“Evaluating Economic Stimulus Proposals”
Testimony before the Committee on the Budget
United States Senate

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Mr. Chairman and Members of the Committee, it is an honor to appear before you to discuss short-term economic stimulus proposals. In my testimony, I analyze various stimulus proposals using a series of common-sense principles for an effective stimulus package. The principles reflect the idea that an effective package needs to do two things: maximize the extent to which it directly stimulates new economic activity in the short term, and minimize the extent to which it indirectly restrains new activity by driving up interest rates. Similar principles have been endorsed by the Chair and Ranking Member of this Committee, as well as by the Chair and Ranking Member of the House Budget Committee, in a recent statement.[2]

My testimony reaches two main conclusions. First, on the tax side, an effective tax stimulus package would focus on temporary (one-year) items for businesses and households, not permanent ones; design business incentives to provide incentives for new investment, rather than windfalls for old investment; target household tax cuts to maximize the effects on short-term spending; and maintain long-term fiscal discipline.[3] Unfortunately, most of the tax proposals that have been endorsed by the Bush Administration and the House Ways and Means Committee do not meet these principles and are therefore poorly designed from the perspective of stimulating the economy in the short run. Limiting any tax stimulus to a *temporary* investment incentive and a household rebate targeted at those most likely to spend it would be much more cost-effective than the proposals supported by the Administration or the Ways and Means Committee.

Second, on spending increases, a distinction should be drawn between transfer programs (such as unemployment insurance benefits) and government purchases of goods and services (such as public construction projects). On transfer programs, the key issue is that they boost spending quickly among their recipients. On government purchases, the key issue -- at least in terms of stimulating the economy -- is their spend-out rate. Given the expected *temporary* nature

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[2] “Revised Budgetary Outlook and Principles for Economic Stimulus,” Senate Budget Committee (Senator Kent Conrad, Chairman; Senator Pete V. Domenici, Ranking Member) and House Budget Committee (Rep. Jim Nussle, Chairman; Rep. John M. Spratt, Jr., Ranking Member), October 4, 2001.

[3] The principles were developed in some recent papers with Bill Gale and Gene Sperling of the Brookings Institution. See William Gale, Peter Orszag, and Gene Sperling, “Stimulating the Economy Through Tax Policy: Principles and Applications,” http://www.brook.edu/views/papers/gale/20011005.htm and “Tax Stimulus Options in the Aftermath of the Terrorist Attack,” http://www.brook.edu/views/articles/gale/20011008.htm, or *Tax Notes*, October 8, 2001.

of the current economic slowdown, the faster that funds can be injected into the economy, the better. Based on these considerations, the most promising spending increases involve temporary changes to the unemployment insurance system, modifications in other low-income programs, and increased Federal support for state governments.

Section 1: Tax proposals

As Dr. Gale emphasizes in his testimony today, a sound set of principles for tax stimulus proposals would:[4]

- Design business incentives to provide incentives for new investment, rather than windfalls for old investment.

- Design household tax cuts to maximize the effects on short-term spending.

- Focus on temporary (one-year) items for businesses and households, not permanent ones.

- Maintain long-term fiscal discipline.

The purpose of this section is to use these principles to examine recent proposals endorsed by the Bush Administration or by the Ways and Means Committee. The Bush Administration has expressed support for five items: a permanent tax incentive (through partial expensing) for business investment; permanent elimination of the corporate alternative minimum tax (AMT); permanent changes in the rules applying to net operating loss carry-backs; acceleration of some of the personal income tax reductions scheduled for 2004 and perhaps for 2006; and a temporary household tax rebate aimed at lower- and moderate-income workers.

The House Ways and Means Committee's tax package includes a larger number of items: permanent elimination of the corporate AMT; a permanent reduction in the capital gains tax rate from 20 percent to 18 percent; a permanent loosening of the subpart F rules applying to international income; permanent changes in the depreciation rules applying to leasehold improvements; an acceleration of the reduction in the tax rate applying to what had been the 28 percent marginal tax bracket; 30 percent expensing for capital assets put into place over the next three years; a three-year change in the rules applying to net operating loss carry-backs; a two-year increase in the Section 179 small business expensing limit; a two-year increase in the deduction for capital losses; a one-time supplemental rebate for low- and moderate-income taxpayers; and a variety of other changes.[5]

This section analyzes the major tax proposals endorsed by the Administration and the Ways and Means Committee. My major conclusion is that most of the proposals (with the exception of the temporary household rebate) are not consistent with principles for a sound

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[4] See William Gale, Testimony before the Committee on the Budget, U.S. Senate, October 25, 2001.

[5] See Joint Committee on Taxation, *Description of the Economic Security and Recovery Act of 2001*, JCX-69-01, October 11, 2001. For an analysis of the Ways and Means Committee proposal, see Joel Friedman and Robert Greenstein, "Ways and Means Package Departs from Bipartisan Principles for Effective Stimulus and Offers Little Help to the Unemployed," Center on Budget and Policy Priorities, October 17, 2001.

stimulus package.[6] For example, the proposed acceleration of the personal income tax reductions would be poorly targeted for generating stimulus because of its patterns across time and across households. Table 1 summarizes the proposals and the degree to which they meet the relevant criteria.

