Perspectives on the Tax Stimulus Debate

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Mr. Chairman and Members of the Committee:

Thank you for the opportunity to present my views on the tax stimulus issues currently facing the Congress. Congress faces several key issues: whether to provide a stimulus; the size of any stimulus package; the composition between spending and tax cuts; and the design of the spending and tax cuts. This testimony focuses mainly on the most effective design and the potential impact of tax cuts.

The Economic and Budget Outlook

If a stimulus package is desired and if tax elements are a part of the package, the tax elements should be designed with the current economic and budget outlook in mind. The short-term economic outlook is uncertain, as the terrorist attack on September 11, 2001 having disrupted the workings of an already slowing economy. Despite the short-term uncertainty, there is widespread agreement that long-term economic prospects remain strong.

In contrast, the long-term budget outlook has deteriorated rapidly. Based on data from a recent bi-partisan statement from the Senate and House Budget Committees, the 10-year baseline budget surplus outside of social security appears to have shrunk by about $3 trillion (or 98 percent) since May, and currently stands at just $50-$100 billion, not counting any stimulus package or any other new proposals that Congress may wish to consider over the next decade.[1] Reasonable allowances for new spending that is widely supported (including defense, education, and prescription drugs) the extension of expiring tax provisions, and providing a fix for the AMT puts the non-social security budget in deficit to the tune of about $1.5 trillion over the next decade.

Principles for Design of an Economic Stimulus

Because the economic outlook suggests the possible need for a short-term boost, while the budget outlook suggests that the long-run revenue impact of any stimulus should be limited, the key guiding principle for a stimulus package, should be to maximize the "bang for the buck." That is, the goal should be to get the most short-term boost at the least long-term cost. To achieve these goals, policy makers should focus on provisions that:

- Encourage new household spending.
- Encourage new business investment.
- Minimizes long-term costs
- Are temporary—that is, expire within about one year.

[1] For further analysis, see Appendix A, "The Changing Budget Outlook: Causes and Implications."

These principles are quite similar to those endorsed in a remarkable bi-partisan statement by the Democratic and Republican leaders of the Senate and House Budget Committees earlier this month.[2] The principles represent sound policy in a number of key dimensions.

New household spending and new business investment provide direct stimulus to the economy. In contrast, raising household saving would reduce current aggregate demand. Likewise, subsidizing investments made in the past (and currently showing up as corporate income) does not provide any stimulus. To state what may be obvious, making tax cuts retroactive to before September 11, 2001, not only has no benefit whatsoever in stimulating the economy, it is plainly wasteful.

Minimizing the long-term costs serves both short-term and long-term purposes. In the short-term, lower budget costs translate into smaller boosts in interest rates. Increases in interest rates would serve to reduce business investment, housing purchases, and other interest-sensitive consumption and thus would choke off part or all of the direct effect of any stimulus package. Minimizing the revenue costs is also important for the long-term*, even if government budgets have no effect on interest rates*. It is clear that the underlying fiscal situation has changed dramatically over the past six months. Whatever one thought of the affordability of the tax cut last spring, it is evident that the nation now has to devote substantial resources to fighting terrorism over the next decade. The deteriorating budget outlook means that, after resolving the stimulus debate, policy makers will need to rethink the long-term fiscal picture and thus should not do anything now that will make the long-term situation significantly worse.

Keeping all items temporary is critical for several reasons. First, it raises the bang-for-the-buck. Temporary business incentives typically have larger short-run impacts that permanent incentives, and cost much less. Temporary household tax cuts may have somewhat smaller short-term impacts than permanent cuts given to the same people. Even so, the bang-for-the-buck for temporary household cuts is likely to be much larger than for permanent cuts, since temporary cuts cost much less. Second, focusing on temporary items is equitable (why should some groups receive permanent tax cuts as part of stimulus package, while others receive only temporary tax cuts?). Third, focusing on temporary cuts reduces the likelihood of enacting permanent changes that are not related to economic stimulus and that may not be good tax policy in any case.[3]

It is also worth emphasizing that stimulus can be provided via new government spending on purchases of goods and services or via increased government transfer payments, such as unemployment insurance.

