"Economic Stimulus and Unemployment Insurance"
Testimony before the Committee on Education and the Workforce
United States House of Representatives

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Mr. Chairman and Members of the Committee, it is an honor to appear before you to discuss current economic conditions and proposals for economic stimulus. In my testimony, I evaluate stimulus proposals using a series of common-sense principles for an effective stimulus package.[2] These 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 harms the long-term budget outlook. Similar principles have been endorsed by the Chair and Ranking Member of the House Budget Committee, as well as by the Chair and Ranking Member of the Senate Budget Committee, in a recent statement.[3]

If anything, recent economic releases have underscored the importance of these principles. Real Gross Domestic Product fell during the third quarter of 2001 and employment declined substantially in October.[4] It seems clear that we are now in the midst of a recession, highlighting the benefits of a timely stimulus package. But according to professional forecasters, the slowdown is expected to be temporary – with the economy recovering sometime next year.[5] The expectations of professional forecasters, of course, can be wrong, but they are the best we

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[2] This testimony draws on work with William 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," The Brookings Institution, October 5, 2001; William Gale, Peter Orszag, and Gene Sperling, "Tax Stimulus Options in the Aftermath of the Terrorist Attack," *Tax Notes*, October 8, 2001; William Gale and Peter Orszag, "Evaluating President Bush's Tax Stimulus Package," The Brookings Institution, October 9, 2001; Peter Orszag, "Evaluating Economic Stimulus Proposals," Committee on the Budget, U.S. Senate, October 25, 2001; William Gale, "Perspectives on the Tax Stimulus Debate," Committee on the Budget, U.S. Senate, October 25, 2001; and Gene Sperling and Peter Orszag, "Unemployment Insurance and Fiscal Stimulus," The Brookings Institution, November 7, 2001.

[3] "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.

[4] Some recent data, including the most recent release of the University of Michigan's consumer sentiment index and the most recent data on initial claims for unemployment insurance, suggest that the rate of economic downturn may be tapering. It should be noted that these data are very volatile, so that conclusions based on a limited number of observations could well be misguided.

[5] For example, the Blue Chip consensus of leading economic forecasters now projects negative growth in the fourth quarter of 2001 (which, given the negative growth in the third quarter, would produce a recession under the informal definition of that term). But these same forecasters also project robust growth by the end of next year, with growth of over 3 percent in the third quarter of 2002 and 4 percent in the fourth quarter of 2002.

have at this point. They strongly suggest that any stimulus should be focused on the next six to nine months, when the economy most needs the assistance.

Recent budget updates also highlight the importance of maximizing the bang for the buck and ensuring minimal costs to long-term fiscal discipline. A recent analysis released by the bipartisan leadership of the House and Senate Budget Committees showed that with the costs of the recently passed tax cuts, measures to combat terrorism, and the weaker economy, the United States will be unable to have a balanced budget without the use of Social Security surpluses until 2007.[6] The situation is far worse once the expected costs of fixing the individual alternative minimum tax and other expected costs are incorporated into the analysis: A recent paper that I co-authored with Bill Gale and Gene Sperling of Brookings suggests that the deficit outside Social Security may amount to about $1.5 trillion over the next 10 years under reasonable assumptions that incorporate these other costs.[7] Within this new budgetary context, tax or spending measures that have long-term costs and are not tightly tied to stimulating demand during the next nine months seem inappropriate and misguided.

The appropriateness and effectiveness of all stimulus options should thus be judged on the degree to which they bolster demand during the current short-term economic downturn without damaging the long-term fiscal picture. In that context, my testimony evaluates a variety of stimulus proposals, with a focus on proposals to expand or extend unemployment insurance.

Temporary spending expansions as economic stimulus

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.[8] 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 government spending on goods and services, the key issue is how quickly the money can be spent. Indeed, in terms of its immediate impact on the economy,

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[6] "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.
[7] William Gale, Peter Orszag, and Gene Sperling, "The Changing Budget Outlook: Causes and Implications," Brookings Institution, October 11, 2001. Richard Kogan of the Center on Budget and Policy Priorities has reached a similar conclusion. See Richard Kogan, "Where Has All the Surplus Gone?" Center on Budget and Policy Priorities, November 1, 2001.
[8] See, for example, Peter Orszag and Joseph Stiglitz, "Budget Cuts vs. Tax Increases at the State Level: Is One More Counter-Productive than the Other During a Recession," Center on Budget and Policy Priorities, November 6, 2001.

the specific category in which the government spending arises appears to make little difference.[9] A 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.

