NEVADA'S Economy

A monthly report produced for COMMERCE REAL ESTATE SOLUTIONS by Stephen P. A. Brown, PhD, Center for Business & Economic Research University of Nevada, Las Vegas

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FISCAL CLIFF RAISES FEARS OF U.S. RECESSION

In late 2012, U.S. policymakers will be faced with making controversial decisions about the nation's fiscal policies. As current law stands, the U.S. government will implement a number of tax increases and spending cuts beginning in 2013. Because implementation of current law results in an abrupt change in government spending and taxation policy, the current laws are seen as creating what is known as a "fiscal cliff." According to many analysts, plunging over the fiscal cliff is likely to push an already weak U.S. economy back into recession.

On the other hand, postponing or cancelling implementation of current laws will leave the U.S. government with a large deficit and a growing debt. A failure to reduce the deficit to a sufficiently small percentage of the nation's gross domestic product (GDP) will lead to a growing debt-to-GDP ratio. Over time, a high debt-to-GDP ratio will weaken the long-term prospects for economic growth.

In what follows, we examine the size of the fiscal cliff and assess its effects on U.S. economic activity. Our assessment suggests that policymakers can reduce the near-term risk of recession and gain most of the benefits of reducing the U.S. government debt-to-GDP ratio by taking a gradualist policy. Under such a policy, the U.S. government would gradually bring its budget deficit as a percent of GDP below the growth rate of U.S. economic activity.

How Big Is the Fiscal Cliff?

As shown in *Table 1*, current law will bring big changes to both U.S. government taxation and spending policies beginning in 2013. Some of the changes brought about by the current tax laws are the expiration of provisions that reduce income, estate and gift taxes (commonly known as Bush-era tax cuts). In addition, the reduction

Projected U.S. Government Deficits as a Percent of GDP

Table 1

	2012	2013	2014	2015	2020
Current Law					
Revenues	15.7	18.4	19.6	20.3	21.1
Outlays	22.9	22.4	21.9	21.5	21.7
Deficit	-7.3	-4	-2.4	-1.2	-0.6
Debt Held by Public as a Percent of GDP	72.8	76.1	76.6	73.8	61.4
CBO's Alternative Fiscal Scenario					
Revenues	15.7	16.3	17.2	17.8	18.5
Outlays	22.9	22.8	22.9	22.5	23.3
Deficit	-7.3	-6.5	-5.6	-4.6	-4.8
Debt Held by Public as a Percent of GDP	72.8	78.6	82.3	82.5	85.7

Source: Congressional Budget Office

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in the employee's portion of the payroll tax will expire. The Affordable Care Act also will bring tax increases.

Among the changes to spending policies are sharp reductions in Medicare payment rates for physicians' services and the expiration of some unemployment benefits. The automatic enforcement procedures established under the Budget Control Act of 2011 also will cut spending across a number of programs including defense.

Together the changes in fiscal policy brought about by current law will sharply reduce the U.S. government budget deficit—from 7.3 percent of GDP in 2012 to 4.0 percent and 2.4 percent of GDP in 2013 and 2014, respectively. To provide a contrast with current law, the Congressional Budget Office (CBO) developed an alternative fiscal scenario, in which some current laws would be changed so that fiscal policy remains relatively unchanged. The alternative scenario shows a much larger deficit—6.5 percent and 5.6 percent of GDP in 2013 and 2014, respectively.

In contrast, CBO expects both reduced revenues and higher expenditures if the laws are changed to sustain current policy. The result is a larger deficit—an additional 2.5 percent of U.S. GDP in 2013.

With the smaller deficits found under current law, the U.S. government's debt-to-GDP ratio is projected to decline gradually. With the larger deficits found under CBO's alternative fiscal scenario, the U.S. government's debt-to-GDP ratio is expected to rise.

What Are the Implications for Long-Term Economic Growth?

Reducing the U.S. government budget deficit by the amount expected under current law seems likely to promote long-term economic growth. Under current law, the deficit as a percent of GDP is expected to fall below the growth rate of U.S. real GDP. Economists see that development as advantageous to long-term economic growth because the debt-to-GDP ratio will fall.

With a change in laws to permit the continuation of current policies, however, the deficit as a percent of GDP will be higher than the growth rate of U.S. GDP. Consequently, the debt-to-GDP ratio will grow. In countries with high debt-to-GDP ratios, economic activity is strangled by high interest rates and a lack of investment. Reducing deficit spending contributes to a higher trajectory of economic growth by avoiding the problems associated with a high debt-to-GDP ratio.

