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FOCUS NOTES

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The fiscal drag on US GDP growth

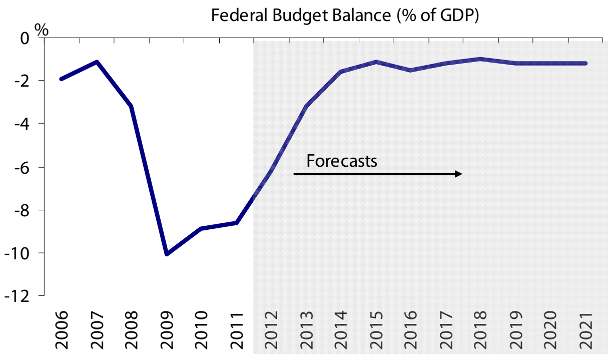
- Congress and the Administration have compromised on extending the 2% payroll tax cuts and emergency unemployment benefits, averting a noticeable fiscal drag on growth in the first part of the year.
- While the current political environment generates some uncertainty concerning further extension, there is a high likelihood that both provisions will be extended through the end of 2012.
- Under this assumption, CBO's forecast for the US federal budget deficit in 2012 changes from -6.2% to -7.3% of GDP.
- According to our estimates, the average fiscal effect on 2012 US growth would be 0.6-0.7%, marginally higher than the average fiscal drag on 2011 US growth (-0.5%).

Following a period of political disagreement over several issues regarding US fiscal policy, Congress and the Administration finally agreed at the beginning of the month to extend the payroll tax cut and 99-week maximum unemployment benefits for two months, through February 2012. The extension of these provisions was a very important factor for US growth in the first part of the year: if they were left to expire at the end of 2011, this would constitute a noticeable fiscal drag on disposable income and, consequently, personal spending. While the current political environment generates some uncertainty concerning further extension, there is a high likelihood that both provisions will be extended through the end of 2012.

While we expect an extension of the 2% employee-side payroll tax cut with no change in current policy, it is very likely that Congress will change the policy for emergency unemployment benefits. According to the Congressional Budget Office (CBO) estimates, the House bill may reduce the annual amount of unemployment benefits by about $20bn through early 2013 (from $57bn under current policy to about $35bn). Maximum benefit duration in many states may reduce to 79 weeks or even more, as a number of policy changes may tighten eligibility for unemployment benefits. Given that these two provisions account for nearly $170bn (i.e. 1% of GDP), a further renewal for the whole year should avoid much of the fiscal drag through 2012.

CBO's baseline budget outlook published in August 2011 includes a federal budget deficit reduction to -6.2% of GDP in 2012 from -8.5% in 2011 (Figure 1). The baseline projections include the following policies: (a) Certain provisions of the 2010 tax act, including extensions of lower rates and expanded credits and deductions originally enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001, the Jobs and Growth Tax Relief Reconciliation Act of 2003, and the American Recovery and Reinvestment Act (ARRA), are extended through the end of 2012, (b) the 2% payroll tax cut and the unemployment benefits expire at the end of 2011, and (c) sharp reductions in Medicare's payment rates for physician's services effective at the end of 2011. Under the above mentioned assumptions, the total federal budget deficit declines from -$1,284bn in 2011 to -$973bn in 2012. Should we incorporate into our calculations the extension of the payroll tax and unemployment benefits through the end if the year, which seems the most likely outcome at the moment, then the budget deficit increases to about -$1,140bn, i.e. 7.3% of GDP for 2012.