Unemployment Insurance

The Unemployment Insurance (UI) program was created during the Great Depression as part of the Social Security Act of 1935. It was designed to attenuate the hardships of involuntary job loss and stabilize the economy by supporting the consumption patterns of the unemployed. Benefits and eligibility are determined at the state level under Federal guidelines, with a majority of the program's funding effectively coming from state-level employer taxes. In addition to these state-level employer taxes, the Federal government imposes an unemployment insurance tax of 0.8 percent of covered wages.[10]

Eligibility is open to workers whose employers contribute to state unemployment insurance funds, federal civilian employees, and former military service members, as long as the workers are unemployed for "good cause" and are able, available, and looking for work. Under all state laws, the weekly benefit amount varies within certain minimum and maximum limits and is calculated as a function of the wages earned in one or more quarters of some base period (which is typically the first four quarters of the last five completed calendar quarters preceding the claim for unemployment benefits). During sound economic times, most states replace 40 to 50 percent of previous wages for up to 26 weeks of unemployment.

Not surprisingly, job loss is often associated with a decline in consumption, which then reduces demand for other goods and services as part of a negative cycle of increasing unemployment and declining economic activity. The unemployment insurance program helps to break this negative cycle: By partially compensating for lost income, it attenuates the reduction in spending and demand that unemployment can cause. For example, 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.[11] Since food is a necessity, spending on other items is presumably even more sensitive to the onset of unemployment.

The macroeconomic counter-cyclical benefits of the UI system have been corroborated in recent studies. One recent study commissioned by the Department of Labor concluded that UI

[9] 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 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.

[10] Technically, the Federal government imposes a 6.2 percent gross tax rate on the first $7,000 of earnings, but then provides a credit to the employer for 5.4 percent of those earnings – so that the effective Federal rate is 0.8 percent. The state employer taxes vary by type of employer, and the state taxes have different wage bases. For example, the tax in Arizona is imposed on the first $7,000 of earnings, but the tax in Alaska is imposed on the first $25,500 of earnings.

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

has had a significant impact in dampening recessions. [12] Another recent study found that, for its size, the unemployment insurance system is remarkably effective as an automatic stabilizer.[13] The study found that the unemployment insurance system provides roughly 25 percent of the automatic stabilizer impact as the entire tax system, despite the fact that UI benefits are only about 1.5 percent to 3 percent of the size of total Federal revenue.

Unemployment insurance benefits are well-targeted in several ways. In particular, they are received only by unemployed workers, they accrue disproportionately in areas and industries that have been the hardest hit by the slowdown, and they automatically decline as unemployment rates do.[14] This targeting explains why temporary *expansions* in unemployment benefits would provide additional stimulus to the economy. Most importantly, households with an unemployed worker have usually experienced a significant decline in income – so that their spending exceeds their current income. The unemployed are therefore likely to spend a high percentage of any additional income received during the period of unemployment. As Nobel prize-winning economist Joseph Stiglitz recently wrote in the *Washington Post*, "give money to people who have lost their jobs in this recession, and it would be quickly spent."[15]

In summary, unemployment insurance benefits are a particularly effective stimulus: They are concentrated on those with relatively high propensities to consume, and translate quickly into higher spending and additional demand. But despite the potential for unemployment insurance to play a significant role as a stabilizing force in the current economic downturn, its effectiveness is limited for three reasons: (1) The triggers for additional weeks of benefits beyond 26 weeks are excessively tight; (2) eligibility rules are outdated and often prevent part-time workers from receiving benefits; and (3) benefit levels are relatively low.[16]

1. Extending the duration of unemployment benefits

Extending the duration of UI benefits beyond 26 weeks may be counter-productive in sound economic times. For example, Lawrence Katz and Bruce Meyer estimate that extending the duration of benefits from six months to one year would increase unemployment spells by 4 to

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[12] Lawrence Chimerine, Theodore Black, and Lester Coffey, "Unemployment Insurance as an Automatic Stabilizer: Evidence of Effectiveness over Three Decades," Unemployment Insurance Occasional Paper 99-8, U.S. Department of Labor, July 1999.