What Are the Implications for Near-Term Economic Growth?

Unfortunately, an abrupt resolution of the budget deficit also removes what many see as a short-term fiscal stimulus to economic activity during a period in which the economy is already performing poorly. That is, government deficit spending is seen as boosting short-term activity. Removing the stimulus could yield a near-term slowdown in economic activity or a recession.

According to CBO estimates, a continuation of the current laws will lead to a mild recession in which U.S. real GDP declines by 0.5 percent from fourth quarter 2012 to fourth quarter 2013. CBO also estimates that the policies in their alternative scenario will result in the U.S. real GDP growing by 1.7 percent from fourth quarter 2012 to fourth quarter 2013. Combined, these estimates indicate that CBO sees the fiscal cliff built into current law as resulting in a 2.2 percent reduction in GDP during 2013.

Other economic perspectives suggest that a 2.5 percentage point reduction in the U.S. government deficit as a share of GDP will yield an estimated GDP loss for 2013 that ranges from 0.0 percent to 3.0 percent, *Table 2*. For instance, application of the Ricardian equivalence theorem suggests no loss in GDP. In contrast, application of Keynesian multipliers similar to those used by Zandi (2008) suggests a GDP loss of 3.0 percent.[1]

Estimated GDP Loss

Table 2

Source	Estimated GDP Loss
CBO	2.2%
Keynesian Multipliers	3.0%
Ricardian Equivalence	0.0%
Imperfect Ricardian Equivalence	0.8%

Sources: Congressional Budget Office; Author's estimates

KEYNESIAN MULTIPLIERS According to Keynesian thinking, an autonomous increase in spending leads to subsequent rounds of spending in the economy with a multiplied effect. An increase in government spending represents such an autonomous increase. The increase in private spending stimulated by tax reductions also represents such an autonomous increase. Using multipliers suggested by Zandi (2008), we estimate that a 2.5 percentage point reduction in the U.S. government deficit as a share of GDP will yield a 3.0 percent loss in GDP.

CBO Implicitly, CBO estimates rely on a total multiplier effect of less than one. According to CBO estimates a 2.5 percentage point reduction in the U.S. government deficit as a share of GDP yields only a 2.2 percent loss in GDP. Those figures imply a multiplier of 0.9.

RICARDIAN EQUIVALENCE According to what is known as the Ricardian equivalence theorem, individuals in the private sector understand that a government's deficit spending must lead to future taxes. Therefore, the private sector will cut its spending by the amount of the deficit to pay for the future taxes. In such a case, each dollar increase in deficit spending is exactly offset by a dollar loss in private spending, and the deficit provides no stimulus. Accordingly, a 2.5 percentage point reduction in the U.S. government deficit as a share of GDP would yield no loss in GDP.

IMPERFECT RICARDIAN EQUIVALENCE In practice, individuals may not fully respond to an increase in government deficit spending by increasing their saving by an equal dollar amount.[2] As a consequence, Ricardian equivalence may not hold perfectly. Using an imperfect equivalence rate of 70 percent, we estimate that a 2.5 percentage point reduction in the U.S. government deficit as a share of GDP will yield a loss in GDP of 0.8 percent.

Taking a Precautionary Approach

Most economists agree that reducing the U.S. government deficit below the growth rate of U.S. real GDP is good for long-term economic activity. Therefore, measures to reduce the deficit—such as those found in current tax and spending laws—are likely to provide a long-term benefit to the U.S. economy.

Nonetheless, current laws are expected to result in an abrupt reduction of the U.S. government deficit. This sharp reduction in the deficit, commonly known as the fiscal cliff, could reduce U.S. GDP by 0.8 to 3.0 percent in 2013. CBO estimates the reduction in GDP at 2.2 percent. Given an already weak economy, an abrupt shift in fiscal policy runs the risk of creating a recession. That risk can be avoided by taking a more gradual approach in reducing the U.S. government budget deficit. A gradualist policy may take as many as five years to achieve the necessary reduction in the U.S. government deficit.

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1 Mark Zandi (2008), "A Second Quick Boost From Government Could Spark Recovery," Testimony before the U.S. House Committee on Small Business (July 24).

2 See W. Michael Cox (1985). "The Behavior of Treasury Securities: Monthly 1942-84." Journal of Monetary Economics (September) and Fred C. Graham and Daniel Himarios (1996), "Consumption, Wealth, and Finite Horizons: Tests of Ricardian Equivalence," Economic Inquiry (July).