Table 1: Summary of tax proposals

	Temporary only	Focus on new investment	Maximize spending impact from household tax cuts	Overall assessment (poor, average, good)
Corporate items				
Partial expensing				
Temporary	Yes	Yes	NA	Good
Permanent	No	Yes	NA	Poor
Corporate AMT repeal	No	No	NA	Poor
Net operating loss carry-backs				
Temporary	Yes	No	NA	Average
Permanent	No	No	NA	Poor
Subpart F relaxation	No	No	NA	Poor
Household items				
Capital gains tax reduction	No	No	No	Poor
Accelerate scheduled income tax reductions	No	NA	No	Poor
Temporary rebate for those who did not receive full rebate in first round	Yes	NA	Yes	Good
Capital loss deduction expansion	Yes	No	No	Poor

As an alternative to the tax proposals put forward by the Administration or the Ways and Means Committee, *temporary* partial expensing for new investment (especially if it applied only to investment rates above some historical average) coupled with a rebate for lower- and moderate-income workers would produce a much higher "bang for the buck" (see concluding section for further discussion).

[6] The proposals would also be regressive. Citizens for Tax Justice (CTJ) finds that the top one percent of the income distribution would receive 41 percent of the benefits from the legislation in 2002, and the top 5 percent would receive 60 percent of the benefits. (The CTJ figures attribute the corporate tax cuts to individuals based on their ownership of capital assets, such as stocks and bonds.) See Citizens for Tax Justice, "Ways and Means Tax Bill Would Almost Double Bush Tax Cuts Over Next Three Years," October 15, 2001. These figures do not include the cost of the household rebate, which the CTJ assumes would occur in 2001. Including the rebate, the top 1 percent would receive 35 percent of the total benefits and the top 5 percent would receive 52 percent of the benefits.

Partial expensing of business investment

The Administration has proposed permanent partial expensing of business investment. Adopting a permanent tax subsidy for business investment has two disadvantages relative to a temporary incentive. The temporary incentive has lower costs, thus limiting any upward pressure on interest rates from the long-term costs of permanent changes. And even apart from their lower budgetary costs, temporary investment incentives are generally considered *more* effective for short-term stimulus than permanent ones. The temporary incentives lead firms to substitute investment into the period in which it enjoys a larger tax benefit. It is not clear why the Administration supports a permanent investment incentive when a temporary incentive would be more effective in stimulating the economy in the short run and less expensive in the long run.

The Ways and Means Committee would extend its expensing proposal for three years, which is better than a permanent incentive but still too long. The most recent Blue Chip consensus of private economic forecasters (issued October 10, 2001) suggests that the recession will end in early 2002, with real GDP growth reaching 4 percent by the fourth quarter of 2002.[7] Even the average among the most pessimistic 10 forecasters suggests growth of 2 to 3 percent by the latter half of 2002. The implication of this forecast is that any temporary corporate tax provisions extending beyond 2002 would be in effect long after the economic slowdown had ended.

Elimination of the corporate alternative minimum tax

Unlike investment incentives, which only give tax breaks to firms that are undertaking new investment, eliminating the corporate AMT would give tax cuts to firms irrespective of whether they are investing at all. Thus, it is very poorly targeted as a stimulus measure.

The corporate alternative minimum tax applies when corporations owe no corporate income tax because of substantial deductions or other tax preferences, relative to their income. The elimination of the corporate AMT would effectively reduce the tax rate on corporate income. But the vast majority of such income represents a return to *previous* investment, not new investment. For example, according to data from the Bureau of Economic Analysis, the value of non-residential structures, equipment, and software amounted to more than $10 trillion at the end of 1999.[8] Yet annual investment in such areas amounts to roughly $1.3 trillion. If the return from existing capital is equal to the return from new investment, and if existing capital is just as likely to be subject to the corporate alternative minimum tax as new capital, roughly 90 percent of the benefits to physical capital from eliminating the corporate alternative minimum tax would accrue to old investment rather than new investment.

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[7] Blue Chip Economic Indicators, Vol. 26, No. 10, October 10, 2001, page 6.

[8] Bureau of Economic Analysis, "Fixed Assets and Consumer Durable Goods for 1925-99," corrected tables, June 15, 2001, http://www.bea.doc.gov/bea/dn1.htm. The $10 trillion figure reflects the current cost estimate of the net stock of private, non-residential structure, equipment, and software.

In other words, elimination of the corporate alternative minimum tax is an extremely blunt and inefficient approach to encouraging new investment in the short run. According to the Joint Committee on Taxation, it would also cost $24 billion over the next decade.[9]

Changes in the rules applying to carrying back losses

Under current law, corporations can offset current losses against previous income taxes for up to two years. Both the Bush Administration's proposal and the Ways and Means proposal would allow such loss carry-backs for up to five years, although the Bush Administration would make that change permanent and the Ways and Means Committee would allow it only for three years.

Like the corporate AMT cuts, this proposal would reward old capital, and may do little to stimulate new investment. For example, the proposal would provide tax subsidies to firms that had high profits three or four years ago, that had ceased investing, and that were currently experiencing losses. Such firms may or may not use the additional funds to undertake new investments; the tax subsidy is provided regardless of how the firms decide to use the funds. To be sure, this proposal (unlike corporate AMT repeal) would provide funds to firms that are losing money and help them weather the economic downturn. But there is no reason to make such a change permanent, nor to extend it beyond the next year. Even if the goal is to provide more cash to firms with current losses, the objective could be achieved at much lower long-term budgetary cost – and therefore with less negative impact on interest rates – by making any change in the carry-back rules limited to 2002.