[13] Alan Auerbach and Daniel Feenberg, "The Significance of Federal Taxes as Automatic Stabilizers," *Journal of Economic Perspectives*, Vol. 14, Number 3, Summer 2000, pages 37-56.

[14] Reflecting its effectiveness as a counter-cyclical stabilizer, the UI program provides the most aid to those geographic areas with the greatest concentration of unemployment and economic distress. Communities that experience high rates of unemployment receive more stimulus in the form of unemployment insurance, thus mitigating the effects of lost wages on the local economy. Indeed, Jonathan Gruber confirms that a newly unemployed person is more likely to live in a county or state with higher unemployment than a person keeping her job. The paper estimates that those who become unemployed reside in counties and states with unemployment rates that average 10.3 percent and 8.2 percent higher respectively than those who remain employed. See Jonathan Gruber, "The Consumption Smoothing Benefits of Unemployment Insurance," National Bureau of Economic Research, Working Paper 4750, May 1994.

[15] Joseph Stiglitz, "A Boost That Goes Nowhere," *The Washington Post*, November 11, 2001, page B01.

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

5 weeks.[17] In sound economic times, increasing the duration of eligibility could increase unemployment and create incentive problems in the job search process. Indeed, many economists believe that Europe's high unemployment rates partially reflect the duration of benefits available there (in addition to the generosity of the unemployment insurance benefits).

The situation may be somewhat different in a deteriorating job market. As the economy slows, longer spells of unemployment more likely reflect scarce job opportunities rather than a lack of effort in finding a new job. In a deteriorating labor market, those already unemployed will find it difficult to obtain a new job no matter how earnestly they search for one. This helps explain why during spells of high unemployment, current law provides for an extension of benefits from the standard 26 weeks by an additional 13 to 20 weeks. Indeed, a system of automatic triggers was adopted in 1970 to extend benefits when insured unemployment rates – that is, unemployed workers receiving benefits as a percentage of the covered labor force – hit predetermined levels, avoiding the delays and disputes inherent in creating temporary benefit extensions. Unfortunately, the triggers were tightened so significantly in the early 1980s that they are no longer relevant in anything but a severe economic recession.[18]

Three automatic triggers exist for the extension of benefits, one of which is mandatory and the other two of which are optional for states. States are required to provide extended benefits when the state's insured unemployment rate averages 5 percent or more over a 13-week period and 120 percent of the state's average in the same period in the last two years. All but 12 states have adopted a second trigger that extends benefits if the insured unemployment rate raises above 6 percent, whether or not it has increased.

The unemployment rates in these triggers are based on the "insured" rate – which measures only those unemployed workers receiving benefits under the state's unemployment insurance program. This figure is currently 2 to 3 full percentage points below the household unemployment rate from the Current Population Survey, which is the more widely quoted and understood number. Thus a trigger defined as 6 percent for the insured rate translates into a household unemployment rate that is substantially higher – perhaps as high as 9 percent or more.

A third trigger, afforded to states in 1992 legislation and adopted by only eight states, extends the period of eligibility if the *total* unemployment rate averages 6.5 percent or higher for the three most recent months and 110 percent of the average over the same period in the past two years**.**

Given the declines in unemployment rates and the percentage of those unemployed receiving benefits, the triggers (especially those based on insured unemployment rates) are now excessively restrictive. As of the second quarter of 2001, Department of Labor data show that only 12 states had an insured unemployment rate (IUR) above 2.5 percent and only 5 states

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[17] Lawrence Katz and Bruce Meyer, "The Impact of the Potential Duration of Unemployment Benefits on the Duration of Unemployment," *Journal of Public Economics*, Volume 41, Issue 1, February 1990, pages 45-72. The estimate is based on analysis of data between 1978 and 1983, which spans periods of economic expansion and recession. The authors note that their approach may not fully reflect the impact of macroeconomic factors on the unemployment rate.