Nevada Economic Conditions

U.S. economic growth slowed substantially in first and second quarter 2012. Early data for third quarter suggest the likelihood of only moderate improvement. Nevada's tourism and gaming industries show evidence of a slowing national economy, but retail spending has been relatively robust. Nevada's construction sector remains mired at relatively low levels. The statewide unemployment rate was stable in June. The unemployment rate fell in Clark County and rose in Washoe County.

Story continues after graphs

Table 3

U.S.	Date	Units	Current	Previous	Change	Year Ago	Change
Employment	2012M07	million, SA	133.245	133.082	0.1%	129.963	2.5%
Unemployment Rate*	2012M07	%, SA	8.3	8.2	0.1%	9.1	-0.8%
Consumer Price Index	2012M06	82-84=100, SA	228.6	228.5	0.0%	224.8	1.7%
Core CPI	2012M06	82-84=100, SA	229.9	229.4	0.2%	224.9	2.2%
Employment Cost Index	2012Q2	89.06=100, SA	115.8	115.3	0.4%	113.8	1.8%
Productivity Index	2012Q2	2005=100, SA	111.0	110.5	0.5%	109.8	1.1%
Retail Sales	2012M07	$billion, SA	403.9	400.7	0.8%	387.9	4.1%
Auto and Truck Sales	2012M06	million, SA	14.33	13.90	3.1%	11.68	22.7%
Housing Starts	2012M06	million, SA	0.760	0.711	6.9%	0.614	23.8%
Real GDP***	2012Q2	2005$billion, SA	13,558.0	13,506.4	1.5%	13,264.7	2.2%
U.S. Dollar	2012M07	97.01=100	101.675	102.162	-0.5%	94.618	7.5%
Trade Balance	2012M06	$billion, SA	-42.924	-48.044	-10.7%	-50.324	-14.7%
S and P 500	2012M07	monthly close	1,379.32	1,362.16	1.3%	1,292.28	6.7%
Real Short-term Rates*	2012M06	%, NSA	-2.90	-3.01	0.1%	-3.36	0.5%
Treasury Yield Spread*	2012M07	%, NSA	1.43	1.53	-0.1%	2.96	-1.5%

Table 4

Nevada	Date	Units	Current	Previous	Change	Year Ago	Change
Employment	2012M06	000s, SA	1,133.1	1,134.1	-0.1%	1,118.3	1.3%
Unemployment Rate*	2012M06	%, SA	11.6	11.6	0.0%	13.8	-2.2%
Taxable Sales	2012M05	$billion	3.711	3.530	5.1%	3.361	10.4%
Gaming Revenue	2012M06	$million	832.52	885.09	-5.9%	885.75	-6.0%
Passengers	2012M06	million persons	3.966	3.995	-0.7%	4.001	-0.9%
Gasoline Sales	2012M05	million gallons	93.12	88.46	5.3%	90.71	2.7%
Visitor Volume	2012M06	million persons	4.289	4.299	-0.2%	4.207	1.9%

Table 5

Clark County	Date	Units	Current	Previous	Change	Year Ago	Change
Employment	2012M06	000s, SA	813.6	813.6	0.0%	805.6	1.0%
Unemployment Rate*	2012M06	%, Smoothed SA	12.0	12.2	-0.2%	14.0	-2.0%
Taxable Sales	2012M05	$billion	2.714	2.598	4.4%	2.467	10.0%
Gaming Revenue	2012M06	$million	707.31	766.05	-7.7%	767.72	-7.9%
Residential Permits	2012M06	units permitted	988	685	44.2%	959	3.0%
Commercial Permits	2012M06	permits	14	18	-22.2%	19	-26.3%
Passengers	2012M06	million persons	3.589	3.663	-2.0%	3.593	-0.1%
Gasoline Sales	2012M05	million gallons	63.59	60.90	4.4%	62.24	2.2%
Visitor Volume	2012M06	million persons	3.663	3.722	-1.6%	3.600	1.8%