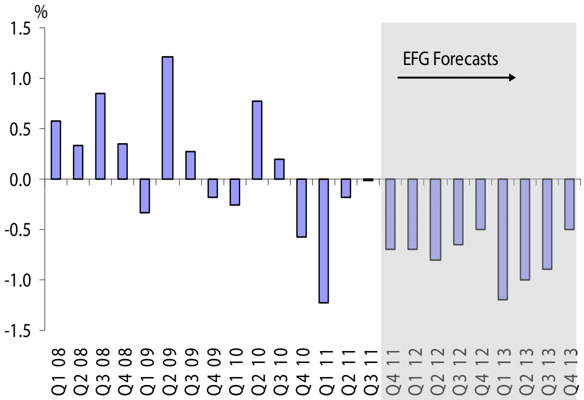
Figure 1



Source: Congressional Budget Office

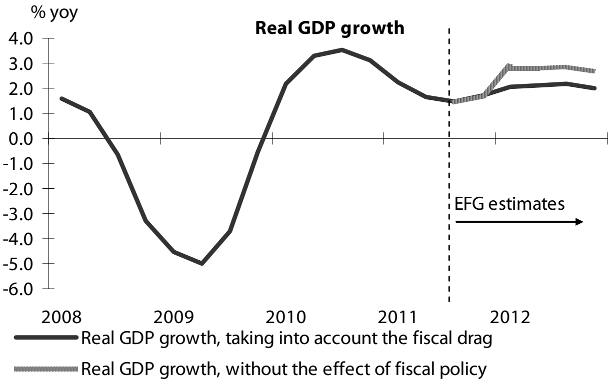
Trying to assess the potential fiscal drag on US growth, we modified our US GDP model so that it takes into account the expected deficit reduction. In particular, we use the expected budget deficit (as a % of GDP) -among other independent variables- in order to project the ISM manufacturing index and the unemployment stress[1]. Hence, our GDP model, which is a function of the unemployment stress, the ISM manufacturing index, nonfarm payrolls and US house prices, will include the effect from fiscal consolidation. Figure 2 shows the overall effect of fiscal policy on US real GDP growth, which reflects the extension of the payroll tax cut and emergency unemployment benefits through the end of 2012. According to our estimates, the average fiscal effect on 2012 US growth is about 0.6-0.7%, marginally higher than the average fiscal drag on 2011 US growth (-0.5%). As is evident in Figure 3, our model-based estimates produce a 2.8% real GDP growth in the US, without taking into account the effect of fiscal consolidation. The growth rate of real economic activity declines to about 2.1% for a budget deficit reduction of about 1.2% (from 8.5% in 2011 to 7.3% in 2012).

Figure 2



Source: U.S. Bureau of Economic Analysis (BEA), EFG model estimates

Figure 3



Source: U.S. Bureau of Economic Analysis (BEA), EFG model estimates

Our results are consistent with the IMF staff calculations for the macroeconomic effects of fiscal consolidation[2]: according to their findings, a budget deficit reduction by 1% of GDP typically reduces real economic activity by about 0.3% and 0.5% in the first and the second year, respectively. The output cost for tax-based consolidation exceeds that for spending-based consolidation by 0.3% in the first year (0.6% versus 0.3%, respectively) and by about 1% in the second year (1.3% versus 0.3%, respectively). Taking these numbers into account, a federal budget deficit reduction of about 1.2% would have a maximum effect on 2012 US real GDP growth of about 0.6%.

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[1] *The unemployment stress is the product of the unemployment rate and the median duration of unemployment.*

[2] *IMF (October 2010), "Will it hurt? Macroeconomic effects of fiscal consolidation", World Economic Outlook, Chapter 3, pp. 93-124.*

Looking ahead, we expect the fiscal drag on US growth to increase to roughly 1% in 2013, given that the payroll tax cut and the unemployment benefits are left to expire at the end of 2012 (Figure 2). However, this forecast does not take into account the expiration of 2001/2003 tax cuts at the end of 2012, which would constitute an additional significant drag on US growth. CBO's baseline forecasts, which assume the expiration of the 2001/2003 tax cuts, report a federal budget deficit of roughly 3.5% of GDP in 2013 (Figure 1), constituting a negative impact of about 1.5-2% on US real GDP growth in 2013. Meanwhile, the Super Committee's[3] failure to pass a new deficit reduction plan leads to automatic spending cuts of about $1.1trn for both discretionary and mandatory spending for the next 9 years starting in January 2013[4]. The automatic spending cuts would reduce spending by about $70bn in 2013. Although lawmakers may intervene sometime in 2012 to pass legislation to avoid -or at least delay- the sequestration process, the lack of political agreement points out that several important issues for medium and long-term US public finances (like the Bush tax cuts first passed in 2001 and 2003 and a new deficit reduction plan during 2013-2021) are difficult to be resolved before the November 2012 elections, elevating the amount of uncertainty for the US economic outlook in the medium-term.

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[3] *The Super Committee is the Joint Select Committee charged with finding $1.5trn of additional budgetary savings through 2013-2021.*

[4] *See CBO's analysis, "Estimated Impact of Automatic Budget Enforcement Procedures Specified in the Budget Control Act", September 12, 2011.*

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