[18] See, for example, 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.

(Alaska, Oregon, Pennsylvania, Puerto Rico, and Washington) had an IUR above 3.0 percent, while the average IUR across states was 2.1 percent. That means 38 states would require a doubling of their IUR and five states would require at least a two-thirds increase in the insured unemployment rate to set off the automatic triggers for extended benefits. In the 1990-91 recession, a separate temporary extension program (the Emergency Unemployment Compensation program) was created because the available triggers were reached in only 10 states. As recent proposals have underscored, the current situation requires a similar program: The automatic triggers are not sufficient to address the underlying problem.

President Bush's 'Back to Work Relief Package' would extend benefits for the unemployed given that they meet certain requirements. The administration would provide an extra thirteen weeks of benefits to the unemployed if they became unemployed after September 11th, 2001, live in states where the total unemployment rate rises 30 percent above the pre-September 11th rate, or live in one of the three states (Virginia, New York, and Pennsylvania) that President Bush declared major disaster areas after the terrorist attacks.

As a stimulus measure, the Administration's approach has several drawbacks. First, because the extension of benefits from 26 to 39 weeks only goes to those who became unemployed after September 11, the extended benefits would not take effect – and therefore no additional stimulus would be provided – until March 12, 2002 at the earliest, even though forecasters project that the most vulnerable economic period will occur over the next several months. It is worth emphasizing that the number of UI beneficiaries who exhaust their benefits has been rising rapidly over the past few months; in the third quarter of 2001, for example, 735,000 beneficiaries exhausted their benefits, up more than 40 percent from the third quarter of 2000.[19] Similar unemployed workers who lost their jobs before September 11 would never receive extended benefits under the President's Back to Work plan.

Another perspective on the adequacy of the Administration's proposal is reflected in cost estimates. 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.[20]

Secondly, the President's plan would only provide benefits to newly unemployed workers in states in which the unemployment rate had increased by 30 percent above its June-July-August 2001 average. This standard undermines the important role of UI as a cushion to the most distressed areas. For example, a state with 3.0 percent unemployment over the summer of 2001 would be eligible for extended benefits if its unemployment rate climbed to 4 percent (a 33 percent increase). Yet, a far more distressed state with, say, 7 percent unemployment over the summer would be ineligible even if its unemployment rate rose to 8 percent (a 14 percent increase), even though it would then have an unemployment rate twice the level of the first state.

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[19] Communication from Isaac Shapiro, Center on Budget and Policy Priorities, November 12, 2001.
[20] Robert Greenstein, "The Administration's Stimulus Proposal: Is it a Sound and Balanced Package?" Center on Budget and Policy Priorities, October 9, 2001.

The unemployment insurance proposal passed by the House of Representatives, although potentially beneficial as part of a broader unemployment insurance package, is also inadequate in terms of meeting the likely needs of the UI program. The legislation simply accelerates the transfer of $9.2 billion to state unemployment accounts from the federal UI Trust Fund. The additional funds are supposed to provide states the option of extending benefits, but it is left as a state option and would require legislative changes in most states. Furthermore, as the Center on Budget and Policy Priorities has emphasized, "the $9 billion in funds that would be transferred to state unemployment accounts would be allocated among the states *not* on the basis of current need or unemployment levels but in accordance with where the revenues in the federal unemployment trust fund were collected. As a result, the level of funds allocated to many states would bear little relationship to the need for additional unemployment benefits for laid-off workers in those states."[21] Since many states would be reluctant to spend the transfer quickly on extended benefits, and since the transferred funds would not be well-targeted to those states that most need them, the Congressional Budget Office estimates that only $2.3 billion would be spent in FY2002.

The Senate Finance legislation would be more effective in providing an effective economic stimulus.[22] It would immediately extend benefits by thirteen weeks to the long-term unemployed, defined as those who have been receiving benefits for 26 weeks. (As of October 2001, 888,000 individuals, or 11.4 percent of the unemployed, had been unemployed 27 weeks or longer.) The proposals would provide federal financing for the extended benefits, ensuring that the extensions did not impose any additional burden on state budgets or unemployment insurance programs.

