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Estimated Impact of the American Recovery and Reinvestment Act on Employment and Economic Output From April 2010 Through June 2010

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Estimated Impact of the American Recovery and Reinvestment Act on Employment and Economic Output From April 2010 Through June 2010

Abstract

[Excerpt] The American Recovery and Reinvestment Act of 2009 (ARRA) contains provisions that are intended to boost economic activity and employment in the United States. Section 1512(e) of the law requires the Congressional Budget Office (CBO) to comment on reports filed by recipients of ARRA funding that detail the number of jobs funded through their activities. This CBO report fulfills that requirement. It also provides CBO's estimates of ARRA's overall impact on employment and economic output in the second quarter of calendar year 2010. Those estimates—which CBO considers more comprehensive than the recipients' reports—are based on evidence from similar policies enacted in the past and on the results of various economic models.

Keywords

American Recovery and Reinvestment Act of 2009, ARRA, Congressional Budget Office, CBO, economic growth, employment, job creation

Comments

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CBO

REPORT

**Estimated Impact of the American Recovery and
Reinvestment Act on Employment and
Economic Output From
April 2010 Through June 2010**

August 2010



CONGRESSIONAL BUDGET OFFICE
SECOND AND D STREETS, S.W.
WASHINGTON, D.C. 20515



**Estimated Impact of the American
Recovery and Reinvestment Act on
Employment and Economic Output from
April 2010 Through June 2010**

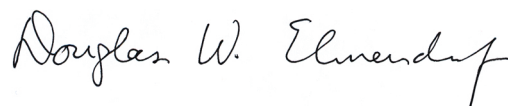
August 2010



Preface

The American Recovery and Reinvestment Act of 2009 (ARRA) contains provisions that are intended to boost economic activity and employment in the United States. Section 1512(e) of the law requires the Congressional Budget Office (CBO) to comment on reports filed by recipients of ARRA funding that detail the number of jobs funded through their activities. This CBO report fulfills that requirement. It also provides CBO's estimates of ARRA's overall impact on employment and economic output in the second quarter of calendar year 2010. Those estimates—which CBO considers more comprehensive than the recipients' reports—are based on evidence from similar policies enacted in the past and on the results of various economic models.

Benjamin Page of CBO's Macroeconomic Analysis Division wrote the report under the supervision of Robert Dennis and William Randolph. Jared Brewster, Mark Lasky, and Joshua Shakin contributed to the analysis. Kate Kelly edited the report, Maureen Costantino prepared it for publication, Chris Howlett proofread it, Monte Ruffin printed it, and Linda Schimmel handled the distribution. This report, along with previous reports on the topic, is available on CBO's Web site (www.cbo.gov).



Douglas W. Elmendorf
Director

August 2010

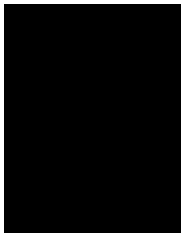


Contents

Measuring ARRA's Impact Using Recipients' Reports	2
Measuring ARRA's Impact Using Economic Models and Historical Data	4
CBO's Modeling Approach	4
Change from CBO's Previous Estimates of the Impact of ARRA	8
Appendix: Evidence on the Economic Effects of Fiscal Stimulus	9

Tables

1. Estimated Macroeconomic Impact of the American Recovery and Reinvestment Act, 2009 to 2012	3
2. Estimated Output Multipliers of Major Provisions of the American Recovery and Reinvestment Act	6



Estimated Impact of the American Recovery and Reinvestment Act on Employment and Economic Output from April 2010 Through June 2010

In February 2009, in response to significant weakness in the economy, lawmakers enacted the American Recovery and Reinvestment Act (ARRA). The legislation's numerous spending and revenue provisions can be grouped into several categories according to their focus:

- Providing funds to states and localities—for example, by raising federal matching rates under Medicaid, providing aid for education, and increasing financial support for some transportation projects;
- Supporting people in need—such as by extending and expanding unemployment benefits and increasing benefits under the Supplemental Nutrition Assistance Program (formerly the Food Stamp program);
- Purchasing goods and services—for instance, by funding construction and other investment activities that could take several years to complete; and
- Providing temporary tax relief for individuals and businesses—such as by raising exemption amounts for the alternative minimum tax, adding a new Making Work Pay tax credit, and creating enhanced deductions for depreciation of business equipment.

When ARRA was being considered, the Congressional Budget Office (CBO) and the staff of the Joint Committee on Taxation estimated that it would increase budget deficits by \$787 billion between fiscal years 2009 and 2019. CBO now estimates that the total impact over the

2009–2019 period will amount to \$814 billion. Close to half of that impact is estimated to occur in fiscal year 2010, and about 70 percent of ARRA's budgetary impact will have been realized by the close of that fiscal year.

