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### Struggling Recovery and Economic Policy Uncertainty: Testimony Before the Joint Revenue Hearing, House and Senate Ways and Means Committees, Massachusetts State House, Boston, MA

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# Center for American Progress Action Fund



## **Struggling Recovery and Economic Policy Uncertainty**

Testimony Before the Joint Revenue Hearing, House and Senate Ways and Means Committees

Massachusetts State House, Boston, MA

December 11, 2012

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### **Introduction**

The U.S. economy is in the fourth year of a recovery that started in June 2009. The fact that the economy is in recovery, even modestly, is something of a miracle given how stacked the deck is against it.

This is absolutely unique in American economic history:

- There has never been a recovery without the housing market expanding substantially as well.
- There has never been a recovery with state and local governments shrinking for three years in a row.
- There has never been a recovery with households owing, on average, well more than 100 percent of their after-tax income in debt.

Yet even with all three of these dogging us, we have avoided slipping back into recession.

And that is not all. Exports, which are a key factor contributing to strong growth and have offered a boost to many a recovery, have been battling the headwinds of the European financial crisis, slowing growth in China and India, and a strengthening dollar, which makes U.S. exports more expensive in the world market. And oil prices swung widely during those three years, from June 2009 to June 2012 as a result of dramatic international events such as the Arab Spring.

Much of this resilient recovery can be traced to past policy choices President Barack Obama and Congress made to specifically focus attention on investments that helped manufacturing and commercial construction, on help to struggling states and localities, and on middle-class tax cuts that boosted consumption. Targeted federal policies strengthened the private sector where possible. This meant attention to the struggling manufacturing and construction sectors through the American Recovery and Reinvestment Act of 2009. It meant support for the struggling construction sector through

infrastructure investments in the Recovery Act and subsequent legislation. And it meant strengthening household after-tax income to reduce household debt burdens more quickly through increased unemployment insurance benefits, the Making Work Pay tax credit, added Social Security benefits, and a payroll tax holiday—all measures targeted toward boosting middle-class incomes, where debt burdens were highest.

The president and Congress once again face a policy choice that could directly impact the strength of the U.S. economic recovery. A number of tax cuts are set to expire and federal across-the-board spending cuts are scheduled to go into effect at the start of 2013. This so-called fiscal cliff is not a natural phenomenon but rather the culmination of past policy decisions that could adversely impact the recovery by substantially weakening economic growth.

There are clear implications from the past few years for the current situation:

- First, the economy is not strong enough to quickly bring down the unemployment rate due to large obstacles, including uncertainty over how policymakers will handle the fiscal cliff.
- Second, the economic recovery appears rather resilient. It has avoided another recession in current years despite severe obstacles. That is, the policy goal is to strengthen the recovery.
- Third, public policy has strengthened the economic recovery sufficiently to avoid another recession. Policymakers have shown a willingness and ability to work together at key moments to focus on avoiding an economic downturn.
- Fourth, past policies have worked because they targeted key weaknesses in the U.S. economy, such as a struggling manufacturing and a decimated construction sector, high household debt burdens, and decreasing state and local government finances. The implication is that policies now need to address the remaining weaknesses to efficiently strengthen the economic recovery in the face of large federal budget deficits.

There are a few things we can infer from past experience—from the economic data and from public opinion surveys on what will happen to the economy and economic policy in 2013—even if we don't know exactly when and how policymakers will address the fiscal cliff. The economic recovery is still strong enough to avoid a recession on its own. The recovery, though, may face a changing set of threats as the lingering financial crisis in Europe seems to have slowed export growth and the economic uncertainty associated with the fiscal cliff may hold back business investments.

Policymakers can once again intervene to strengthen the recovery, particularly by emphasizing infrastructure investments and support for U.S. exports. Ideological positions may encumber some policymakers and delay the economic policy compromise necessary to boost job growth that voters really want. A faster recovery is in the cards as long as the political will to compromise on taxes and spending exists in both parties, but it may take some time to arrive at such a compromise.

