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The Administration's Stimulus Proposal: Is it a Sound And Balanced Package?

By Robert Greenstein

On October 4, Bush Administration officials briefed several reporters on the stimulus plan the Administration favors. The officials presented the plan as being half tax cuts and half spending provisions and as including significant help for unemployed workers. The Administration also released on October 4 a more detailed proposal on the assistance it would provide to the unemployed.

1. Ultimately, 90 percent or more of the stimulus plan consists of tax cuts. The presentation of the plan as being evenly split between spending and tax cuts rests on budgetary sleight-of-hand. As explained below, more than 90 percent of the plan appears to consist of tax cuts, many of them permanent.

2. While being generous to large corporations, the assistance the plan would provide to the unemployed is surprisingly meager. For example, no unemployed workers who exhausted their 26 weeks of unemployment benefits and were unable to find jobs could receive additional weeks of federal unemployment benefits *until mid-March*, and then only in a modest number of states. Moreover, workers who lost their jobs before September 11 would be ineligible regardless of the level of unemployment in their state. Under the Administration's proposal, if the recession is as deep as the recession in the early 1990s, the amount of additional unemployment benefits provided would be only a modest fraction of the amount provided in that earlier recession. The Administration's other proposals for the unemployment are modest.

3. While all aid to the unemployed — as well as the tax cut the Administration is contemplating for low-and moderate-income workers — would be temporary, as they should be, the corporate tax cuts would be permanent. That would worsen the nation's deteriorating medium- and long-term budget outlook and consequently could exert upward pressure on long-term interest rates, which are sensitive to long-term fiscal problems. Increased long-term rates would have a dampening effect on economic activity and undercut some of the stimulative effect a stimulus package might otherwise have.

4. The plan would accelerate income-tax reductions for higher-income Americans, which makes little sense as a stimulus measure. A proposal that Treasury Secretary O'Neill has mentioned — to accelerate the reduction in the 28 percent rate to 25 percent — would benefit only the top quarter of households and be of greatest benefit to the top five percent. These households tend to save rather than spend much of any new income they receive, so this change is unlikely to have a substantial stimulative impact. This proposal seems designed to lock in rate reductions so policymakers will not have the option of deferring or cancelling them when the recession ends and the budget problems of financing the war on terrorism and other costs of government return. The Committee for Economic Development, an organization of leading corporate executives and university presidents, is issuing a report warning of long-term fiscal difficulties and pointing to the gradual phase-in of provisions of the tax cut as providing a possible budgetary safety valve, since tax cuts could be deferred or removed before taking effect. The Administration's plan would weaken this safety valve.

5. Most economists concur that one of the plan's principal corporate tax cuts — partial expensing — would be more stimulative if it were temporary rather than permanent. If temporary, it would encourage firms to accelerate certain purchases to take advantage of the tax break. If made permanent, this inducement is lost. Here, the Administration seems to be choosing to weaken the stimulative effect of the plan to confer a sizeable permanent tax cut on profitable corporations.

The Misleading Claim About the 50-50 Split

The Administration's plan calls for a $75 billion stimulus package, with $60 billion for tax cuts and $15 billion for programs for the unemployed. It turns out, however, that the $60 billion figure is *not* the true cost of the tax cut, which is likely to be more than twice that. The $60 billion is the cost of the tax cuts only in their first year or two (it is not clear which). All costs of the tax cuts after the initial year or two are ignored in the Administration's accounting. Over the long term, the proposal is more than 90 percent tax cuts and less than 10 percent aid to the unemployed.

How does the Administration arrive at the claim that the plan is a 50-50 split? Two mechanisms are used.

- First, the Administration counts as stimulus the $45 billion in expenditures estimated for 2002 from legislation for defense, security, and counter-terrorism measures, New York and the Pentagon, and the airline bailout. It adds this to the $75 billion for the new package, bringing the total to $120 billion — and then says the $60 billion it is proposing for tax cuts constitutes 50 percent of the total.

  Under this accounting, defense spending increases the Administration proposed last June when there was little sign of recession are counted as part of the stimulus package. Under this accounting device, each new dollar Congress provides the Administration for ongoing defense spending increases is used to justify a dollar for tax cuts.