Table 6

Washoe County	Date	Units	Current	Previous	Change	Year Ago	Change
Employment**	2012M06	000s, SA	189.0	189.6	-0.3%	189.6	-0.3%
Unemployment Rate*	2012M06	%, Smoothed SA	11.6	11.5	0.1%	13.2	-1.6%
Taxable Sales	2012M05	$billion	0.464	0.436	6.4%	0.442	4.9%
Gaming Revenue	2012M06	$million	66.78	62.33	7.1%	62.26	7.3%
Residential Permits	2012M06	units permitted	76	61	24.6%	41	85.4%
Commercial Permits	2012M06	permits	6	8	-25.0%	14	-57.1%
Passengers	2012M06	million persons	0.325	0.280	16.2%	0.343	-5.2%
Gasoline Sales	2012M05	million gallons	14.18	13.38	6.0%	13.96	1.5%
Visitor Volume	2012M06	million persons	0.421	0.372	13.2%	0.407	3.4%

*Growth data represents change in percentage rate
**Reflects the Reno-Sparks MSA which includes Washoe and Storey Counties
***Recent growth is an annualized rate

Sources: Nevada Department of Taxation; Nevada Department of Employment, Training, and Rehabilitation; UNR Bureau of Business and Economic Research; UNLV Center for Business and Economic Research; McCarran International Airport; Reno/Tahoe International Airport; Las Vegas Convention and Visitors Authority; Reno-Sparks Convention and Visitors Authority; U.S. Department of Commerce; U.S. Bureau of Labor Statistics; U.S. Census Bureau; U.S. Federal Reserve Bank.

Note: NSA = Not Seasonally Adjusted, SA = Seasonally Adjusted

U.S. Economy Shows Signs of Weak Growth

The U.S. economy continues to experience slowing growth. Second quarter data for U.S. real GDP show an annualized growth rate of 1.5 percent, lower than the annualized rate of 2.0 percent during first quarter 2012. Consumer spending drove most of the gains, but was much lower than in first quarter. Business fixed investment and residential investment also made smaller contributions than in previous quarters. Government spending and net exports made negative contributions. U.S. nonfarm employment rose by a robust 163,000 jobs in July after poor showings of 80,000 jobs in June and 77,000 in May. The unemployment rate held steady at 8.3 percent in July. Also seeing increases in June were housing prices and sales of new homes. Both consumer sentiment and consumer confidence slipped in July. Personal consumption expenditures declined in June, but both retail and auto/truck sales grew. The Kansas City Financial Stress Index remained near its long-run average in July, which suggests no financial headwinds or tailwinds. For almost a year now, the quantity of commercial paper outstanding has remained low—an indication that little external financing is being used to support business investment, *Table 3*.

Nevada Economy Shows Mixed Signs

The Nevada economy showed mixed signs. Seasonally adjusted, statewide employment decreased slightly by 1,000 jobs (0.1 percent) from May to June. The Nevada unemployment rate remained stable at 11.6 percent in June. Visitor volume was 1.9 percent higher in June than a year earlier. Gaming revenue was 6.0 percent lower in June than a year earlier, mostly as the result of reduced slot machine play. More favorably, taxable sales were 10.4 percent higher in May than a year earlier, *Table 4*.

Clark County Shows Signs of Slower Economic Growth

Clark County's economy also saw mixed signs. Seasonally adjusted, the region's employment showed no change from May to June, remaining at 813,600 jobs. Nonetheless, the Las Vegas unemployment rate fell from 12.2 percent in May to 12.0 percent in June. Compared to a year earlier, visitor volume was up by 1.8 percent in June. Gaming revenue was 7.9 percent lower in June than a year earlier, mostly as the result of reduced slot machine play. Similar to the state's experience, Clark County's taxable sales for May were 10.0 percent above those for a year earlier. Residential construction permits rose sharply in June. Commercial construction permits remained volatile at a low level, *Table 5*.

Positive Economic Growth Evident in Washoe County

Washoe County saw mostly positive signs, despite a weak month for jobs. Seasonally adjusted Reno-Sparks employment decreased by 600 jobs (0.3 percent) from May to June. The Reno-Sparks unemployment rate rose slightly, from 11.5 percent in May to 11.6 in June. Compared to a year earlier, June visitor volume was up by 3.4 percent. Gaming revenues for June were up by 7.3 percent over the same period. Residential construction permits increased in June, while commercial construction permits remained at a low level, *Table 6*.

Nevada Economic Outlook in Brief

U.S. economic growth slipped further during the second quarter, and preliminary signals—such as weak gains in employment and decreases in personal consumption expenditures—indicate the likelihood of only a slight acceleration for the third quarter. Nevada is beginning to see evidence of sluggish U.S. economic growth in the form of slowing growth of its tourism. Nonetheless, the most recent data suggest relative stability in Nevada's employment and gains in spending.

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