### **A resilient recovery built on past targeted policy interventions**

The economy has sustained consistent growth for more than three years despite substantial obstacles. The primary obstacles to faster economic growth in the first three years of the recovery that started in

June 2009 were high household debt levels, shrinking state and local government spending, and a depressed housing market. These obstacles started to abate in the middle of 2012 but new obstacles emerged in their stead—specifically U.S. exports stalled amid the lingering European crisis and slower growth in China and India, and U.S. businesses held back on investments amid the growing uncertainty over how the president and Congress will address the looming tax increases and spending cuts.

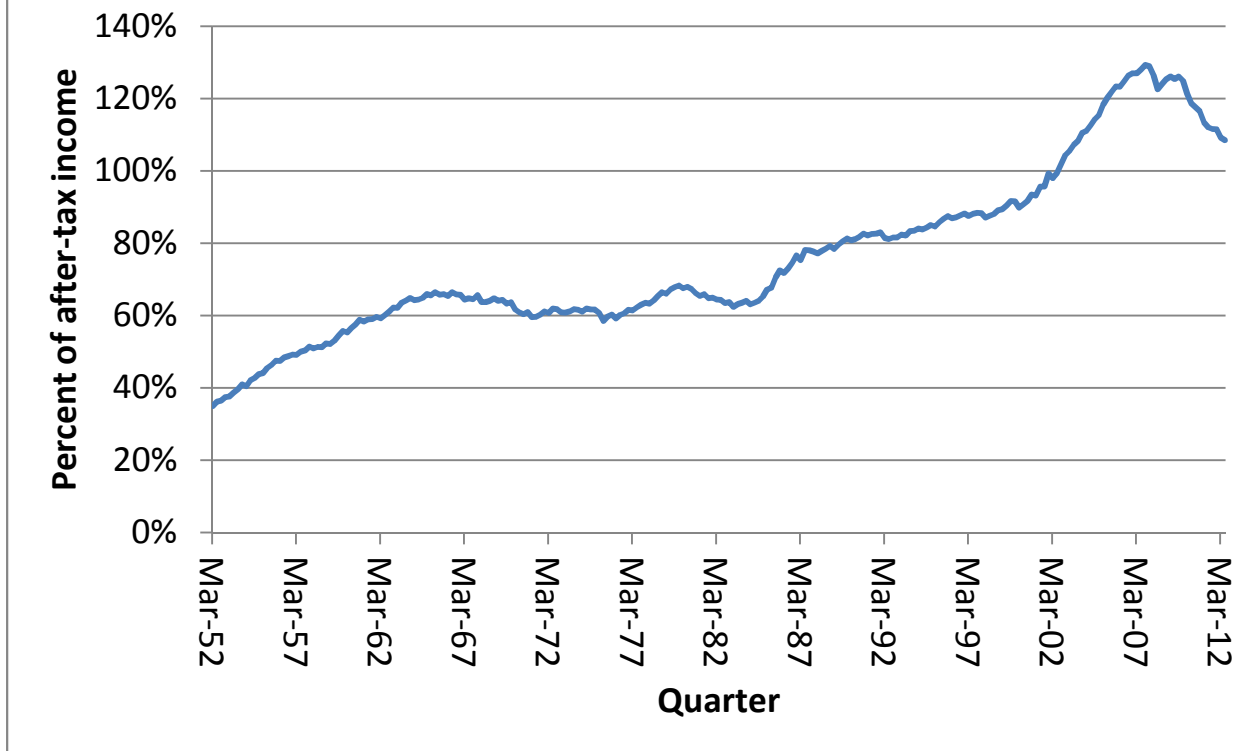
*The first three years of the recovery: Moving against unprecedented headwinds*

The first three years of this economic recovery have been unique in modern economic history, dating back to World War II. There has never been a recovery without the housing market expanding substantially as well, for instance. But the housing market remained weak throughout the recovery. It declined for four quarters out of the first eight quarters of the recovery before growing again throughout the third year of the recovery. But real housing spending was only 10.3 percent greater in June 2009 than in June 2012, compared to an average increase of 41.2 percent in the first three years of previous recoveries.<sup>1</sup>

There also has never been a recovery with state and local government spending shrinking for three years in a row. Yet real state and local government spending declined each quarter, except in the first one, from June 2009 to June 2012, so that real state and local government spending was 6.6 percent lower in June 2012 than three years earlier, compared to an average increase of 8.8 percent in prior recoveries.<sup>2</sup>

And there has never been a recovery with households owing, on average, well more than 100 percent of their after-tax income in debt, as was the case in this recovery. (see Figure 1)

**Figure 1: Household debt to after-tax income, 1952 to 2012**



Source: Board of Governors of the Federal Reserve System, “Release Z.1 - Flow of Funds Accounts of the United States” (2012).