2. Expanding eligibility

For various reasons, the majority of unemployed workers do not qualify for unemployment insurance benefits. Indeed, only about 40 percent of the unemployed currently receive benefits. To be sure, a substantial percentage of the unemployed are either new entrants to the labor market or are recent re-entrants – and therefore should not be expected to receive unemployment benefits. But even unemployed workers with a recent attachment to the workforce will sometimes be excluded from unemployment insurance benefits for reasons described below. Furthermore, the eligibility rules appear to exclude low-income workers in particular: For example, according to the General Accounting Office, only 18 percent of low-wage unemployed workers were collecting unemployment benefits in March 1995, relative to 40 percent of higher-wage unemployed workers.[23]

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[21] 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, November 5, 2001.

[22] For a description of the legislation, see Senate Finance Committee, "Economic Recovery and Assistance for American Workers Act of 2001," November 6, 2001.

[23] General Accounting Office, "Unemployment Insurance: Role as Safety Net for Low-Wage Workers is Limited," GAO-01-181, December 2000, page 5. The GAO data are based on the Survey of Income and Program Participation, and are not directly comparable to the more frequently cited data on the share of the unemployed receiving unemployment benefits that are based on the Current Population Survey. The GAO defined a low-wage worker as one earning $8 per hour or less.

One eligibility restriction involves the definition of "available for work." In 31 states, part-time workers are excluded from unemployment insurance benefits because the states require that workers be available for full-time work as a condition for eligibility.[24] 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.

Another reason many unemployed workers do not qualify for unemployment insurance benefits is that their most recent work experience is not counted in determining eligibility for UI benefits. In many states, the current quarter and the previous quarter of work are not included in the calculations that determine eligibility. Therefore workers who have recently joined the labor force are often ineligible.

These two limitations fall particularly hard on single working mothers who have just left welfare to join the workforce. Such former welfare recipients may be the first let go in an economic downturn because of their lack of seniority; the inability to count the last two quarters they work can be critical for their eligibility. Furthermore, because many are single mothers, they may have difficulty meeting the full-time work requirements discussed above. The unemployment rate for women who maintain families has risen from 5.4 percent in October 2000 to 6.9 percent in October 2001.[25]

Temporarily expanding unemployment insurance benefits to these types of unemployed workers would likely have a very high bang for the buck: Since the benefits are relatively well-targeted toward those with low incomes and without substantial assets, the additional benefits would be spent quickly. Yet the Administration's proposal and the House bill do nothing to extend unemployment insurance along these dimensions. The Senate Finance legislation would provide Federally funded benefits for workers who would qualify for benefits if their most recent quarters of work were included in their wage record, and workers seeking part-time work. The cost of this temporary change is relatively modest, but may be among the highest bang-for-the-buck components of any stimulus package.

3. Raising benefit levels

Unemployment insurance benefits are relatively low: In many cases, they fall significantly below poverty levels. The *average* unemployment benefit is just over $200 per week – which is below the poverty threshold for families with two or more people. UI benefits, furthermore, vary substantially from state to state. In Mississippi, for example, the average state benefit is roughly $150 a week – relative to roughly $300 in Massachusetts. Since benefits are only received by those who have experienced a reduction in income from the loss of their jobs and whose consumption expectations may therefore exceed their current income, an increase in

[24] 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.
[25] Bureau of Labor Statistics, "Employment Situation," October 2001, Table A-5.

benefit levels (especially in relatively low-benefit states) would spur spending and stimulate the economy.

As with the extension of benefits beyond 26 weeks, policy-makers should be careful in raising UI benefits during sound economic times. Economic research suggests that more generous benefits may reduce the effort that the unemployed devote to finding a job and therefore cause workers to remain unemployed longer.[26] But as with the duration of benefits, this concern appears to be somewhat less relevant in the context of an economic downturn: Given a weakening labor market, the search effort of unemployed workers will likely be a relatively less important determinant of whether they find a job than in strong economic times. Any incentive issues associated with increased UI benefits – especially if the increases are temporary – may therefore be less problematic during an economic downturn than at other times.