- As noted, the Administration counts the cost of only the first year or two of its permanent corporate tax cuts, ignoring all costs after that. Thus, eight or nine years of the 10-year cost of these provisions is ignored.

Brookings Experts Warn Against Permanent Business Tax Cuts

On October 5, the Brookings Institution issued an analysis, "Stimulating the Economy Through Tax Policy: Principles and Applications," by William Gale, Peter Orszag, and Gene Sperling. The analysis states:

> "It is important that any investment incentives be temporary for four reasons. First, making the incentive temporary would encourage firms to shift investments into 2002 — and therefore maximize the stimulus effect in 2002. Second, a temporary incentive involves significantly lower budgetary cost — and therefore less harmful pressure on interest rates — than a permanent incentive. Third, the costs and benefits of permanent tax incentives for investment are complicated, and debate over whether such permanent incentives would be advisable would divert policy-makers from the immediate task at hand. Finally, allowing permanent investment incentives would open the door to other permanent components of the stimulus package, which would undermine its effectiveness."

How the Unemployed Would Fare

The proposal includes additional weeks of unemployment benefits and some funding for health care or job training for the unemployed. In this part of the plan, the devil is in the details, which the Administration released on October 4. The details show there is much less here than the rhetoric surrounding these proposals might suggest.

Unemployment Insurance

- Only workers laid off after September 11 would qualify for additional weeks of benefits. Workers laid off in August, when the unemployment rate jumped to 4.9 percent, would be shut out, even if the unemployment rate is six percent or higher at the time when their benefits run out this winter and they cannot find another job.

- Additional weeks of federal benefits would be provided only in states where the unemployment rate rises 30 percent above its June/July/August average. In a state such as California, where the unemployment rate averaged 5.1 percent in that three-month period, unemployment would have to hit 6.6 percent before any additional weeks of benefits would be paid to workers who exhaust their 26 weeks of benefits and cannot find employment.

- Under the Administration's proposal, if the recession is as deep as the recession of the mid-1990s, extra weeks of benefits will be provided in only about one-third of the states. (Assuming a recession as large as the downturn of the early 1990s, the Labor Department estimates the additional benefits would be provided in 10 to 20 states.) By contrast, in the recession of the early 1990s, these benefits were provided in all states.

- Even in states where the extra weeks of benefits are provided, they would not begin to be paid until March 11, and then only to workers laid off after September 11.

- In addition, if the recession is of comparable depth to the recession of the early 1990s, most of the 10 to 20 states that would qualify to provide extra weeks of benefits would not do so until late in calendar year 2002, weakening the effectiveness of the proposal as a stimulus measure.

- The Labor Department estimates that if the recession is similar to the recession of the early 1990s, the extra weeks of jobless benefits provided by the President's proposal will cost $5 billion. In the earlier recession, $28 billion of additional weeks of benefits — or $35 billion in 2002 dollars — were provided through the temporary mechanism that Congress created at that time.

- The Administration's proposal also fails to address flaws in unemployment insurance coverage that cause many low-income workers and working mothers to be ineligible for unemployment benefits when they lose their jobs. For example, in most states, a mother with young children who works 70 percent or 80 percent time and is laid off — and who meets all other qualifications for unemployment benefits and is seeking similar employment — is denied because she is available for work on less than a full-time basis. A bipartisan commission in the 1990s and a business-labor-state task force last year recommended that these problems be fixed.

Level of Unemployment That Would Be Needed in Various States To Trigger Extra Weeks of Benefits[1]

Alaska	8.1%	Nevada	6.1%
Arkansas	6.1%	New Mexico	7.3%
California	6.6%	North Carolina	6.6%
District of Columbia	8.3%	Oregon	7.8%
Idaho	6.2%	Pennsylvania	6.1%
Illinois	6.9%	Rhode Island	6.5%
Kentucky	6.5%	South Carolina	6.5%
Louisiana	6.5%	Texas	6.2%
Michigan	6.2%	Washington	7.7%
Mississippi	6.0%	West Virginia	6.6%

[1]These are states in which an unemployment rate of at least 6.0% would be required.