The U.S. economy avoided slipping back into a recession despite these three major headwinds to economic growth. Targeted federal policies strengthened the private sector where possible.<sup>3</sup> The American Recovery and Reinvestment Act of 2009, for instance, and other subsequent legislation targeted the struggling manufacturing and construction sectors through infrastructure investment spending and money for green technologies. And the Making Work Pay tax credit, higher unemployment insurance and Social Security benefits that were included in the Recovery Act, and the subsequent payroll tax holiday for 2011 and 2012 boosted household after-tax income, particularly among middle-class families where household debt burdens were highest.

Key economic data show that public policies intended to strengthen the economic recovery had indeed the desired effect. Manufacturing production, for example, grew by an annualized rate of 5.6 percent from June 2009 to June 2012.<sup>4</sup> Further, federal, state, and local governments spent more money on construction of highways, schools, railroads, hospitals, among other projects fueled in part by Recovery Act funds, such that their spending increased by an annual inflation-adjusted rate of 3 percent from June 2009 to June 2012, which helped counter the decrease in private-sector construction spending.<sup>5</sup> And real personal disposable income increased at an annual rate of 1.2 percent from June 2009 to June 2012,

helping reduce the debt-to-after-tax-income ratio from 125.4 percent in June 2009 to 108.5 percent in June 2012<sup>6</sup>—an unprecedented deleveraging (see Figure 1).

Faster production, more construction spending on infrastructure projects, and higher after-tax incomes consequently helped to stabilize the economy and ultimately the U.S. labor market. Job growth returned in February 2010 and by June 2012 there were 2.6 million more jobs than in June 2009.<sup>7</sup> And the unemployment rate fell from 9.5 percent in June 2009 to 8.2 percent in June 2012.<sup>8</sup> The resurgence in manufacturing also allows firms to continue to build on past successes by better using their plant and equipment and their workers. This was reflected in strong U.S. export growth from June 2009 to June 2012, averaging an annual growth rate of 7.9 percent, despite a strong dollar that made U.S. products more expensive in world markets.

*Now: Replacing old obstacles to growth with new ones*

The three major past obstacles—a struggling housing market, decreasing state and local government spending, and high household debt—are all becoming weaker hindrances to faster economic growth. This is especially true for the housing sector. Real residential housing investment, mainly spending on new homes, increased by 14.2 percent in the third quarter of 2012—the third double-digit increase in a year.<sup>9</sup> And new home sales in September 2012 totaled a seasonally adjusted, annualized rate of 389,000—the highest level since April 2010.<sup>10</sup> Furthermore, state and local government spending in the third quarter of 2012 was essentially flat with an annual decline of only 0.4 percent—the smallest decrease since September 2009.<sup>11</sup> One quarter may not make a trend but it may be a sign that the fiscal challenges for state and local governments are slowly coming to an end, especially since the spending decreases have become successively smaller in 2012.<sup>12</sup> And finally, household debt levels will likely decrease further from their 108.5 percent level in June 2012—the lowest since September 2003—as banks continue to tighten lending.<sup>13</sup>

But economic growth is held back by two new obstacles, specifically slower U.S. exports due to the lingering crisis in Europe and slower growth in China and India, and less business investment due in part to the economic uncertainty over what will happen to tax rates and federal spending as Congress and President Obama address the fiscal cliff. Real U.S. exports grew by an annual rate of 1.1 percent in the third quarter of 2012—their lowest growth rate since June 2009—and business investment actually fell at an annual rate of 2.2 percent in the third quarter of 2012—its largest decline since the end of 2009.<sup>14</sup>