Raising UI benefits on a temporary basis would have a relatively high bang for the buck. The Senate Finance legislation would raise unemployment insurance benefits by 15 percent of the worker's benefit, or $25 per week, whichever is greater. But the Administration's proposal and the House legislation include no explicit provisions for increased UI benefits.

4. Summary

Expanding unemployment insurance benefits would provide economic stimulus when it is needed without damaging the long-term budget outlook. The UI program is able to target the pockets of the economy that need the most stimulus, effectively limit the decline in consumption for those who become unemployed, prevent the loss of more jobs, and dampen the severity of the recession. Temporary expansions in unemployment insurance to cover part-time workers, extend benefits beyond 26 weeks, and raise benefit levels would have a high "bang for the buck" in stimulating the economy over the next few quarters.

<u>Other low-income programs</u>

A variety of other programs for low-income families could also be temporarily expanded as part of an effective stimulus package.[27] For example, temporary increases in funding could be provided in the Low-Income Home Energy Assistance Program (LIHEAP) for low-income families, which generally "spends out" quickly. In addition, under the 1996 welfare law, Federal TANF funding 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. Temporary expansions in other low-income programs would also represent an effective response to the economic slowdown.

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[26] See Anthony B. Atkinson, John Micklewright, "Unemployment Compensation and Labor Market Transitions: A Critical Review," *Journal of Economic Literature*, Vol. 29, December 1991, pages 1679-1727.
[27] See discussion in Robert Greenstein, "Observations on a Stimulus Package," Center on Budget and Policy Priorities, October 4, 2001.

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.[28] 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.[29] 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 package unless the vast majority of the additional spending would occur over the next 12 months.

Revenue sharing

States are suffering substantial fiscal stress as a result of the economic slowdown. Mississippi, Ohio and South Carolina enacted broad-based spending cuts – and eight states raised taxes – in enacting their fiscal year 2002 budgets. A number of states are slated to consider additional budget cuts in special legislative sessions that have been called for that purpose. In addition, several governors – including those in Colorado, Georgia, Iowa, Maryland, North Carolina, and Vermont – have used their executive authority to reduce spending. Many more 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.[30] 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 House-passed stimulus 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

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

[29] 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.

[30] Iris Lav, "State Fiscal Problems Could Weaken Federal Stimulus Efforts," Center on Budget and Policy Priorities, October 4, 2001.

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.[31]

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 1980s. Such an approach may take time to design and implement, however.[32] 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.[33] 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.[34]

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.

Tax cuts as economic stimulus

Most of the tax cuts that have been proposed to stimulate the economy are unfortunately flawed from that perspective. A sound set of principles for tax stimulus proposals would:

- 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.

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[31] 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.

[32] 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.

[33] 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.

[34] 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.

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

- Maintain long-term fiscal discipline.

Let me highlight just four of the components of the House-passed stimulus legislation that violate these principles. These four components – repeal of the corporate alternative minimum tax, permanent extension of the subpart F rules, reduction in the maximum capital gains tax rate, and acceleration of the 25 percent individual income tax rate – cost more than $100 billion over the next 10 years, or over two-thirds of the 10-year cost of the entire package. Yet each is fundamentally flawed as a stimulus measure.

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.[35] 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. Even supporters of corporate AMT repeal have shown that it would generate virtually no stimulus in the first two years of its existence.[36]

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 – especially when previous AMT credits are fully refunded, as under the House legislation. According to the Joint Committee on Taxation, the AMT repeal would also cost $24 billion over the next decade.[37]

Subpart F

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[35] 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.

[36] See, for example, American Council on Capital Formation, "The Case for AMT Repeal," 1996. The paper estimates that aggregate investment would rise by just $2 billion (in 2001 dollars) in the first year of complete repeal and by less than $5 billion in the second year.

[37] 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.

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. A temporary provision alters these rules for financial services firms. The House proposal would make this temporary provision permanent, and thus permanently exempt income earned in banking, finance, or insurance from the Subpart F rules. The change clearly provides a tax benefit to firms in these industries, but could also provide a disincentive to repatriation of foreign income. In any case, 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 House legislation would reduce the maximum tax rate on long-term capital gains from 20 percent to 18 percent.[38] Whatever its merits in other contexts, a capital gains tax cut has several crucial drawbacks as a stimulus tool.[39] In particular, a permanent capital gains tax cut is poorly designed to address the short-term economic problems at hand:[40]

- 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.[41]

[38] 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. 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, an 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.