Subpart F

Under the "Subpart F" rules of current law, U.S. shareholders are taxed on some types of income earned by a controlled foreign corporation – regardless of whether the income is distributed to the U.S. shareholder. The purpose of these rules was to prevent international firms from using internal organizational shifts and distorted transfer pricing to hide income from U.S. taxation. The House Ways and Means proposal would permanently exempt income earned in banking, finance, or insurance from these rules – thus providing a tax benefit to firms in these industries. As with the repeal of the corporate AMT, the proposal primarily represents a windfall for old capital – and therefore does not reflect sound stimulus principles. It is also permanent rather than temporary. Reflecting its permanent nature, it provides only $260 million in tax relief in 2002 – or only 1.2 percent of its ten-year cost of $21 billion. It is extremely difficult to see how this provision represents a cost-effective stimulus proposal.

Capital gains tax rate reduction

The Ways and Means Committee would reduce the maximum tax rate on long-term capital gains from 20 percent to 18 percent.[10] Whatever its merits in other contexts, a capital gains tax cut has several crucial drawbacks as a stimulus tool.[11]

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[9] Joint Committee on Taxation, *Estimated Budget Effects of a Modified Chairman's Amendment in the Nature of a Substitute to the Revenue Provisions Contained in H.R. 3090*, JCX-70-01, October 12, 2001.

[10] For assets held more than one year, taxpayers in the 15 percent bracket and lower brackets face a 10 percent capital gains rate, while taxpayers in the 27 percent bracket and higher brackets face a 20 percent capital gains rate.

In particular, a permanent capital gains tax cut is poorly designed to address the short-term economic problems at hand:[12]

- First, cutting the tax rate on capital gains is unlikely to stimulate consumption. Indeed, proponents of a capital gains tax reduction typically argue that it would stimulate national saving, not consumption.[13]

- Second, a capital gains tax cut is typically promoted as producing economic benefits in the long run, not the short run. Even those who believe that a capital gains tax cut would encourage business investment acknowledge that the impact is slow.[14] And even in the long run, the benefits are limited. For example, a recent Congressional Budget Office study concluded that reducing the top tax rate on long-term capital gains from 20 percent to 15 percent would have a minuscule effect on private saving and long-term economic growth.[15]

Rates lower than these can currently apply to assets held for at least five years. Assets acquired after December 31, 2000 that would otherwise be subject to the 10 percent rate will be taxed at 8 percent if they have been held for more than five years before being sold. For assets otherwise subject to the 20 percent rate, a 18 percent rate will apply if the asset has been held for more than five years and was acquired after December 31, 2000. This 18 percent rate thus will be applied to some assets sold beginning in 2006. Assets held for less than one year (short-term capital gains) are taxed at the same rate as regular income.

[11] This material draws upon Joel Friedman, Iris Lav, and Peter Orszag, "Would a Capital Gains Tax Cut Stimulate the Economy?" Center on Budget and Policy Priorities, September 20, 2001.

[12] For further discussion of the effects of a capital gains tax cut, see Leonard Burman, *The Labryrinth of Capital Gains Tax Policy: A Guide for the Perplexed* (Brookings Institution: Washington, 1999), and Henry Aaron, "The Capital Gains Tax Cut Mystery," Tax Notes, March 9, 1992.

[13] It is also worth noting that a capital gains tax reduction -- whether temporary or permanent -- would produce disproportionate benefits for higher earners, who would be unlikely to spend a large percentage of their tax gains. Based on estimates by the Congressional Research Service (CRS), it is likely that 80 percent of the benefits from a capital gains tax cut would accrue to the two percent of the population with the highest incomes -- those with incomes exceeding $200,000. Using Joint Committee on Taxation data for 1999, CRS estimated that the 1.8 percent of taxpayers with incomes over $200,000 (in 1999 dollars) pay 78.6 percent of capital gains taxes. Jane G. Gravelle, "Capital Gains Taxes: Distributional Effects," Congressional Research Service, September 24, 1999. See also Citizens for Tax Justice, "Proposed Capital Gains Tax Cut Would Divert Stimulus Funds to the Very Wealthy," October 12, 2001, which finds that the top 1 percent of the income distribution would receive 71 percent of the benefits from the capital tax rate reduction included in the Ways and Means legislation, and that the top 5 percent would enjoy 87 percent of the benefits.

[14] See, for example, "Capital Gains Taxes and the Economy: A Retrospective Look," prepared for American Council for Capital Formation by Standard and Poor's DRI, June 25, 1999.

[15] Congressional Budget Office, "An Analysis of the Potential Macroeconomic Effects of the Economic Growth Act of 1998," CBO Memorandum, August 1998. CBO estimated that private saving would rise by 0.3 percent, adding about 0.06 percent to the capital stock after ten years. The increase in GDP would amount to about $2 billion to $3 billion in the tenth year -- or less than two one-hundredths of one percent of GDP. The long-run benefits of a capital gains tax cut are limited for several reasons. For example, many assets would be unaffected. Assets held in pension funds and individual retirement accounts do not face individual capital gains tax -- nor do assets held by foreign investors, corporations, non-profits, or those who offset capital gains with capital losses. Similarly, capital gains on assets held for less than one year are subject to the regular income tax rate, not the preferential long-term capital gains rate, and therefore would be unaffected. Furthermore, for most families, any gain on the sale of their personal residence is exempt from the capital gains tax, since the first $500,000 of the gain for married couples ($250,000 for singles) is exempt from the tax. Investors can also reduce or avoid the impact of capital gains taxes by deferring the sale of assets. In fact, about half of all capital gains tax is avoided by investors altogether, as they hold onto assets until they die. (Heirs do not have to pay tax on the gains accrued during the lifetime of the original owner.)

