BBVA Research

U.S.

Economic Watch

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Economic Analysis

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Fiscal Stimulus 3.0

Agreement will raise GDP growth in 2011-12

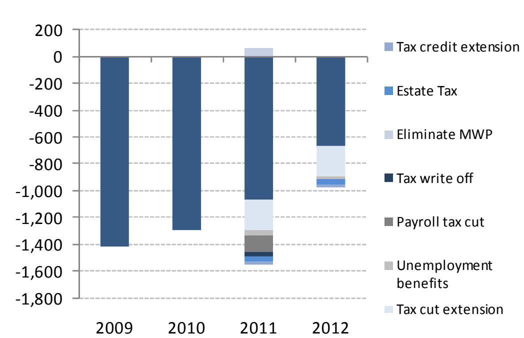
- **The deal extends tax cuts, tax credits and unemployment benefits. It also lowers payroll taxes and incentivizes business investment**
- **Many elements of the agreement were likely to happen**
- **The proposal increases fiscal deficit and debt levels; complicates future fiscal consolidation**

President Obama announced a bipartisan fiscal agreement for the next two years. The deal extends the expiring Bush tax cuts for all income bracket rates, as well as the Earned Income Tax Credit, the Child Tax Credit, and the American Opportunity Tax Credit. It also avoids tax rate hikes on estates and reduces the payroll tax by 2 percentage points for employees, which substitutes the expiring Making Work Pay (MWP) tax credit. In addition, the deal extends the unemployment insurance benefit for another 13 months and will allow businesses to write off 100% of their investment in 2011, instead of 50% proposed back in September. In total, these measures add up to around $800bn or 5% of GDP. The size of this agreement is similar to the American Recovery and Reconstruction Act of 2008 and 5 times the size of the Economic Stimulus Act of 2008.

Lower tax rates and tax credits have a positive fiscal multiplier effect that will boost GDP growth in 2011-12. According to our estimates, the impact on GDP growth could be around 0.3 to 0.9% for 2011, and 0.2 to 0.6% for 2012. However, the agreement doesn't include spending cuts and thus raises the fiscal deficit and public debt levels, which tend to dampen long-term economic growth. Therefore, while the agreement may boost short-term economic expansion, the net effect over the long-run is likely to be negative. In addition, by delaying fiscal consolidation, the need for austerity measures would be greater in the future and more complicated to implement. A better outcome would have been a comprehensive fiscal package that tackles structural problems and increases potential GDP growth.

Graph 1

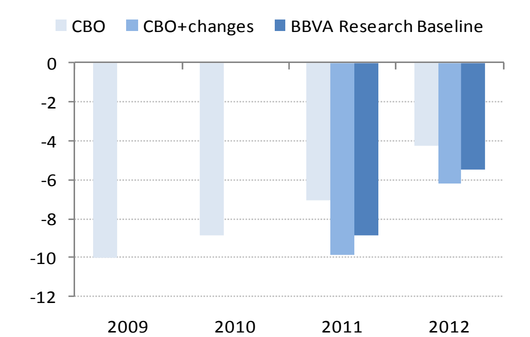
Impact on fiscal deficit ($bn)



Source: CBO and BBVA Research

Graph 2

Fiscal deficit (% of GDP)



Source: CBO and BBVA Research

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