Slowing export growth follows less overseas demand for U.S. products. European economic growth has slowed in most major countries due to lingering financial and fiscal crises in several southern European countries. There is little that U.S. policymakers can do to directly impact the crisis in Europe. The policy lesson then for domestic policymakers is to strengthen the U.S. economy and the competitiveness of its manufacturing sector. Stronger domestic demand can offset the fallout from declining overseas demand, and a more competitive manufacturing sector will more easily overcome the obstacles posed by a strong dollar and slowing overseas growth.<sup>15</sup>

The decline in business investment is in part attributable to the uncertainty over what will happen to the scheduled end-of-year changes in taxes and spending. The expiration of past tax cuts and the onset of

automatic spending cuts is the culmination of past policy decisions that Congress could and likely will alter in the coming weeks or months:<sup>16</sup>

- The tax cuts enacted in 2001 and 2003 under President George W. Bush as well as a series of smaller tax cuts enacted under President Obama in 2009 expire on January 1, 2013, potentially taking \$281 billion out of the economy in 2013.
- The expiration of the payroll tax cut that was in place for 2011 and 2012 will take another \$115 billion out of the economy, starting on January 1, 2013.
- Other tax changes, such as the end of an expansion of the alternative minimum tax, expiring tax extenders and depreciation rules for businesses, and new taxes associated with the Patient Protection and Affordable Care Act of 2010, would take another \$139 billion out of the economy, starting on January 1, 2013.
- The expiration of extended unemployment insurance benefits would directly impact the economy to the tune of an estimated \$34 billion, starting on January 1, 2013.
- Changes to Medicare reimbursements for doctors would take another \$14 billion out of the economy, and spending cuts totaling \$78 billion start on January 2, 2013.

The total bill for these tax and spending changes comes to \$661 billion for 2013 alone.<sup>17</sup>

The looming sizeable changes in taxes and spending creates enormous uncertainty for businesses and consumers in two ways. First, businesses and consumers don't know which taxes will ultimately expire and which spending cuts will be enacted, even if people expect that President Obama and Congress will ultimately reach a deal to smooth the potential adverse effects on the economy.<sup>18</sup> Second, the combination of tax increases and spending cuts, even if they are smaller than expected, could adversely impact economic growth, but without a political deal, businesses cannot estimate and thus cannot properly plan for the eventuality of a smaller economic impact. The Congressional Budget Office, for instance, expects that the economy would shrink by 0.5 percent in inflation-adjusted terms in 2013 if all provisions of the fiscal cliff go into effect, rather than grow by about 2 percent if many provisions are eliminated.<sup>19</sup> There is no single estimate to show what would happen to the U.S. economy if the fiscal cliff is avoided since the exact impact depends on the provisions that are changed and the ones that are kept. The potential adverse effect on the U.S. economy consequently can swing widely. (see Table 1)<sup>20</sup>

Policymakers can and likely will affect both sources of economic uncertainty. In the worst-case scenario, there will be no political deal to avoid the scheduled fiscal tightening. The scheduled tax increases and spending cuts will go into effect, thus creating certainty over both the fiscal and economic outlook. The removal of this uncertainty will likely be insufficient to stop the economy from going into recession. Alternatively, there will be a deal, although its timing is hard to predict. Any deal will also create certainty over the fiscal and economic outlook and thus lead to more investment and consumption than would be the case in a situation with less certainty. The remaining questions consequently are when President Obama and Congress will reach a deal; how large the fiscal tightening, if any, will be; and whether policymakers will set some money aside to address remaining and new obstacles—for example, by supporting manufacturing and construction businesses with more infrastructure spending.