Various recipients of ARRA's funds (most recipients of grants and loans, contractors, and subcontractors) are required to report, after the end of each calendar quarter, the number of jobs funded through ARRA. The law also requires CBO to comment on those reported numbers.¹

During the second quarter of 2010, recipients reported, ARRA funded almost 750,000 full-time-equivalent (FTE) jobs.² Those reports, however, do not provide a comprehensive estimate of the law's impact on U.S. employment, which could be higher or lower than the number of FTE jobs reported, for several reasons (in addition to any issues concerning the quality of the

1. Public Law 111-5, sections 1512(c) and 1512(e); 123 Stat. 115, 288. This current report is the fourth in CBO's series of quarterly reports. For the previous report, see Congressional Budget Office, *Estimated Impact of the American Recovery and Reinvestment Act on Employment and Economic Output from January 2010 Through March 2010* (May 2010).

2. Data compiled from recipients' reports (on jobs funded and other information) are shown at www.recovery.gov. Recipients were asked to calculate FTEs by taking the total number of hours worked in a quarter that were funded by ARRA, and dividing the total by the number of hours that a full-time employee would have worked in that quarter.

reports' data).³ First, some of the jobs included in the reports might have existed even without the stimulus package, with employees working on the same activities or other activities. Second, the reports cover employers that received ARRA funding directly and those employers' immediate subcontractors (the so-called primary and secondary recipients of ARRA funding) but not lower-level subcontractors. Third, the reports do not attempt to measure the number of jobs that were created or retained indirectly as a result of recipients' increased income, and the increased income of their employees, which could boost demand for other products and services as they spent their paychecks. Fourth, the recipients' reports cover only certain ARRA appropriations, which encompass about one-fifth of the total either spent by the government or conveyed through tax reductions in ARRA during the second quarter; the reports do not measure the effects of other provisions of the stimulus package, such as tax cuts and transfer payments (including unemployment insurance payments) to individual people.

Estimating the law's overall effects on employment requires a more comprehensive analysis than can be achieved by using the recipients' reports. Therefore, looking at recorded spending to date along with estimates of the other effects of ARRA on spending and revenues, CBO has estimated the law's impact on employment and economic output using evidence about the effects of previous similar policies and drawing on various mathematical models that represent the workings of the economy. On that basis, CBO estimates that ARRA's policies had the following effects in the second quarter of calendar year 2010:

- They raised real (inflation-adjusted) gross domestic product (GDP) by between 1.7 percent and 4.5 percent,
- Lowered the unemployment rate by between 0.7 percentage points and 1.8 percentage points,

3. For a discussion of data quality, see Government Accountability Office, *Recovery Act: One Year Later, States' and Localities' Uses of Funds and Opportunities to Strengthen Accountability*, GAO-10-437 (March 2010), www.gao.gov/new.items/d10437.pdf.

- Increased the number of people employed by between 1.4 million and 3.3 million, and
- Increased the number of full-time-equivalent jobs by 2.0 million to 4.8 million compared with what would have occurred otherwise (see Table 1). (Increases in FTE jobs include shifts from part-time to full-time work or overtime and are thus generally larger than increases in the number of employed workers).

The effects of ARRA on output are expected to gradually diminish during the second half of 2010 and beyond. The effects of ARRA on employment and unemployment are expected to lag slightly behind the effects on output; they are expected to wane gradually in 2011 and beyond.

CBO's current estimates reflect small revisions to its earlier projections of the timing and magnitude of changes to federal revenues and spending under ARRA. They also reflect, for 2011 and 2012, a small shift in CBO's assumptions about the future actions of the Federal Reserve.

Although CBO has examined data on output and employment during the period since ARRA's enactment, those data are not as helpful in determining ARRA's economic effects as might be supposed because isolating the effects would require knowing what path the economy would have taken in the absence of the law. Because that path cannot be observed, the new data add only limited information about ARRA's impact.⁴

Measuring ARRA's Impact Using Recipients' Reports

ARRA requires primary and secondary recipients of more than \$25,000 from appropriations made under the law to report a variety of information each calendar quarter. That group includes most grant and loan recipients,

4. For an analysis of the economic effects of ARRA based on the amount of ARRA spending and employment outcomes by state, see Daniel J. Wilson, *Fiscal Spending Multipliers: Evidence from the 2009 American Recovery and Reinvestment Act*, San Francisco Federal Reserve Bank Working Paper 2010-17 (June 2010), www.frbsf.org/publications/economics/papers/2010/wp10-17bk.pdf.