Other Proposals for the Unemployed

The Administration's plan includes $3 billion in grants to state and local workforce boards through a National Emergency Grant program. The workforce boards could use the funds for health insurance coverage, income supplements, and/or job training for unemployed workers. This proposal has several large flaws. First, the workforce boards are generally advisory or planning groups with little administrative experience. There are serious questions about whether many of them have the administrative capacity to gear up to administer a complex program quickly. It could take a substantial period of time — many months — in a large number of areas before these boards gear up, decide how to use the funds, and actually get the programs that administer these funds up and running. Second, the amount involved is far too small to make much of a dent in the need for health insurance among workers (and their families) who lose employer-based coverage when they lose their jobs (unless states are willing to take risks with the future health care needs of low-income children).

The Administration says these funds could be used to cover up to 75 percent of the cost of health insurance premiums (through COBRA) for laid-off workers. The amount of funding that would be made available, however, would be sufficient only to cover such costs for a small fraction of laid-off workers. A proposal developed by Senators Baucus and Kennedy that would subsidize a smaller portion of the COBRA premium costs (50 percent) but would be available to all laid-off workers who qualify for COBRA — and would be supplemented by granting states a temporary option to cover low-income unemployed workers who cannot afford 50 percent of the COBRA premium or are ineligible for COBRA (because they worked for a small business or for a firm that did not offer insurance) — would cost $16 billion. If every dollar in the Administration's proposal were used for health insurance coverage, which is highly unlikely, and the workforce boards were sufficiently well organized to use all of the funds made available to them, the mechanism the Administration is proposing would provide less than one-fifth of the health insurance coverage that the Baucus-Kennedy proposal would provide.

The Administration's plan also purports to make up to $11 billion in "unused" funds in the State Children's Health Insurance Program available to cover unemployed workers. This proposal is more public relations than substance. It is not a new proposal but a restatement of current policy that allows a state to seek a waiver to use some of its SCHIP funds to serve groups other than children. This proposal is likely to be of little value in covering the unemployed.

The notion that there are large amounts of unused SCHIP funds that can be shifted to coverage of unemployed workers is incorrect and is belied by data the Office of Management and Budget released earlier this year. States do have unspent SCHIP funds from the early years of SCHIP when states were just gearing up their programs. But these funds are virtually all slated to be used in the next few years. The 1997 law that established SCHIP sought to balance the budget by 2002. To meet that goal under the budget forecasts in use at that time, policymakers wrote into the law a *26 percent cut* in SCHIP funding starting in fiscal year 2002. Data and projections that OMB released this spring show that the effects of this cut will be delayed a few years because states will draw down the unspent SCHIP funds in the interim, but that eventually states will cut their programs and insure fewer low-income children. Specifically, OMB projected that the number of children insured through SCHIP will be reduced by 400,000, starting in 2005.

Even this figure may prove to be optimistic — the cutbacks could start earlier than 2005 if the recession makes more children eligible for SCHIP and causes more children to enroll now (and thus causes SCHIP funds to be used more rapidly than earlier anticipated). If states were to shift billions in SCHIP funds to cover unemployed workers, they would have to start reducing the number of children they insure at an earlier time. For this and other reasons, few states are likely to use this mechanism. (The problems with this proposal are described in more detail in an appendix to this analysis.)

The Tax Proposals

As outlined by Administration officials, the plan includes five tax cuts: 1) a rebate for those who received less than $300 per filer in the first rebate (including those who pay payroll tax but not income tax); 2) acceleration of one or more of the tax rate reductions enacted this spring; 3) permanent partial expensing of business equipment; 4) permanent repeal of the corporate alternative maximum tax; and 5) a permanent change in "carryback" rules that would let corporations carry back losses for five years rather than two. The one tax cut for low- and moderate-income workers would be temporary, as it should be, while the corporate tax cuts would all be permanent. Since the rebate would amount to $16 billion to $20 billion of the initial $60 billion in cost, it would constitute one-third of the initial tax cut but less than one-sixth of the tax cut on a long-term basis when the permanent costs of the corporate tax cuts are taken into account.