- Third, a capital gains tax reduction is not an efficient way to target *new* investment, because the tax cut would apply to capital gains on *existing* assets, and those gains are a return to prior investment.

- Finally, the capital gains rate cut would reduce revenue in the long run, and exert upward pressure on long-term interest rates.[16]

Another version of the proposed reduction in capital gains taxes would make the reduction temporary. A temporary reduction in capital gains tax rates is particularly problematic. For example, a temporary capital gains tax cut could generate short-term stimulus if individuals were more likely to consume out of realized capital gains than unrealized gains, and the realized gains induced by a temporary capital gains tax cut therefore boosted consumption. But to the extent the realized gains were consumed, stock prices would tend to decline because the realized gains would not be reinvested in the stock market. Any such stock market decline could harm consumer confidence and hurt the economy. Fundamentally, policies that could induce stock market declines are unlikely to be beneficial at this point. A temporary capital gains tax cut is thus an inappropriate response to the current economic slowdown.

These considerations lead me to the same conclusion as economist Jane Gravelle in a recent Congressional Research Service report: "a capital gains tax cut appears the least likely of any permanent tax cut to stimulate the economy in the short run; a temporary capital gains cut is unlikely to provide any stimulus."[17]

Acceleration of the tax reductions for higher-income households

Another component of the Administration's proposals would accelerate to January 1, 2002, the income tax rate cuts -- or some portion thereof -- currently scheduled to occur on January 1, 2004, and January 1, 2006. The Ways and Means Committee would limit the acceleration to the previous 28 percent marginal tax bracket.

This proposal violates the principle that any household tax reductions should maximize the effect on demand in the short run, and it may *undermine* fiscal discipline in the long run.

- First, the proposal does not maximize the effect on demand in 2002. The ten-year cost from accelerating all the marginal rate reductions scheduled through 2006 would amount to $122 billion, yet only $27 billion of the costs would arise in 2002. Accelerating just the previous 28 percent marginal bracket (which is scheduled to reach 25 percent by 2006) would cost $54 billion over ten years, with only $13 billion of the cost arising in 2002. Furthermore, the accelerated rate cuts would only apply to high-income households – regardless of whether all the rates or just the previous 28 percent rate is accelerated. Either proposal would affect only those who are in the top 25 percent of the income distribution (although acceleration of all the rates would be even more regressive and less fiscally responsible than acceleration of the

[16] The Joint Tax Committee estimated that the Ways and Means proposal on capital gains would reduce revenue by more than $10 billion between 2002 and 2011.

[17] Jane G. Gravelle, "Economic and Revenue Effects of Permanent and Temporary Capital Gains Tax Cuts," Congressional Research Service, September 17, 2001.

previous 28 percent rate alone).[18] The marginal propensity to consume income among the higher-income group who would benefit from the acceleration is below that of lower- and moderate-income groups.[19] Since most of the cost would occur after 2002, and since the amounts that would flow to individuals in 2002 would be concentrated among those with relatively low propensities to consume, accelerating the tax cuts would have a low bang for the buck.

- Second, the ultimate objective of the proposal may have the effect of undermining long-term fiscal discipline. Accelerating the rate cuts would have the political effect of helping to lock in further tax rate cuts for the highest-income taxpayers. Yet in the near future, Americans will need to reconsider such further reductions in tax rates for high-income taxpayers, as the economic and budget outlook after the terrorist attack and the current slowdown become clearer. Careful consideration will have to be given to the policy adjustments necessary to maintain a sound long-term fiscal position (particularly in light of ongoing anti-terrorism costs). Steps that would be perceived as reducing policy-makers' flexibility to re-establish fiscal discipline could actually be counter-productive in the short run, by causing long-term interest rates to remain substantially higher than they otherwise would.

A temporary household tax rebate aimed at lower- and moderate-income workers

The final component of the proposed tax stimulus packages is the only one that represents a sound short-term stimulus item. The Ways and Means Committee would provide another round of temporary household rebates, targeted on lower and middle income households, a proposal also endorsed by the Bush Administration. In particular, roughly 34 million tax filers received no rebate under the first round of rebates sent out this summer, and another 17 million received only a partial rebate.[20] The proposals would focus the new rebate on these tax filers. Recent research suggests that these households have tendencies to spend a greater proportion of any new income than high-income households do – and the more the rebate is spent, the more effective it is as a stimulus. Since it is temporary and maximizes its effect on demand, this proposal represents the most auspicious component of the Administration's package.

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[18] Roughly three-quarters of tax filers either have no taxable income (because their income is less than their deductions and exemptions) or face a marginal tax rate of no more than 15 percent. Only 30 million tax filers – or about 25 percent of all tax filers – have a portion of their taxable income in the former 28 percent bracket. See David Campbell and Michael Parisi, "Individual Income Tax Rates and Tax Shares, 1998," *Statistics of Income Bulletin*, Spring 2001, Tables 1 and 5.