Table 1.**Estimated Macroeconomic Impact of the American Recovery and Reinvestment Act, 2009 to 2012**

	Change Attributable to ARRA							
	Real Gross Domestic Product (Percent)		Unemployment Rate (Percentage points)		Employment (Millions of people)		Full-Time-Equivalent Employment (Millions) ^a	
	Low Estimate	High Estimate	Low Estimate	High Estimate	Low Estimate	High Estimate	Low Estimate	High Estimate
2009 (Calendar Year Quarter)								
Q1	0.1	0.1	*	*	*	*	*	0.1
Q2	0.8	1.3	-0.2	-0.3	0.3	0.5	0.4	0.7
Q3	1.2	2.4	-0.3	-0.6	0.6	1.1	0.9	1.7
Q4	1.4	3.3	-0.5	-1.0	0.9	1.9	1.3	2.7
2010 (Calendar Year Quarter)								
Q1	1.7	4.1	-0.7	-1.5	1.2	2.7	1.7	3.9
Q2	1.7	4.5	-0.7	-1.8	1.4	3.3	2.0	4.8
Q3	1.5	4.2	-0.8	-2.0	1.4	3.6	2.0	5.2
Q4	1.1	3.6	-0.7	-1.9	1.3	3.5	1.8	5.0
Calendar Year Average								
2009	0.9	1.8	-0.3	-0.5	0.5	0.9	0.7	1.3
2010	1.5	4.1	-0.7	-1.8	1.3	3.3	1.9	4.7
2011	0.7	2.3	-0.5	-1.5	0.9	2.7	1.2	3.7
2012	0.2	0.5	-0.2	-0.5	0.3	0.9	0.3	1.0

Source: Congressional Budget Office.

Note: * = between -0.05 and 0.05.

a. A year of full-time-equivalent employment is 40 hours of employment per week for one year.

contractors, and subcontractors, but it excludes individual people. The information to be submitted includes the amount of funding received and spent; the name, description, and completion status of the project or activity funded; the number of jobs funded; and, for investments in infrastructure, the purpose and cost of the investment. Recipients who filed second-quarter reports in July 2010 reported the number of jobs on the basis of the number of employee hours paid for with ARRA funds in the quarter.⁵

According to those reports, 749,142 full-time-equivalent jobs were funded by ARRA during the second quarter.⁶

However, the reported number of jobs funded is not a comprehensive measure of ARRA's effect on overall employment, or even of those provisions of ARRA for which recipients' reports are required. The actual impact could, in principle, be significantly larger or smaller than the number of jobs reported.

If, for example, recipients' reports include employment that would have occurred without ARRA, the impact on employment suggested by the reports could be too great. Some people whose employment was attributed to ARRA might have worked on other activities in the absence of the law—for example, a business might have bid on other projects if its resources had not been committed to projects funded by ARRA. In the case of government employees, state or local taxes might have been raised in the

5. Specifically, recipients were instructed to calculate the number of FTE jobs funded through ARRA by counting the total number of hours worked that were funded by ARRA during the second quarter, divided by the number of hours in a full-time schedule for a quarter. For details and examples, see Office of Management and Budget, "Recovery FAQs for Federal Contractors on Reporting," www.whitehouse.gov/omb/recovery_faqs_contractors/#report15.

6. For the number of jobs by agency, see "Top Agencies, as Reported by Recipients (Apr 1–Jun 30, 2010)," www.recovery.gov/Pages/TextView.aspx?data=jobSummaryAgency&topnumber=200&qtr=2010Q2.

absence of ARRA funding (or transfer payments might have been reduced) to pay for some of the jobs that were counted as funded by ARRA.

Conversely, the reported figure could be too low because the reporting requirement is limited to primary and secondary recipients of funds and thus excludes lower-level recipients, such as subcontractors hired by a main subcontractor. Thus, if expenditures under ARRA led to increases in employment among lower-level subcontractors and vendors, those effects would be missed by the reports.

Recipients' reports also do not include indirect effects that could increase or decrease the impact on employment. Among those effects are potential declines in employment in other businesses or economic sectors as demand shifts toward the recipients of ARRA funding—a phenomenon often called the “crowding out” effect of government policies. Conversely, spending under ARRA could lead to higher employment at companies that are not directly connected to that spending—for example, because of additional purchases made by people who would be unemployed were it not for ARRA funds. CBO estimates that, under current conditions, the positive indirect effects outweigh the negative indirect effects. Taken together, in CBO's estimation, ARRA's indirect effects boost the law's impact on economic output and employment.

Finally, the recipients' reports reflect only about one-fifth of the total amount of spending increases or tax reductions during the second quarter of 2010 that are attributable to ARRA's provisions. The reports cover direct government purchases of goods and services, grants and loans to private entities, and grants to states and localities, but they do not cover tax cuts or increases in transfer payments to individuals. The tax reductions and spending that are not covered by the recipients' reports probably had substantial effects on purchases of goods and services and, therefore, on employment.

Measuring ARRA's Impact Using Economic Models and Historical Data

CBO used various economic models and historical data to guide its estimate of the way in which output and employment are affected by increases in outlays and reductions in revenues under ARRA. CBO's assessment is that different elements of ARRA (such as particular types of tax cuts, transfer payments, and government purchases) have had different effects on economic output per dollar of higher spending or lower tax receipts. Multiplying estimates of those per-dollar effects by the dollar amounts of each element of ARRA yields an estimate of the law's total impact on output. To produce estimates of ARRA's total impact on employment, CBO combined that estimate with estimates of how changes in output affect the unemployment rate and participation in the labor force.

