

## Spending Versus Tax Cuts: Who Pays the Cost of Political Compromise?

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President Obama and the Democratic leadership will undoubtedly have to make some political compromises in order to get a stimulus package through Congress. However, it is important to keep in mind that there will be real costs associated with these compromises insofar as they result in a less effective stimulus package. A less effective package will mean less economic growth, which will, in turn, mean that fewer people will have jobs.

This paper calculates how the costs of a less effective stimulus package will be borne. Relying on estimates of the multipliers from various spending and tax measures from Moody's Economy.com, this paper projects the impact on overall job growth and employment, as well as on job growth and employment for African Americans and Hispanics, of political compromises that lead to less effective stimulus.<sup>1</sup>

**Table 1** below compares the projected impact of spending increases to a temporary rebate of the payroll tax or to a cut in corporate taxes. The assumed multiplier for spending increases is 1.5, which is approximately the average multiplier for the various types of spending from Moody's Economy.com. The multiplier for a payroll tax holiday was estimated as 1.29.

The multiplier for cuts in corporate tax cuts used in the table is 0.3. This is the estimated multiplier for a cut in corporate income tax rates. This figure might be a reasonable approximation for some of the corporate tax cuts that the administration is reportedly considering, however, it almost certainly overstates the multiplier for one tax cut supposedly under consideration.

According to several reports, President Obama is considering a measure that will allow firms to write off losses in 2008 and 2009 against five years of past profits, instead of the two years allowed under current law. This change in the tax code would only help a relatively small number of firms, disproportionately banks and builders, who have very large losses. Unlike a cut in the corporate income tax, which changes firm's incentives going forward, this tax cut simply hands firms money, without changing their incentives going forward.

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Therefore, there is little reason to believe that this particular tax cut would lead to any noticeable increase in investment. For this reason, a multiplier of 0.3 likely overstates the impact of this proposed tax cuts.

**TABLE 1: The Impact of Various Types of Fiscal Stimulus**

|                               | Government Spending | Individual Tax Rebate | Corporate Tax Cut |
|-------------------------------|---------------------|-----------------------|-------------------|
| Amount of Stimulus (billions) | \$100               | \$100                 | \$100             |
| Impact on GDP (billions)      | \$150               | \$129                 | \$30              |
| Impact on Employment          | 1,000,000           | 860,000               | 200,000           |
| Impact on Unemployment        |                     |                       |                   |
| Overall                       | -0.50%              | -0.40%                | -0.10%            |
| African American              | -0.71%              | -0.57%                | -0.14%            |
| Hispanic                      | -0.67%              | -0.53%                | -0.13%            |
| Impact on Employment Rates    |                     |                       |                   |
| Overall                       | 0.70%               | 0.60%                 | 0.14%             |
| African American              | 1.05%               | 0.90%                 | 0.21%             |
| Hispanic                      | 1.05%               | 0.90%                 | 0.21%             |

Source: See text.

The table shows that \$100 billion of additional government spending will lead to an increase in GDP of approximately \$150 billion (about 1 percent of GDP at current levels). Following the analysis presented by President-elect Obama’s staff, the table assumes that an increase in GDP of 1 percent leads to an increase in employment of 1 million workers.<sup>2</sup> This means that \$100 billion of additional spending will lead to 1 million additional jobs, while a temporary cut in payroll taxes will generate 860,000 jobs. By contrast, a \$100 billion cut in corporate taxes will lead to just 200,000 new jobs.

Using the assumption that a 2.0 percent increase in GDP leads to a 1.0 percentage point drop in the unemployment rate (Okun’s Law), we can project that a \$100 billion increase in spending will cause the overall unemployment rate to drop by 0.5 percentage points. A reduction in the payroll tax of the same size will lead to a 0.4 percentage point drop in the unemployment rate, while the same cut in corporate taxes will cause the unemployment rate to fall by just 0.1 percent.

African Americans and Hispanics feel the effects of a downturn (and upturn) disproportionately. Assuming that unemployment for these groups tracks the overall unemployment in the same way as it did in the last two downturns,<sup>3</sup> the \$100 billion increase in spending can be expected to reduce unemployment among African Americans by 0.71 percentage points and among Hispanics by 0.67 percentage points. The payroll tax rebate lowers the unemployment rate amongst these groups by 0.57 percentage points and 0.53 percentage points, respectively. By contrast, the corporate tax cut will lead to drops of just 0.14 percentage points and 0.13 percentage points, respectively.

Finally, the same comparisons can be made with employment. The \$100 billion increase in spending leads to a 0.7 percentage point increase in total employment. The payroll tax rebate increases employment by 0.6 percentage points, while the corporate tax cut leads to an increase in employment of just 0.14 percentage points. The effects of the employment of both African Americans and Hispanics are 1.5 times as large. This means that a \$100 billion increase in spending will lead to 1.05 percentage point increase in employment for African Americans and Hispanics, while a corporate tax cut of the same size will increase employment for these groups by just 0.21 percentage points.

These projections indicate that insofar as tax cuts are substituted for government spending, there will be fewer jobs created by the stimulus and that African Americans and Hispanics will feel this effect disproportionately. Insofar as corporate tax cuts are substituted for spending, the impact of a given amount of stimulus will be only one-fifth as great. This sort of substitution could lead to considerably higher rates of unemployment for African Americans and Hispanics.

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- <sup>1</sup> Page 3 of Zandi, Mark M. 2008. "Assessing the Macro Economic Impact of Fiscal Stimulus 2008," Moody's Economy.com. Available online at <http://www.economy.com/mark-zandi/documents/assising-the-impact-of-the-fiscal-stimulus.pdf>.
- <sup>2</sup> Romer, Christina and Jared Bernstein. 2009. "The Job Impact of the American Recovery and Reinvestment Act," Office of the President-Elect. Available online at [http://otrans.3cdn.net/ee40602f9a7d8172b8\\_ozm6bt5oi.pdf](http://otrans.3cdn.net/ee40602f9a7d8172b8_ozm6bt5oi.pdf).
- <sup>3</sup> See Table 3 of Schmitt and Baker. 2008. "What We're In For: Projected Economic Impact of the Next Recession," Center for Economic and Policy Research. Available online at [http://www.cepr.net/documents/publications/JSDB\\_08recession.pdf](http://www.cepr.net/documents/publications/JSDB_08recession.pdf).