The proposed acceleration of tax rate reductions merits particular note. The Administration is reportedly considering accelerating the reduction in what was the 28 percent bracket to 25 percent. That is likely to be presented as a middle-class tax cut. That would be misleading.

Reducing this rate benefits all taxpayers in the higher brackets, along with taxpayers in the 28 percent bracket. In fact, the taxpayers who would benefit most from this proposal are those in brackets *higher than* the 28 percent bracket; it is only these individuals who would be able to apply the lower rate against the full amount of income the 28 percent bracket covers. The 28 percent bracket in 2002 for married taxpayers begins with taxable income of $46,700 (which corresponds to a minimum of $60,550 in adjusted gross income if the taxpayer has no children and higher levels if the taxpayer has children) and ends with taxable income of $112,850. Thus, a married taxpayer with taxable income of $56,700 has $10,000 of income in the 28 percent bracket and would receive a tax cut of $200 as a result of dropping the rate from the 27 percent rate that otherwise would be in effect next year to 25 percent. By contrast, a taxpayer with taxable income exceeding $112,850 — the top of the bracket — would receive a tax cut of more than $1,300, since the two percent rate reduction from 27 percent to 25 percent would be applied to more than $66,000 in income (the full width of the bracket).

- Fewer than one in every four tax filers is in the 28 percent bracket or a higher bracket. Only they would benefit from the proposed rate acceleration.

- Fewer than *five* percent of tax filers are in a bracket higher than the 28 percent bracket. Only they would benefit fully from the proposal.

The skewing of the proposal to more affluent individuals is of particular note. Economic research shows that the higher a household's income level, the lower its propensity to spend a dollar of income and the higher its propensity to save the dollar. Thus, this proposal is not likely to be very effective as a stimulus mechanism.

It also is likely to be inefficient. If the reductions in the 28 percent bracket scheduled for 2004 and 2006 are accelerated to 2002, some 75 percent to 80 percent of the cost of this provision will occur *after* 2002, when the economy is likely to have recovered but budgetary pressures will be intense.

The permanent corporate tax cut proposals also pose problems. One of the principal such proposals is to allow partial expensing on a permanent basis. As a number of leading economists and tax experts have noted, expensing would be most effective as a stimulus measure if it were temporary. (Expensing allows corporations to write off the costs of equipment and other capital items immediately rather than depreciating the equipment over its useful life). If it were temporary, that could induce some firms to speed up purchases, purchasing more now rather than later to take advantage of the temporary tax break. Making this a permanent change removes that inducement. It weakens the measure's stimulative impact in order to confer upon corporations a permanent tax break.

Permanent repeal of the corporate AMT also is problematic. This provision was enacted to address a widespread problem of large, highly profitable corporations using so many tax loopholes that they paid little or no corporate income tax. Repeal of this provision would encourage corporate lobbyists to seek enactment of more such loopholes in the years ahead; in the absence of the AMT, such loopholes would become more lucrative and attractive.

Fiscal Discipline

One of the problems with the proposal is the damage it could do to fiscal discipline. On October 4, in an unusual and welcome move, the four chairs and ranking minority members of the House and Senate Budget Committees issued a strong statement warning that the *total* budget surplus was rapidly shrinking and urging that a stimulus package be limited to temporary measures. They showed that under some assumptions, the *total* budget surplus is already gone.

Furthermore, both Federal Reserve chairman Alan Greenspan and Treasury Secretary Robert Rubin have noted that the Fed's efforts to lower interest rates have caused short-term rates to come down sharply but that long-term rates have not followed. Both men have said this reflects market nervousness over the government's long-term fiscal situation. Nothing should be done in a stimulus package to cloud further the medium and long-term fiscal outlooks.

The Administration's proposal fails this test in two ways. Its permanent tax cuts would make the long-term budget picture more problematic. In addition, its acceleration of tax rate reductions would place further pressure on the budget in years just after the economy recovers and narrow an option policymakers may want to consider in those years if strong action to restore fiscal discipline proves necessary.