CBO's Modeling Approach

CBO used evidence from models and historical relationships to determine estimated “multipliers” for each of several categories of spending and tax provisions in ARRA (see Table 2 on page 6). Each multiplier represents the estimated direct and indirect effects on the nation's output of a dollar's worth of a given policy. Therefore, a provision's multiplier can be applied to the budgetary cost of that provision to estimate its overall impact on output.

Direct effects consist of immediate (or first-round) effects on economic activity. Government purchases of goods and services directly elicit economic activity that would not occur otherwise and thereby have a direct dollar-for-dollar impact on output. For reductions in taxes, increases in transfer payments, and increases in aid to state and local governments, the size of the direct effect depends on the policy's impact on the behavior of recipients. If someone receives a dollar in transfer payments and spends 80 cents (saving the other 20 cents), production increases over time to meet the additional demand generated by that spending, and the direct impact on output is 80 cents. Similarly, if a dollar in aid to a state government leads that government to spend 50 cents more on employees' salaries (but causes no other changes in state spending or revenues, with the other 50 cents used to reduce borrowing or build up rainy-day funds), the direct impact on output is 50 cents.

CBO reviewed evidence on the responses of households, businesses, and governments to various types of tax cuts and transfer payments to estimate the size of those policies' direct effects on output.⁷ For example:

- A one-time cash payment is likely to have less impact on a household's purchases than is a longer-lasting change to disposable income because the one-time payment has a smaller effect on total lifetime disposable income.
- Increases in disposable income are likely to boost purchases more for lower-income than for higher-income households. That difference arises, at least in part, because a larger share of people in lower-income households cannot borrow as much money as they would wish in order to spend more than they do currently.
- Changes to corporate taxes that primarily affect after-tax profits on past investment generally have a smaller impact on output than do policies that alter the return from new investment.

Government policies also can have indirect effects that enhance or offset the direct effects. Direct effects are enhanced when, for example, a government policy creates jobs and those who are hired use their income to boost consumption. Direct effects also are enhanced when greater demand for goods and services prompts companies to increase investment to bolster their future production.

In the other direction, substantial government spending can cause a shift in resources (including employees) away from production in other businesses and sectors to

government-funded projects. That indirect crowding-out effect could cause growth in employment among recipients of ARRA funding to be offset by declines in employment elsewhere in the economy. Increases in interest rates are one possible mechanism for such crowding out: Higher interest rates discourage spending on investment and on durable goods such as cars because they raise the cost of borrowing. However, because the Federal Reserve kept short-term interest rates very low, that mechanism does not appear to have been an important factor through the second quarter of 2010. Another mechanism for crowding out is that activities funded by ARRA could reduce production elsewhere in the economy if they used scarce materials or workers with specific skills, creating bottlenecks that hindered other activities. That effect, too, was probably much smaller in the past year and a half than it might have been otherwise because of high unemployment and a large amount of unused resources (as well as the diversity of activities funded under ARRA).

In estimating the magnitude of indirect effects, CBO relied heavily on estimates from macroeconomic forecasting models, informed by evidence from other types of models and from direct estimation using historical data. (For more details about those sources of information, see the appendix.)

CBO grouped the provisions of ARRA into general categories and assigned high and low multipliers to each. The ranges between high and low were chosen judgmentally to encompass most economists' views about the direct and indirect effects of different policies. The multipliers indicate the cumulative impact of policies on GDP over several quarters, and they should be understood to apply to periods when the Federal Reserve is holding short-term interest rates about as low as possible and would not tighten monetary policy in response to a fiscal stimulus, as over the past year and a half. For instance, CBO estimates that a one-time increase of \$1 in federal purchases of goods and services in one calendar quarter last year raised GDP above what it would have been otherwise by a total of \$1 to \$2.50 over several quarters. That cumulative multiplier of \$2.50 at the high end of the range comprises increases in GDP of roughly \$1.45 in the quarter when the federal spending occurred, roughly 60 cents in the following quarter, and roughly 45 cents in later quarters combined.

The multipliers are applied to outlays when they occur and to changes in taxes or transfer payments when they

7. On household spending, for example, see Jonathan A. Parker and others, "Consumer Spending and the Economic Stimulus Payments of 2008" (February 2010), www.kellogg.northwestern.edu/faculty/parker/htm/research/PSJM2010.pdf; Matthew D. Shapiro and Joel Slemrod, "Did the 2008 Tax Rebates Stimulate Spending?" *American Economic Review*, vol. 99, no. 2 (May 2009), pp. 374–379; Sumit Agarwal, Chunlin Liu, and Nicholas S. Souleles, "The Reaction of Consumer Spending and Debt to Tax Rebates: Evidence from Consumer Credit Data," *Journal of Political Economy*, vol. 115, no. 6 (December 2007), pp. 986–1019; and David S. Johnson, Jonathan A. Parker, and Nicholas S. Souleles, "Household Expenditure and the Income Tax Rebates of 2001," *American Economic Review*, vol. 96, no. 5 (December 2006), pp. 1589–1610.