[19] Dynan, Skinner and Zeldes (2001) show that, in several different data sets, average propensities to consume out of current and permanent income fall as those income measures rise. Parker (1999) uses data from the Consumer Expenditure Survey and finds that the marginal propensity to consume out of transitory income at low levels of resources (which for most low-income households is effectively current income) is much higher than the MPC out of transitory income for very high-income households. McCarthy (1995) uses data from the Panel Survey of Income Dynamics and shows that the marginal propensity to consume out of idiosyncratic income shocks is larger for low-wealth households than for high-wealth households. The weight of the evidence suggests that lower- and middle-income households do have higher propensities to consume out of available resources. See Karen E. Dynan, Jonathan Skinner, and Stephen P. Zeldes, "Do the Rich Save More?" NBER Working Paper 7906, National Bureau of Economic Research, September 2000; Jonathan Parker, "The Consumption Function Re-estimated," mimeo, August 1999; and Jonathan McCarthy, "Imperfect Insurance and Differing Propensities to Consume Across Households," *Journal of Monetary Economics*, November 1995, pages 301-27.

[20] Gregg Esenwein and Steve Maguire, "The Rate Reduction Tax Credit (The "Tax Rebate") in P.L. 107-16," Congressional Research Service, July 15, 2001.

Expand deduction for capital losses

Under current law, taxpayers may deduct net capital losses of up to $3,000 against ordinary income. The Ways and Means Committee proposal would increase the permissible deduction amount to $4,000 in 2001 and $5,000 in 2002 and thereafter. This proposal has several flaws: It is permanent, rather than temporary; it is likely to benefit higher-income taxpayers more than lower-income taxpayers, given the concentrated distribution of financial assets and the fact that the expanded deduction is more valuable to taxpayers in higher marginal tax brackets; and it may induce additional stock market sales in the short run (among those who have net capital losses amounting to more than $3,000), which could reduce stock prices and therefore pose risks to consumer confidence.

Summary

With the exception of the household tax rebate aimed at lower- and moderate-income workers, the tax proposals endorsed by the Bush Administration are flawed as stimulus measures, as are the Ways and Means Committee's proposals. Both the Administration and the Ways and Means Committee endorse permanent or extended changes that are *less* effective at stimulating the economy in the short run, but *more* expensive in the long run, than temporary one-year changes. And both the Administration and the Ways and Means Committee accelerate the recently enacted tax cuts for higher-income taxpayers, which is poorly targeted and potentially counter-productive. A more effective stimulus package would combine the household rebate aimed at lower- and moderate-income workers with a *temporary* incentive for business investment.

<u>Section 2: Spending proposals</u>

Spending increases represent an alternative form of fiscal stimulus to tax cuts. In analyzing spending proposals, it is important to draw a distinction between transfer programs (such as unemployment insurance or Social Security) and direct government spending on goods and services (such as purchasing military equipment or building roads). Simple Keynesian economy theory suggests that direct spending increases will generate *more* bang for the buck than tax cuts or transfer programs.[21] The reason is that some of any tax cut or transfer payment will be saved, dissipating its positive impact on the economy in the short run, whereas the full amount of government spending on goods and services will directly add to demand.

For transfer programs, the principles for evaluating their stimulus impact should be similar to those used to evaluate tax cuts: In particular, any expansion in transfer programs should be temporary (to limit the long-term budgetary cost) and should maximize their immediate effect on spending. For direct government spending, the key issue is how quickly the money can be spent. Indeed, in terms of its immediate impact on the economy, the specific category in which the direct government spending arises appears to make little difference.[22] A

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[21] See, for example, N. Gregory Mankiw, *Macroeconomics* (Worth Publishers: New York, 2000), pages 262-266.

[22] For example, the one-quarter multiplier for defense purchases, non-defense purchases, and state and local purchases in the United States were estimated to be 1.24, 1.36, and 1.24 respectively – suggesting little difference in

secondary issue is that among those programs that have rapid spend-out rates, those that provide larger economic benefits in the long run are generally preferable.

Spending proposals under discussion include changes to unemployment insurance, health insurance for unemployed workers, other low-income programs, public capital investments, and assistance to state and local governments.

Unemployment insurance

The unemployment insurance (UI) system is an important "automatic stabilizer" that mitigates the severity of any economic downturn.[23] For example, UI benefits play a crucial role in cushioning the blow from unemployment: According to research undertaken by MIT Professor Jonathan Gruber, the amount a family spends on food falls by 7 percent, on average, when the head of a household becomes unemployed, but would decline by 22 percent in the absence of unemployment benefits.[24]

Unfortunately, the UI system is not well prepared for the current economic slowdown. The eligibility rules are outdated, some states did not accumulate sufficient trust funds during the recent economic boom, and benefit levels are relatively low.[25] For example:

- Part-time workers are excluded from unemployment insurance programs in 31 states because the states require workers be available for full-time work as a condition for eligibility.[26] In such states, an individual who has been working even 30 hours a week and cannot commit to more hours -- perhaps because of child care needs -- is not eligible for unemployment insurance benefits, even though UI taxes had been collected on the worker's previous earnings and the person is seeking work.