[39] 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.

[40] For further discussion of the effects of a capital gains tax cut, see Leonard Burman, *The Labyrinth 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.

[41] It is also worth noting that a capital gains tax reduction 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.

- 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.[42] 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.[43]

- 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.[44]

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..."[45]

<u>Acceleration of the tax reductions for higher-income households</u>

Another component of the House proposals would accelerate to January 1, 2002, the income tax rate reductions in the previous 28 percent marginal tax bracket currently scheduled to take effect in 2004 and 2006.

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.

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[42] 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.

[43] 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.)

[44] 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.

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

- First, the proposal does not maximize the effect on demand in 2002. The ten-year cost amounts to $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 – it would affect only those who are in the top 25 percent of the income distribution.[46] 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.[47] 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.

<u>Two more promising tax cuts</u>

Two components of the House tax package represent sound short-term stimulus, although one should be significantly modified to be cost-effective.

First, the legislation would provide another round of temporary household rebates, targeted on lower- and middle-income households, a proposal also endorsed by the Bush Administration and the Senate Finance Committee. In particular, roughly 34 million tax filers received no rebate under the first round of rebates sent out this summer, and another 17 million

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[46] 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.

[47] 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.

received only a partial rebate.[48] The new round would focus its rebates 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 a sound stimulus measure.

Second, the legislation would allow firms to immediately expense 30 percent of new investments over the next three years. The basic idea behind the investment incentive is sound, but the details of the House proposal are problematic. In particular, the incentive should be limited to investments made over the next year or so, not the next three years. As noted above, the current slowdown is expected to be over well before 2004, and therefore the investment incentive should not persist that long. By extending the period during which the incentive applies, the House legislation weakens its impact during 2002, when stimulus is most needed.

For example, consider a firm deciding whether to make an investment in 2002 or 2003. If the tax incentive applies only in 2002, the firm may be tempted to accelerate the investment into that year. But if the incentive applies to both 2002 and 2003, it would have no additional incentive to move the investment into 2002. Since the economy is expected to have recovered by 2003 or 2004, the principal aim of the incentive should be to encourage additional investment in 2002, not later. Extending the incentive beyond 2002 not only increases its budgetary cost; it also attenuates its benefits during the critical months and quarters ahead. In addition, allowing the incentive to exist for three years -- especially since it would remain in effect long after the economy is currently expected to recover -- potentially undermines the credibility of sunsetting the provision at all.

One problem with temporary investment incentives is that they can create a decline in investment after they expire. To address this problem and to bolster the credibility of the sunset itself, Congress could adopt a proposal put forward by Bill Gale of Brookings. Dr. Gale would allow firms making qualifying investments to write off 50 percent of expenses immediately if the investment were made before the end of calendar year 2001, 40 percent if made in the first quarter of 2002, 30 percent if made in the second quarter, 20 percent if made in the third quarter, and 10 percent if made in the fourth quarter of 2002.[49]

Summary and conclusions

Temporary expansions in unemployment insurance benefits would provide economic stimulus when it is needed without damaging the long-term budget outlook. The unemployment insurance program is able to target the pockets of the economy that need the most stimulus, effectively limit the decline in consumption for those who become unemployed, and dampen the severity of the recession. Temporary expansions in unemployment insurance to cover part-time workers, extend benefits beyond 26 weeks, and raise benefit levels would provide cost-effective stimulus to the economy over the next few quarters. In addition to these expansions in

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[48] Gregg Esenwein and Steve Maguire, "The Rate Reduction Tax Credit (The "Tax Rebate") in P.L. 107-16," Congressional Research Service, July 15, 2001.
[49] See William Gale, "Perspectives on the Tax Stimulus Debate," Committee on the Budget, U.S. Senate, October 25, 2001.

unemployment insurance benefits, an effective stimulus package would provide assistance to state governments, make modest expansions in other low-income programs, and combine the household rebate aimed at lower- and moderate-income workers with a better-designed *temporary* incentive for business investment.