Table 2.**Estimated Output Multipliers of Major Provisions of the American Recovery and Reinvestment Act**

Type of Activity	Estimated Output Multipliers ^a		Major Provisions of ARRA
	Low Estimate	High Estimate	
Purchases of Goods and Services by the Federal Government	1.0	2.5	Division A, Title II: Other; Title IV: Energy Efficiency and Renewable Energy; Title IV: Innovative Technology Loan Guarantee Program; Title IV: Other Energy Programs; Title V: Federal Buildings Fund; Title VIII: National Institutes of Health; Title VIII: Other Department of Health and Human Services
Transfer Payments to State and Local Governments for Infrastructure	1.0	2.5	Division A, Title VII: Clean Water and Drinking Water State Revolving Funds; Title XI: Other Housing Assistance; Title XII: Highway Construction; Title XII: Other Transportation
Transfer Payments to State and Local Governments for Other Purposes	0.7	1.8	Division A, Title VIII: Education for the Disadvantaged; Title VIII: Special Education; Title IX: State Fiscal Stabilization Fund; Division B, Title V: State Fiscal Relief Fund
Transfer Payments to Individuals	0.8	2.1	Division A, Title I: Supplemental Nutrition Assistance Program; Title VIII: Student Financial Assistance; Division B, Title II: Unemployment Compensation; Title III: Health Insurance Assistance ^b
One-Time Payments to Retirees	0.3	1.0	Division B, Title II: Economic Recovery Payments
Two-Year Tax Cuts for Lower- and Middle-Income People	0.6	1.5	Division B, Title I: Refundable Tax Credits; Making Work Pay Credit; American Opportunity Tax Credit
One-Year Tax Cut for Higher-Income People	0.2	0.6	Increase in Individual AMT Exemption Amount
Extension of First-Time Homebuyer Credit	0.3	0.8	Extension of First-Time Homebuyer Credit

Continued

affect disposable income. CBO's estimates, therefore, account for the different rates of spending for various types of appropriations and, similarly, for the timing of different tax cuts or transfer payments. In some cases, when different elements of a single provision were estimated to have different multipliers, the total cost of a provision was divided among more than one category. In those cases, the provision is shown in Table 2 in the category to which most of its budgetary cost applied. Provisions that affect outlays (including refundable tax credits) are identified by the same names used in CBO's cost estimate for the conference agreement on ARRA.⁸ Provisions that affect revenues are identified by the names used in

the revenue estimate prepared by the staff of the Joint Committee on Taxation for the same legislation.⁹

The ranges for multipliers in Table 2 are close to those that CBO used in its initial analysis of the economic effects of ARRA in March 2009. Since then, CBO has

8. See Congressional Budget Office, *cost estimate for the conference agreement for H.R. 1, the American Recovery and Reinvestment Act of 2009* (February 13, 2009).

9. See Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the Conference Agreement for H.R. 1*, JCX-19-09 (February 12, 2009), www.jct.gov/x-19-09.pdf.

Table 2.

Continued

Estimated Output Multipliers of Major Provisions of the American Recovery and Reinvestment Act

Type of Activity	Estimated Output Multipliers ^a		Major Provisions of ARRA
	Low Estimate	High Estimate	
Corporate Tax Provisions Primarily Affecting Cash Flow	0	0.4	Deferral and Ratable Inclusion of Income Arising from Business Indebtedness Discharged by the Reacquisition of a Debt Instrument; Clarification of Regulations Related to Limitations on Certain Built-In Losses Following an Ownership Change; Recovery Zone Bonds; Qualified School Construction Bonds

Source: Congressional Budget Office.

Notes: Provisions affecting outlays (including refundable tax provisions) are identified by the same names used in CBO's cost estimate for the conference report on H.R. 1. Provisions affecting revenues—all of which are included in title I of the American Recovery and Reinvestment Act—are identified by the names used in the estimate by the staff of the Joint Committee on Taxation (JCT) (see www.house.gov/jct/x-19-09.pdf).

Some provisions include individual elements that have different multipliers, by CBO's estimate; in those cases, the provisions are listed with the multiplier used for the majority of the 2009–2019 budgetary cost.

The economic impact of three tax provisions with budgetary costs over \$5 billion was analyzed using a different methodology, and their effects cannot easily be summarized by a multiplier. Those provisions were titled "Extend by Three Years the Placed-In-Service Date for Each Section 45 Qualified Facility" and "One-Year Extension of Special Allowance for Certain Property Acquired During 2009" in JCT's estimate and "Health Information Technology" in CBO's estimate. Some other provisions, with total budgetary costs of less than \$7 billion, were included in the analysis but are not shown in the table.

AMT = alternative minimum tax.

- a. The output multiplier is the cumulative impact of spending under the provisions on gross domestic product over several quarters. The ranges shown in the table assume that the Federal Reserve is holding short-term interest rates about as low as possible and would not tighten monetary policy in response to a fiscal stimulus.
- b. This provision is a reduction in taxes, but it is treated as having the same economic impact as a transfer payment to an individual.

continued to review research on the economic impact of various government policies. Although some new research has emerged, CBO judges that the evidence, taken as a whole, continues to support roughly the same ranges for multipliers. However, earlier in the year CBO revised the multipliers slightly, primarily to better reflect the relatively low probability of different parameters being at the same extremes (high or low) of the ranges of assumptions that CBO considered. As a result, the current ranges for multipliers are generally a bit narrower than the ranges reported last year.