- Workers who have recently joined the labor force are also often ineligible because the system for determining whether earnings have been high enough to qualify for benefits was designed before the availability of substantial computing power and therefore does not take into account the most recent two calendar quarters.

As a result of these and other eligibility issues, only about 40 percent of the unemployed currently receive UI benefits. (A substantial percentage of the unemployed, however, are either new entrants to the labor market or are recent re-entrants – and therefore should not be expected

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the immediate economic impact from the different types of spending. See Christopher Sims, "Annex A: Identifying Policy Effects," in Ralph Bryant, Dale Henderson, Gerald Holtham, Peter Hooper, and Steven Symansky, eds., *Empirical Macroeconomics for Interdependent Economies* (The Brookings Institution: Washington, 1988), page 314.

[23] Alan Krueger, "Economic Outlook and Policies in Light of Recent Events," Committee on the Budget, U.S. Senate, October 2, 2001.

[24] Jonathan Gruber, "The Consumption Smoothing Benefits of Unemployment Insurance," *American Economic Review*, Vol. 87, March 1997, pages 192-205.

[25] See, for example, National Employment Law Project, "Unemployment Insurance: Key Elements for an Economic Stimulus Package," September 2001.

[26] Wendell Primus, "Economic Security: Helping Working Americans and Those Out of Work," prepared testimony for the Health, Education, Labor & Pensions Committee, United States Senate, October 2001.

to receive unemployment benefits. UI beneficiaries therefore represent a larger percentage of the unemployed who lost their jobs.[27])

Temporary changes in the unemployment insurance program would represent an effective stimulus; most of any additional benefits provided would likely be spent. Unemployment insurance is particularly well targeted to maximize its bang for the buck, since it is available only to unemployed workers (who have experienced a reduction in income from the loss of their jobs and whose consumption expectations may therefore exceed their current income). Unfortunately, the UI proposals put forward by both the Administration and the Ways and Means Committee do not address the fundamental issues.[28] For example, neither proposal addresses the eligibility rules that cause many low-income workers and working mothers to be ineligible for unemployment benefits when they lose their jobs.[29] Additional resources should be provided on a temporary basis to bolster the UI program, especially by expanding eligibility.

Other low-income programs

A variety of other programs for low-income families could also be temporarily expanded as part of an effective stimulus package.[30] For example, among the programs that should receive temporary increase in funding are:

- Expanded WIC funding. Hundreds of thousands of low-income women, infants and children could be turned away from the Special Supplemental Nutrition Program for Women, Infants and Children (WIC) in Fiscal Year 2002 because of insufficient funding based on obsolete economic projections.[31] A temporary increase in funding for the program would be an effective short-term stimulus (with longer-term benefits).

- Expanded LIHEAP funding. Funding could be provided in the Low-Income Home Energy Assistance Program (LIHEAP) for low-income families, which generally "spends out" quickly.

- Extension of the TANF contingency fund. Under the 1996 welfare law, Federal funding for states no longer rises automatically in recessions. The Temporary Assistance for Needy Families (TANF) contingency fund should be fixed and extended one year (after which it can be revised in the normal TANF reauthorization process), and funding for the TANF "supplemental grants" received by 17 of the lowest-income states should also be extended.

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[27] I thank Gary Burtless and Wendell Primus for point this fact out to me.

[28] See Wendell Primus, "Economic Security: Helping Working Americans and Those Out of Work," prepared testimony for the Health, Education, Labor & Pensions Committee, United States Senate, October 2001.

[29] They also provide insufficient funding to address the potential need for extended UI benefits if the unemployment rate increases significantly: The Labor Department estimated that if the recession is comparable to the recession of the early 1990s, the extra weeks of jobless benefits provided by the Administration's proposal would cost $5 billion. In the 1990-1991 recession, by contrast, $35 billion (in 2002 dollars) of additional weeks of benefits were provided through the mechanism that Congress created at that time. Robert Greenstein, "The Administration's Stimulus Proposal: Is it a Sound and Balanced Package?" Center on Budget and Policy Priorities, October 9, 2001.

[30] See discussion in Robert Greenstein, "Observations on a Stimulus Package," Center on Budget and Policy Priorities, October 4, 2001.

[31] See Center on Budget and Policy Priorities, "Low WIC Funding Levels Would Cut Nutrition Help For Women And Children," October 15, 2001.

Health insurance proposals

Under the system created by the 1986 Consolidated Omnibus Budget Reconciliation Act (COBRA), unemployed workers may generally maintain their employer-based health coverage for up to 18 months if they pay the full cost of the premium.[32] The average annual cost of family coverage is $7,000, however, which is prohibitive for many displaced workers. Given the high cost of COBRA coverage, temporary measures may be needed to prevent unemployed workers from losing health insurance. Potential measures include subsidies for COBRA premium costs or creating a new state Medicaid option, supported by an enhanced Federal matching rate, to cover displaced workers who have low incomes but can not qualify for Medicaid because they do not fall into an eligible category (for example, low-income unemployed workers without children would generally not qualify). These measures would likely provide less stimulus effect than an expansion in unemployment insurance benefits or other low-income assistance programs, but they do provide an important source of support for newly unemployed workers and may help to keep more people in the health care system – which is a critical form of protection against bio-terrorism.