**Table 1: Possible growth effects of selected changes to the fiscal cliff**

	<i>Difference against CBO baseline for 2013 (GDP)</i>	<i>Projected growth in 2013 (GDP)</i>
<a href="#">CBO Baseline</a>	0.00	1.30
Eliminating the automatic enforcement procedures established by the Budget Control Act of 2011 for both discretionary and mandatory spending, maintaining Medicare’s payment rates for physicians’ services at the current level	0.75	2.05
Extending all expiring tax provisions other than the cut in the payroll tax and indexing the alternative minimum tax for inflation beginning in 2012	1.50	2.80
Doing both of the above (i.e., the Congressional Budget Office’s “alternative fiscal scenario”)	2.25	3.55
Extending all expiring tax provisions other than the cut in the payroll tax, indexing the alternative minimum tax for inflation—except for allowing the expiration of lower tax rates on income above \$250,000 for couples and \$200,000 for single taxpayers	1.25	2.55
Extending both the current 2 percentage-point cut in the payroll tax and emergency unemployment benefits—extensions that are not assumed in the alternative fiscal scenario—would boost real GDP by about three-quarters of a percent by the end of 2013; making those changes along with making all of the changes in the Congressional Budget Office’s alternative fiscal scenario	3.00	4.30

Sources: All figures in percent. All figures reflect real GDP growth rates for 2013. Congressional Budget Office, “An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022” (2012); Congressional Budget Office, “Economic Effects of Policies Contributing to Fiscal Tightening in 2013” (2012).

**Public opinion may point the way to a resolution**

It is virtually impossible to divine answers to the questions related to a possible resolution of the looming fiscal tightening. Policymakers, though, may take a look at public opinion polls to help them frame their decisions.

There is no doubt that people take the looming federal budget deficits seriously, but addressing deficits generally ranks lower in people’s minds than job creation. In a *USA Today*/Gallup poll taken from November 9–12, 2012, for instance, 95 percent of respondents ranked “taking major steps to restore a strong economy and job market” as extremely/very important for President Obama to accomplish, compared to 72 percent who ranked “make major cuts in federal spending” and 70 percent who ranked “simplify the tax code to lower rates, eliminate deductions/loopholes” as extremely/very important.<sup>21</sup>

A poll by the Mellman Group conducted on November 12, 2012, similarly found that 67 percent of respondents favored creating jobs to 29 percent who favored deficit reduction in response to the question “which would you rather have Congress and the President focus on: reducing the federal



budget deficit or creating jobs?”<sup>22</sup> And Stan Greenberg at Democracy Corps found in a poll conducted November 6–7, 2012, that 51 percent of respondents in this poll ranked creating jobs and getting the economy going as one of the three most important things to focus on, compared to 47 percent who mentioned deficit reduction—the two most-often-mentioned issues to focus on in this poll.<sup>23</sup>

Little recent polling exists on specific measures to strengthen the economy. The polling data, though, suggest that people are looking for a balance between short-term help for the economy and the labor market and longer-term measures to reduce the federal deficits. People also seem to accept the notion of a balance between tax increases and spending reductions. It is thus possible that policymakers will strike a deal soon that balances these competing goals.

## Conclusion

The economic recovery has shown tremendous resilience in the face of major obstacles in recent years. This was no accident. Past policy interventions that targeted middle-class income growth and promoted a faster recovery in construction and manufacturing achieved their goals of building a stronger recovery. Policymakers can and will intervene to stop the economy from going into another recession—that is, there will in all likelihood be a deal to avoid the most severe impact of the expected fiscal tightening in early 2013. Economic growth could then very well accelerate over the course of 2013 as major obstacles to faster growth, including the so-called fiscal cliff, slowly disappear.

## Endnotes

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<sup>1</sup> Calculations based on: Bureau of Economic Analysis, *National Income and Product Accounts* (Department of Commerce, 2012).

<sup>2</sup> Economic growth during the first three years of this recovery was 12.6 percent lower due to the drag from the spending cuts among state and local governments. *Ibid.*

<sup>3</sup> For additional details on past policy efforts and the relationship between the onset of policy measures and changes in key economic indicators, see: Christian E. Weller, “10 Reasons Why Public Policies Rescued the U.S. Economy,” Center for American Progress, May 29, 2012, available at <http://www.americanprogress.org/issues/economy/news/2012/05/29/11593/10-reasons-why-public-policies-rescued-the-u-s-economy/>.

<sup>4</sup> Calculation based on data from: Board of Governors of the Federal Reserve System, “Release G.17 - Industrial Production and Capacity Utilization” (2012), available at <http://www.federalreserve.gov/releases/g17/current/g17.pdf>.