The estimates of ARRA's effects on output were translated into estimates of the effects on the unemployment rate, total employment, and FTE employment in a series of steps. First, the impact on the output gap—the percentage difference between actual and potential output—was calculated.¹⁰ Next, the effect of the change in the output gap on the unemployment rate was estimated using

the historical relationship between those two measures.¹¹ Then, the effect of changes in the unemployment rate on the labor force was taken into account: If unemployment declines and the economic environment improves, discouraged workers and people who have chosen to pursue activities such as education rather than work will tend to return to the labor force. Together, the estimated effect on the unemployment rate and the effect on the labor force were used to estimate the impact on the number of people employed. The change in FTE employment was then estimated using the historical relationship between changes in hours per employed worker and changes in the

10. Potential output is the level of production that corresponds to a high rate of use of labor and capital.

11. Changes in the output gap affect unemployment gradually over several quarters. Initially, part of a rise in output shows up as higher productivity and hours per worker rather than as reduced unemployment.

gap between the unemployment rate and CBO's estimate of the natural rate of unemployment.¹² Because higher spending and lower taxes can affect output and unemployment for some time after they occur, the impact of ARRA on employment in the second quarter of 2010 depended partly on the law's effect on spending and revenues in the previous year.

A key advantage of the model-based approach used in this analysis is the ability to provide estimates of the total effects throughout the economy of the government spending, transfer payments, and tax cuts resulting from ARRA. By focusing on the net change in employment, that approach captures both the jobs created and the jobs retained as a result of ARRA.

A key disadvantage of the model-based approach is the considerable uncertainty about many of the economic relationships that are important in the modeling. Because economists differ on which analytical approaches provide the most convincing evidence about such relationships, they can reach different conclusions about those relationships. In addition, each study involves uncertainty about the extent to which the results reflect the true effects of a given policy or the effects of other factors. For those reasons, CBO provides ranges of estimates of ARRA's economic effects that are intended to encompass most economists' views and thereby reflect the uncertainty involved in such estimates.

12. The natural rate of unemployment is the rate that arises from all sources except cyclical fluctuations in economywide demand for goods and services.

Change from CBO's Previous Estimates of the Impact of ARRA

The current estimates of the impact of ARRA on output and employment differ from those presented in May 2010 primarily because new information has led CBO to revise its estimates of ARRA's impact on tax revenues and because CBO now projects that ARRA's policies will not result in higher interest rates until slightly later than previously forecast.

The estimated effect on revenues through the first quarter of 2010 was revised downward by roughly \$25 billion from the amount CBO estimated in May 2010 largely because preliminary tax data indicated lower than previously estimated revenue losses from subsidies for the continuation of health insurance for certain involuntarily terminated employees (under the Consolidated Omnibus Reconciliation Act or COBRA) and from increased expensing of business investment.¹³ In addition, CBO's estimates now incorporate the assumption, based on CBO's most recent economic forecast, that the economic impact of ARRA will not affect the Federal Reserve's interest rate targets until the first quarter of 2012, rather than the final quarter of 2011.¹⁴ That change increases the projected economic effects of ARRA slightly in the fourth quarter of 2011 and in 2012.

13. Provisions allowing businesses to take rapid depreciation of investments were in effect under ARRA in 2009. The lower than previously estimated revenue losses from those provisions through the first quarter of 2010 are largely offset by lower revenue gains over the next several years.

14. See Congressional Budget Office, *The Budget and Economic Outlook: An Update* (August 2010).



Appendix:

Evidence on the Economic Effects of Fiscal Stimulus

The Congressional Budget Office (CBO) based its estimates of the economic effects of the American Recovery and Reinvestment Act of 2009 (ARRA) on information from various sources: macroeconomic forecasting models, general-equilibrium models, and direct extrapolations of past data. Macroeconomic forecasting models incorporate relationships among aggregate economic variables that are based largely on historical evidence. General-equilibrium models, by contrast, are built on explicit assumptions about the decision-making of individual people and businesses. Direct extrapolations of past data are generally based on correlations among economic variables in the past or on the effects of specific types of policy events in the past.

Macroeconomic Forecasting Models

In analyzing ARRA's economic effects, CBO drew heavily on versions of the commercial forecasting models of two economic consulting firms, Macroeconomic Advisors and Global Insight, and on the FRB-US model used at the Federal Reserve Board. Those models assume that the economy has an underlying potential output determined by the size of the labor supply, the capital stock, and technology. They also assume that actual output can change relative to potential output because of shifts in aggregate demand for goods and services from households, businesses, and the government. With those basic assumptions, the details of interactions among economic variables in the models are based largely on historical relationships, informed by theories of how those variables are determined (for example, the theory that total consumption depends mostly on disposable income, wealth,

and interest rates).¹ Because they emphasize the influence of aggregate demand on output in the short run, the macroeconomic forecasting models tend to predict greater economic effects from demand-enhancing policies such as ARRA than some other types of models do.