Revenue sharing

States are suffering substantial fiscal stress as a result of the economic slowdown. Mississippi, Ohio and South Carolina have already enacted across-the-board spending cuts, while eight states were forced to raises taxes in their fiscal year 2002 budgets. A much larger number of states are expected to initiate budget cuts when state legislatures reconvene this winter and confront budgets that have fallen out of balance as a result of the downturn.[33] In all states except Vermont, some form of balanced budget rule forces such fiscal policies: When the state enters a recession, revenue naturally falls and expenditures (including on Medicaid) rise. The balanced budget rules then force the state to reduce spending, raise taxes, or some combination thereof, which is counter-productive in terms of stimulating the economy.

The fiscal stress on states could be exacerbated by recent proposals. For example, provisions in the Ways and Means Committee package would reduce revenue received from state corporate taxes. Some 44 states use Federal depreciation rules for their own corporate income taxes and would therefore be adversely affected by the Ways and Means proposal to provide partial expensing of business investment. Preliminary estimates from the Center on Budget and Policy Priorities suggest that states would likely lose approximately $5 billion a year (in state revenues) from 2002 through 2004 as a result of this provision.[34]

To avoid restrictive fiscal policies at the state level in the middle of an economic downturn, the Federal government should provide temporary fiscal assistance to the states. One mechanism for doing so would be a revenue-sharing program, such as existed in the 1970s and

[32] The premium cannot exceed 102 percent of the cost to the plan for similar individuals who remain employed with the firm.
[33] Iris Lav, "State Fiscal Problems Could Weaken Federal Stimulus Efforts," Center on Budget and Policy Priorities, October 4, 2001.
[34] Joel Friedman and Robert Greenstein, "Ways and Means Package Departs from Bipartisan Principles for Effective Stimulus and Offers Little Help to the Unemployed," Center on Budget and Policy Priorities, October 17, 2001.

1980s. Such an approach may take time to design and implement, however.[35] A more timely alternative would temporarily increase the Federal matching rate for the Federal-state Medicaid program. An enhanced match would serve two purposes. It could partially help states meet expanded Medicaid costs resulting from an economic downturn.[36] Since Medicaid costs now are rising over the levels that states budgeted for them as unemployment climbs and more people become eligible for the program, the program is widely expected to be a prime candidate for budget cuts in many financially strapped states. An increased Federal match would also partially enable states to use less of their own funds for Medicaid, which would help to avoid counter-productive tax increases or reductions in other state programs.[37]

Some form of Federal assistance to state governments would likely help attenuate the restrictive fiscal policies that would otherwise be adopted at the state level – and therefore would represent an effective stimulus.

Public capital investments

Public capital investments involve direct government purchases of goods and services and therefore directly inject demand into the economy. Many public investments also appear to have high social returns, and thus even temporary expansions in capital investments may carry long-term benefits.[38] The key issue from the perspective of short-run stimulus, however, is how quickly any expansion in capital spending could be implemented. The record from the response to recent natural disasters raises questions about how quickly capital investments could be made: Only 30 percent of the outlays from recent disaster appropriations occurred in the first fiscal year following enactment of the funding, with 64 percent in the second fiscal year and 6 percent in the third year.[39] The spend-out rate could perhaps be faster if existing projects were simply accelerated, but public capital investments should not be undertaken as part of a stimulus

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[35] After the current economic slowdown is over, Congress may want to consider designing a counter-cyclical grant program to the states that would automatically take effect if and when needed during recessions.

[36] Evidence shows that when unemployment rises during an economic downturn, the percentage of people with job-based health insurance declines. Medicaid partially compensates, as a greater number of low-income workers become eligible for it. Using Medicaid baseline spending projections by the Congressional Budget Office from April, the Kaiser Commission on Medicaid and the Uninsured informally projects that if the national unemployment rate rises by two percentage points to 6.5 percent from the 4.5 percent CBO previously assumed for FY 2002, Medicaid enrollment would be expected to increase by 3.2 million people. As a result, the economic downturn will cause state Medicaid expenditures to increase significantly.

[37] Exacerbating these problems, Federal Medicaid matching rates for more than half of the states are being reduced in fiscal year 2002. The Federal Medicaid matching rate for each state is based on the state's per capita income relative to that of the nation, as determined by Census data for the most recent three calendar years for which these data are available. The new matching rates for fiscal year 2002 are based on state per capita incomes in 1997-1999, a period when the economy was very strong. Some 29 states that experienced solid economic growth between 1997 and 1999 have just had their Federal matching rates reduced. In most of these states, however, the state's ability to finance its share of Medicaid costs is now becoming weaker rather than stronger.

[38] Council of Economic Advisers, *Economic Report of the President 1994*, pages 42-43.

[39] Communication from Richard Kogan, Center on Budget and Policy Priorities, October 16, 2001, and author's calculations. The legislation includes PL 102-229, PL 102-266, PL 102-368, PL 103-75, and PL 103-211. The numbers may be distorted by the timing of the legislation relative to the end of a fiscal year, but the results still raise questions about how quickly capital investment can spend-out – which should be a crucial concern in the current context.

package unless the vast majority of the additional spending would occur over the next 12 months.

