the recession began, an economic stimulus package of approximately $150 billion was adopted.[9] A provision that was considered (but not enacted) in the February stimulus bill was a 26-week extension of unemployment benefits; this extension was eventually enacted.[10]

A number of financial-sector interventions have also been undertaken, before and after financial market conditions worsened significantly in September 2008. The Federal Reserve (Fed) has taken many unconventional actions to stimulate the economy, discussed below. 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).[11] A number of programs have been 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 include an FDIC guarantee of debt issued by banks, a Treasury guarantee of money market mutual funds, and Treasury support of the GSEs.[12]

111th Congress

As the recession deepened, congressional leaders and President Obama proposed much larger stimulus packages at the beginning of 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.[13] It was a wide-ranging package that included infrastructure spending, revenue sharing with the states, middle class tax cuts, business tax cuts, unemployment benefits, and food stamps. Similar legislation was passed in the Senate on February 10 (an amendment in the nature of a substitute for H.R. 1) and would cost $838 billion, with $292 billion in tax cuts. CBO projected that the largest budgetary effects

[9] A second stimulus plan (H.R. 7110) passed the House on September 26, 2008, but was not passed by the Senate before the 110th 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.

[10] For a discussion of the tax, housing, and unemployment legislation adopted in the 110th 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 Mark Jickling; and CRS Report RS22915, *Temporary Extension of Unemployment Benefits: Emergency Unemployment Compensation (EUC08)*, by Katelin P. Isaacs, Julie M. Whittaker, and Alison M. Shelton.

[11] See CRS Report R41427, *Troubled Asset Relief Program (TARP): Implementation and Status*, by Baird Webel.

[12] See CRS Report R41073, *Government Interventions in Response to Financial Turmoil*, by Baird Webel and Marc Labonte.

[13] 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.

of P.L. 111-5 occurred in FY2010 (equaling 2.2% of GDP, compared with 1.3% in 2009). Some of the stimulus spending is expected to occur in FY2011; CBO projects 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 included 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 these employees once they have been retained for 52 weeks.[14] This provision is the principal one, in dollar amounts, of the package, costing $13 billion, with $7.6 billion for the payroll relief and $5.3 billion for the retention credit; the costs for the credit will occur in 2010 and 2011.[15] 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 provides transfers between the general funds and trust funds. S.Amdt. 3310 also contained offsets relating to foreign tax compliance (a gain of $8.7 billion)[16] and a further two-year delay in the worldwide interest allocation for the foreign tax credit ($7.9 billion).[17] The House passed the bill as well, and it was signed by the President on March 18, 2010 (P.L. 111-147).

The Small Business Jobs Act of 2010 (H.R. 5297) was signed into law on September 27, 2010, as 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, including 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, extended all other parts of the 2001 and 2003 ("Bush") tax cuts until the end of 2012, extended alternative minimum tax relief and various other expiring tax provisions until the end of 2011, extended and expanded bonus depreciation until the end of 2011, extended emergency unemployment benefits, and 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 increased 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.

In addition, a series of extensions to emergency unemployment benefits have been signed into law since 2008.[18]

---

[14] The original House-passed version of this bill included an extension in unemployment insurance benefits and COBRA health benefits, aid to troubled U.S. states and small businesses, and an increase in infrastructure spending. Some policy analysts have proposed hiring subsidies.

[15] 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.

[16] 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

[17] See CRS Report RL34494, *The Foreign Tax Credit's Interest Allocation Rules*, by Jane G. Gravelle and Donald J. Marples.

[18] For a legislative history of unemployment benefit extensions, see CRS Report RL33362, *Unemployment Insurance:* (continued...)

Federal Reserve

The Federal Reserve 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."[19] 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).[20] From the spring of 2009 to the spring of 2010, the Federal Reserve completed purchases of $1.25 billion of mortgage-backed securities, $175 billion in Government-Sponsored Enterprise (GSE) debt, and $300 billion of long-term Treasury debt. On November 3, 2010, it 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.