Macroeconomic forecasting models of this sort are used widely, and they underlie most of the forecasts offered to the clients of economic consulting firms. In addition, the models that CBO uses generally produce results that are roughly in line with the consensus of private-sector forecasters, as compiled in the *Blue Chip Economic Indicators*. However, some analysts criticize this sort of model for being based on historical relationships among aggregate economic variables, such as income and consumption, rather than being built up from clearly specified rules governing the behavior of households and businesses. In particular, some critics argue that models based on historical relationships will not provide accurate predictions in the face of new policies or new circumstances. Partly to address that concern, CBO presents a range of possible effects rather than a single number for each economic variable.

To reflect current economic conditions—in which there is considerable uncertainty about the financial and economic outlook and in which short-term interest rates are low and are expected to remain so for some time—CBO altered the models' usual formulation to reduce the extent

1. The FRB-US model differs from the other two forecasting models in that it explicitly incorporates the influence of expected future developments on current outcomes.

to which interest rates respond to increases in output.² Under more normal economic conditions, higher interest rates would offset roughly two-thirds of the cumulative impact of stimulative policies on gross domestic product over two years.³

General-Equilibrium Models

Some skeptics of the efficacy of stimulus policies have cited the results of an alternative class of models, which

2. Stimulative policies such as ARRA can lead to higher interest rates in two ways. First, if they increase economic activity, they can prompt the Federal Reserve to raise interest rates to combat inflation. However, that effect has been smaller than usual during the past year and a half and is likely to remain so in the near term. The federal funds rate (the interest rate directly controlled by the Federal Reserve) has been near zero since late 2008 and is unlikely to be increased significantly until economic conditions have improved substantially. Interest rates on short-term government securities, which tend to move closely with the federal funds rate, also are unlikely to rise for some time. Therefore, CBO estimates that expansionary government policies are likely to have less effect on interest rates now than under more normal conditions, which implies less crowding out. Second, stimulative policies can influence longer-term interest rates if they create expectations of higher inflation-adjusted interest rates or higher inflation in the future. In particular, policies that imply increases in future deficits could lead to higher current interest rates to the extent that people expect that the deficits will crowd out private investment and result in a lower capital stock (which tends to imply both higher rates of return on capital and higher interest rates). However, the policies in ARRA are temporary and thus are unlikely by themselves to have a large impact on the interest rates that people expect beyond the next few years.
3. CBO assumes that as the recovery progresses, the Federal Reserve will see less need to provide monetary stimulus. Under CBO's current macroeconomic forecast, that assumption implies that in early 2012, the Federal Reserve will gradually begin to offset fiscal policy actions by raising interest rates (or engaging in other actions to tighten monetary policy) in order to reduce the risk in later years of excessive inflation.

tend to imply more modest economic effects from such policies. In those models, people are assumed to make decisions about how much to work, buy, and save on the basis of current and expected future values of the wage rate, interest rates, taxes, and government purchases, among other things. In the basic form of such models, stimulus policies tend to crowd out a significant amount of other economic activity, and multipliers tend to be less than 1—meaning that stimulative policies have less than a dollar-for-dollar impact on output.

Although some analysts favor the rigor of that approach to modeling behavior, other analysts view the assumptions underlying households' and businesses' decision-making in those models to be unrealistic and to lead to unrealistic predictions. In particular, this type of model generally assumes that people are fully rational and forward-looking, basing their current decisions on a full lifetime plan. The extreme version of the forward-looking assumption implies that people expect eventually to pay for any increased government spending or reduced revenues in the form of tax increases and that they incorporate those expected payments—even if beyond their own lifetimes—into their current spending plans. Thus, they are assumed to curtail their consumption when government spending rises because their lifetime income and that of their heirs has fallen by the amount of the eventual taxes. For the same reason, in such models, cash transfer payments and tax refunds have little or no effect on current consumption. People in the models generally also have full access to credit markets, so they can borrow to maintain consumption in the face of a temporary loss of income. This class of model does not typically incorporate involuntary unemployment: People can work as many hours as they choose at the wage rate determined by the market. Finally, in these models, monetary policy usually follows the rule that increased output or inflation implies higher inflation-adjusted interest rates.

Recent research has shown that relaxing some of those modeling assumptions can result in much higher multipliers.⁴ CBO has incorporated the results of that research into its view of the effects of government policies. However, the research results appear to be too dependent on particular assumptions for CBO to rely on them heavily.