Conclusion

In conclusion, Mr. Chairman, the proposals put forward by the Bush Administration and the Ways and Means Committee do not maximize their bang for the buck. They include permanent or extended tax incentives for businesses, and provide insufficient funding for highly effective spending programs such as unemployment insurance. A more promising alternative would involve the following elements:

Table 2: Summary of potential stimulus package

	Budget effect in 2002	Budget effect, 2002-2011
Temporary partial expensing	-$20 billion	-$10 billion
Household rebate for low-income and moderate-income workers	-$15 billion	-$15 billion
Temporary UI expansions	-$25 billion	-$25 billion
Temporary improvements in other low-income programs	-$1 billion	-$1 billion
Revenue sharing	-$15 billion	-$15 billion
Freeze top marginal tax rate	NA	+$100 billion
TOTAL	-$76 billion	+$34 billion

- Temporary (one-year) partial expensing for capital investments. A temporary investment incentive would be more effective in stimulating investment in the short run than a permanent incentive.[40] Such an incentive would be even more efficient -- it would have an even bigger "bang for the buck" in stimulating the economy -- if it applied only to new investment that would not have occurred immediately without the credit. This issue could be partially addressed by designing a subsidy only for investment above some firm-specific threshold (such as 80 percent of the firm's average investment in the last three years), although design of such an incremental incentive may be complicated. The one-year cost should not exceed perhaps $20 billion, which could be achieved by adjusting the types of property that qualify for the incentive, the percentage of new investment that would qualify for expensing, and the "threshold" for incremental investments. The ten-year cost would then be much lower than $20 billion, since the expensing would reduce firms' depreciation basis and therefore future depreciation deductions. (As a rough approximation, I estimate the ten-year cost as one-half the one-year cost.)

- One-time rebate for low-income households. The rebate proposal included in the Ways and Means package is sound: It would provide 76 percent of its benefits to the lowest 40 percent of the income distribution, and would therefore provide a relatively large stimulative "bang

[40] William Gale, Peter Orszag, and Gene Sperling, "Stimulating the Economy Through Tax Policy: Principles and Applications," http://www.brook.edu/views/papers/gale/20011005.htm and "Tax Stimulus Options in the Aftermath of the Terrorist Attack," http://www.brook.edu/views/articles/gale/20011008.htm, or *Tax Notes*, October 8, 2001.

for the buck."[41] It may also be beneficial to time the rebate checks for the holiday shopping season. Intuitively, putting more resources in the hands of lower- and moderate-income families during the holiday season seems likely to bolster the volume of shopping during the holiday season. Shopping establishments -- which have already experienced one rebate round -- may be particularly astute about marketing sales and deals based on the rebates.

- Temporary UI expansions. Proposals to expand the unemployment insurance system by enhancing eligibility for low-wage and part-time workers, raising benefit levels, and adding additional weeks of benefits for workers who exhaust their regular UI benefits have been scored to cost roughly $25 billion, assuming the changes sunset at the end of 2002. The principal focus of the temporary package should be on expanding eligibility; any extension of benefits should be conditional on an increase in the unemployment rate.

- Temporary increases in WIC and other programs. As noted above, temporary expansions in funding for the Women, Infants, and Children program, the LIHEAP program, and other low-income programs would be beneficial. The total cost would amount to perhaps $1 billion.

- Temporary revenue sharing for state government/expanded Medicaid match. Increased support for state governments is important in avoiding counter-productive fiscal policies. The support could take the form of a new revenue sharing mechanism, or simply an enhanced Federal Medicaid match rate. The amount of the Federal assistance could be dialed up or dialed down to fit the overall budget for the stimulus package; the proposal here includes about $15 billion.

- Freeze marginal tax rate reductions in the previous 39.6 bracket. Freezing the top marginal tax rate at 38.6 percent, rather than allowing it to decline in the future, could finance the short-term stimulus package above without endangering long-term fiscal discipline. According to the Joint Committee on Taxation, freezing the 38.6 marginal tax rate would save roughly $100 billion between 2002 and 2011 (excluding debt service savings).[42] Such a freeze would not represent a change relative to current law until 2004, well after the nation's short-term economic challenges are likely to have passed. It would also affect only 1.1 million taxpayers, who have an average adjusted gross income of $1.025 million. Even those high-income taxpayers would only forgo a future marginal tax cut, rather than experiencing a tax increase relative to today's rates, and would still enjoy a continuing reduction in average tax rates (since the tax rates applying at lower levels of income would continue to decline).

This package includes only temporary stimulus measures and maintains long-term fiscal discipline. Indeed, as Table 2 shows, the package as a whole would *save* roughly $35 billion over the next 10 years, and thus could help to reduce long-term interest rates – which would provide a

[41] Citizens for Tax Justice, "Ways and Means Tax Bill Would Almost Double Bush Tax Cuts Over Next Three Years," October 15, 2001.

[42] Letter from Bernard Schmitt, Joint Committee on Taxation, to Senator Barbara Boxer, September 4, 2001. The Joint Committee estimate applies specifically to the projected cost of reducing the 38.6 percent rate to 35 percent, given the tax code prior to the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001. The savings from freezing the 38.6 percent rate at this point may be somewhat smaller than this estimate, since other provisions of that Act interact with the marginal tax rate revenue effects.

further spur to the economy in the short run. Since the long-term response to preventing terrorism will cost much more than the short-term stimulus package alone, other adjustments will have to be considered by the Congress and the Administration in the future to help the nation meet its long-term fiscal obligations.