<sup>5</sup> Calculations based on Bureau of the Census, *Value of Construction Put in Place* (Department of Commerce, 2012); Bureau of Labor Statistics, *Consumer Price Index for Urban Consumers* (Department of Labor, 2012).

<sup>6</sup> Calculation based on: Bureau of Economic Analysis, *National Income and Product Accounts*.

<sup>7</sup> Calculation based on: Bureau of Labor Statistics, *Current Employment Statistics* (Department of Labor, 2012).

<sup>8</sup> Data from: Bureau of Labor Statistics, *Current Population Survey* (Department of Labor, 2012).

<sup>9</sup> Data from: Bureau of Economic Analysis, *National Income and Product Accounts*.

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<sup>10</sup> Data from: Bureau of the Census, *Residential Sales Statistics* (Department of Commerce, 2012).

<sup>11</sup> Data from: Bureau of Economic Analysis, *National Income and Product Accounts*.

<sup>12</sup> Ibid.

<sup>13</sup> Banks still reported tightening lending standards for both traditional and subprime mortgages in October 2012. See: Board of Governors of the Federal Reserve System, “Senior Loan Office Opinion Survey on Bank Lending Practices Chart Data” (2012).

<sup>14</sup> Data from: Bureau of Economic Analysis, *National Income and Product Accounts*.

<sup>15</sup> For a discussion of the linkages between the European and U.S. economies and the policy lessons for U.S. policymakers, see: Sabina Dewan and Christian E. Weller, “When Europe’s Sovereign Debt Crisis Hits Home,” Center for American Progress, September 22, 2011, available at <http://www.americanprogress.org/issues/economy/news/2011/09/22/10379/when-europes-sovereign-debt-crisis-hits-home/>.

<sup>16</sup> The term “fiscal cliff,” which invokes a natural inevitability, thus seems an inappropriate metaphor.

<sup>17</sup> See: “Fiscal Cliff Timeline,” available at <http://bipartisanpolicy.org/fiscalcliff> (last accessed December 2012).

<sup>18</sup> For discussions about how similar policy uncertainty associated with the debt ceiling in the summer of 2011 negatively impacted the economy, see: Scott Lilly, “Creating Unemployment” (Washington: Center for American Progress, 2011), available at [http://www.americanprogress.org/issues/2011/10/creating\\_unemployment.html](http://www.americanprogress.org/issues/2011/10/creating_unemployment.html); Michael Ettlinger and Michael Linden, “Default Dangers amid Slowing Economy,” Center for American Progress, July 29, 2011, available at [http://www.americanprogress.org/issues/2011/07/default\\_dangers.html](http://www.americanprogress.org/issues/2011/07/default_dangers.html).

<sup>19</sup> See: Congressional Budget Office, “An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022” (2012), available at <http://www.cbo.gov/publication/43539>.

<sup>20</sup> Moody’s Analytics estimates that the effect of the full fiscal tightening will be somewhat greater for Massachusetts than the rest of the country. They expect that employment will fall by 1.5 percent in Massachusetts from the fourth quarter of 2012 to the fourth quarter of 2013, compared to a decline of 1 percent nationally. The disproportionate effect in Massachusetts reflects higher personal incomes and a greater reliance on federal spending, especially due to a prevalence of defense contractors. Personal communication from Moody’s Analytics, November 30, 2012, and December 4, 2012.

<sup>21</sup> Lydia Saad, “Economy, Entitlements, Iran and Americans’ Top Priorities,” Gallup, November 15, 2012, available at <http://www.gallup.com/poll/158834/economy-entitlements-iran-americans-top-priorities.aspx>.

<sup>22</sup> The Mellman Group, “Voters Overwhelmingly Oppose Cuts,” November 18, 2012, available at <http://tpmdc.talkingpointsmemo.com/PDF/Mellman%20Poll%20Memo.pdf>.

<sup>23</sup> Greenberg Quinlan Rosner Research, “Democracy Corps Economy Media Project: Frequency Questionnaire,” November 6–7, 2012, available at <http://www.democracycorps.com/attachments/article/932/dcor.ecnpe.fq.110812.pdf>.