Extrapolations from Historical Data

Another type of research uses historical data to directly project how government policies will affect the economy on the basis of how economic variables such as output and consumption have behaved in the past relative to government spending and revenues. However, estimates of economic effects from this research vary widely and are sensitive to the period and estimation strategy used. Many estimates of this sort suggest that crowding-out effects dominate in the case of government purchases so that the impact on output tends to be less than one-for-one and tends to diminish over time. Some estimates,

4. For examples of model estimates that incorporate a lower-than-usual response of interest rates to policy changes, see Robert E. Hall, *By How Much Does GDP Rise If the Government Buys More Output?* Working Paper 15496 (Cambridge, Mass.: National Bureau of Economic Research, November 2009); Lawrence Christiano, Martin Eichenbaum, and Sergio Rebelo, *When Is the Government Spending Multiplier Large?* Working Paper 15394 (Cambridge, Mass.: National Bureau of Economic Research, October 2009); and Troy Davig and Eric M. Leeper, *Monetary–Fiscal Policy Interactions and Fiscal Stimulus*, Working Paper 15133 (Cambridge, Mass.: National Bureau of Economic Research, July 2009). For examples of models that include liquidity-constrained or “rule of thumb” agents, see Marco Ratto, Werner Roeger, and Jan in ’t Veld, “An Estimated Open-Economy DSGE Model of the Euro Area with Fiscal and Monetary Policy,” *Economic Modelling*, vol. 26, no. 1 (January 2009), pp. 222–233; Lorenzo Forni, Libero Monteforte, and Luca Sessa, *The General Equilibrium Effects of Fiscal Policy: Estimates for the Euro Area*, Banca d’Italia Working Paper 652 (November 2007); and Jordi Gali, J. David López-Salido, and Javier Vallés, “Understanding the Effects of Government Spending on Consumption,” *Journal of the European Economic Association*, vol. 5, no. 1 (March 2007), pp. 227–270. For model estimates in which government spending can contribute to future production, see Eric M. Leeper, Todd B. Walker, and Shu-Chun Susan Yang, *Government Investment and Fiscal Stimulus in the Short and Long Runs*, Working Paper 15153 (Cambridge, Mass.: National Bureau of Economic Research, July 2009). For a model that incorporates financial frictions in the form of a wedge between the interest rate paid by businesses on loans and the rate received by households on savings, see Jesús Fernández-Villaverde, “Fiscal Policy in a Model with Financial Frictions,” *American Economic Review*, vol. 100, no. 2 (May 2010), pp. 35–40.

however, suggest multipliers higher than the range estimated by CBO. Estimated multipliers for tax cuts are generally higher than those for spending, and they tend to grow over time.⁵

One pitfall of this approach is that the direction of causation between policies and the economy is not always clear. For example, poor economic conditions can prompt the government to enact policies such as ARRA in an effort to boost economic activity. If weak economic performance led to such a policy, it would not be accurate to ascribe that performance to the policy, rather than vice versa. Likewise, if states and localities reduced purchases and laid off employees when their budgets deteriorated in a recession, it would not be accurate to blame the recession on the cuts in government spending. When causation runs in both directions in this way, the historical correlation between variables is not always the best guide for predicting the effects of a new policy proposal.

One strategy that has been applied to overcome that obstacle is to try to isolate the economic impact of specific policies, such as wartime spending, that are arguably unrelated to other economic conditions. Wartime spending, however, might not be indicative

5. See Christina D. Romer and David H. Romer, “The Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks,” *American Economic Review*, vol. 100, no. 3 (June 2010), pp. 763–801; Robert J. Barro and Charles J. Redlick, *Macroeconomic Effects from Government Purchases and Taxes*, Working Paper 15369 (Cambridge, Mass.: National Bureau of Economic Research, September 2009); Andrew Mountford and Harald Uhlig, *What Are the Effects of Fiscal Policy Shocks?* Working Paper 14551 (Cambridge, Mass.: National Bureau of Economic Research, December 2008); Roberto Perotti, *In Search of the Transmission Mechanism of Fiscal Policy*, Working Paper 13143 (Cambridge, Mass.: National Bureau of Economic Research, June 2007); Olivier Blanchard and Roberto Perotti, “An Empirical Characterization of the Dynamic Effects of Changes in Government Spending and Taxes on Output,” *Quarterly Journal of Economics*, vol. 117, no. 4 (November 2002), pp. 1329–1368; and Valerie Ramey and Matthew Shapiro, “Costly Capital Reallocation and the Effects of Government Spending,” *Carnegie–Rochester Conference Series on Public Policy*, vol. 48, no. 1 (June 1998), pp. 145–194. In interpreting the results of this research, it is important to note that the reported multipliers are generally “peak” multipliers—that is, they represent the largest effect on output in any one quarter of a dollar change to policy that persists in a way that is consistent with historical behavior—rather than the cumulative effect of a one-time dollar’s worth of policy change, as CBO defines its multipliers.

of the effects of other increases in government spending. For example, during World War II, the rationing of many goods might have reduced the indirect effects of government spending on private consumption and investment. More generally, historical evidence shows the effects of policies under average economic conditions.

Under current conditions—in which interest rates are apt to be less affected than usual by expansionary government policies and in which there are large amounts of idle resources—the effects would probably be greater than they were, on average, in the past.