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.[21] 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

(...continued)

Available Unemployment Benefits and Legislative Activity, by Katelin P. Isaacs, Julie M. Whittaker, and Alison M. Shelton.

[19] See CRS Report R41540, *Quantitative Easing and the Growth in the Federal Reserve's Balance Sheet*, by Marc Labonte.

[20] See CRS Report RL34427, *Financial Turmoil: Federal Reserve Policy Responses*, by Marc Labonte.

[21] 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.

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 effect on aggregate demand.

Many economists view fiscal policy as less effective than monetary policy in an open economy. 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 some of the tax cut may be saved, and not spent.[22] Some argue that tax cuts that are aimed at higher-income individuals are more likely to be saved.[23] 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.[24] 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 range 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,
- infrastructure range between 0.5 and 1.2.[25]

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.

The challenge for spending programs is that there may be a lag time for planning and administration before the money is spent. Some analysts suggest that aid 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.

[22] See CRS Report RS21136, *Government Spending or Tax Reduction: Which Might Add More Stimulus to the Economy?*, by Marc Labonte.

[23] CRS Report RS21126, *Tax Cuts and Economic Stimulus: How Effective Are the Alternatives?*, by Jane G. Gravelle.

[24] 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.

[25] Congressional Budget Office, *Policies for Increasing Economic Growth and Employment in 2010 and 2011*, Jan. 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.

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 suggest that such subsidies are not very effective.[26] 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 phaseout 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.[27] 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.[28] 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).[29] Two proponents of this policy, Bartik and Bishop, have argued that the proposal will be successful in creating a significant number of jobs.[30] 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 1977-78 credit, but rather they predicted the effect on jobs based on the average labor demand elasticity.[31] Note that this estimate is a

[26] See CRS Report RL31134, *Using Business Tax Cuts to Stimulate the Economy*, by Jane G. Gravelle.

[27] For more information, see CRS Report RL30089, *The Work Opportunity Tax Credit (WOTC)*, by Linda Levine.

[28] Amore 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.

[29] See CRS Report 92-939, *Countercyclical Job Creation Programs*, by Linda Levine for a discussion.

[30] 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/.

[31] See Daniel L. Hamermesh, *Labor Demand* (Princeton University Press: Princeton, NJ, 1993), for a survey: Hamermesh suggests a midpoint elasticity of 0.3 on p. 92.

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.[32] 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.[33] Tannenwald surveyed Wisconsin and New England firms.[34] 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.[35]

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 can possibly be evaded (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.[36]

[32] 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.

[33] Jeffrey J. Perloff and Michael L. Wachter, "The New Jobs Tax Credit," *American Economic Review*, vol. 69, May 1989, pp. 173-179.

[34] 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.

[35] 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 Linda Levine.

[36] 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?

Another consideration is how to finance any proposed fiscal policy measure. The choice of financing affects both the macroeconomic impact and the cost-benefit tradeoff of the policy proposal. Policy measures can be financed by cutting other spending, raising other taxes, or increasing the budget deficit.

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 can be used 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 deep recession, 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.[37] 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.[38] 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.[39] 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 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.

[37] For more information, see CRS Report RL31775, *Do Budget Deficits Push Up Interest Rates and Is This the Relevant Question?*, by Marc Labonte.

[38] 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.

[39] This relationship is due to the balance of payments accounting identity (i.e., dollars sold equals dollars bought).

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.[40]

Author Contact Information

Jane G. Gravelle
Senior Specialist in Economic Policy
jgravelle@crs.loc.gov, 7-7829

Marc Labonte
Specialist in Macroeconomic Policy
mlabonte@crs.loc.gov, 7-0640

Thomas L. Hungerford
Specialist in Public Finance
thungerford@crs.loc.gov, 7-6422

[40] For more information, see CRS Report R40770, *Economic Effects of a Budget Deficit Exceeding $1 Trillion*, by Marc Labonte.