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

[3] These issues are discussed in depth in Appendix B, "Why the Stimulus Package Should Contain Only Temporary Items" and Appendix C, "Stimulating the economy through tax policy: principles and applications."

Applications to proposals for household tax cuts[4]

A rebate to low- and middle-income households would be the most effective way to provide a tax stimulus. These households are more likely to spend any new income than high-income households are. The rebate checks this summer do not appear to have generated much in the way of new spending, perhaps because they were not targeted to low-income households.

Accelerating the previously enacted tax cuts is a poor way to provide stimulus. Most of the costs occur in years beyond 2002, when most commentators believe the economy will already have recovered. Almost all of the benefits go to higher-income households, who are less likely to spend the funds. The proposed accelerations would be expensive relative to the stimulus "budgets" proposed by President Bush, Fed Chairman Greenspan, and former Treasury Secretary Rubin. Finally, enacting the previously enacted tax cuts will have the effect of locking in a tax cut whose wisdom will need to be re-examined in the near future, in light of the substantial deterioration in the budget.

Capital gains tax cuts are at best an inefficient way to stimulate the economy in the short-turn, and could well be counterproductive. Capital gains tax cuts are usually advocated on the grounds that they will stimulate saving and long-term growth, not a short-term consumer spending boost.

Applications to proposals for business tax cuts

Temporary incentives for new business investment (e.g, accelerated depreciation or an investment tax credit) are the business tax cuts most consistent with the principles listed above. These tax cuts target new economic activity and, given their temporary nature, they would have a bigger short-term impact and a smaller long-term cost than permanent incentives.

Corporate tax cuts are, in general, a poor way to stimulate the economy. Almost all of the funds would go to providing windfalls to current corporate income, which is the return to old investment, rather than giving incentives to new investment.

Repeal of the corporate alternative minimum tax is mainly a subsidy to old investments, and even advocates of repeal have shown that it would generate virtually no stimulus in the first two years of its existence.[5] Even if the AMT is repealed, there is no reason why such a repeal should be retroactive, as discussed above.

Temporary expansion of the carryback provision for net operating losses is also mainly a subsidy to old investments. It is different from corporate tax rate cuts or AMT repeal, however, in that expanding the lookback provisions is better targeted to helping firms that are currently losing money.

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[4] For further analysis of both individual and business tax policies, see Appendix C, "Stimulating the economy through tax policy: principles and applications."

[5] See "The Case for AMT Repeal,," American Council on Capital Formation, 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.

Issues in the design of a temporary investment incentive

Although temporary investment incentives are much more appropriate than permanent incentives for stimulus purposes, temporary tax cuts raise a number of issues worth considering in detail and applying to the current situation.

First, the historical record suggests that it is difficult to time fiscal interventions accurately and that past interventions have destabilized rather than stabilized investment flows over the business cycle. In addition, *discussion* of temporary incentives by policy makers may create a decline in investment before the incentives come into existence, as firms wait to see when the incentives will take effect. For both of these reasons, Congress should announce immediately that any investment incentives that are eventually included in a stimulus package would be apply to investments made as of today (or as of September 11, 2001).

Second, temporary incentives may also create a decline in investment after they expire. This may create demand for extending the expiring provision, which adds uncertainty to the tax system. But if it is known (or suspected) that Congress will extend the incentive when it expires, then the temporary incentive loses some of its appeal. A third problem is if temporary incentives are placed to stay in operation for too long, they will provide little incentive to invest *now*, when the investment is most needed. For example, the 3-year period for partial expensing passed by the House Ways and Means Committee is much too long. It provides little reason for firms to invest more now, and gives them plenty of reason to hold off for a year or two to gauge the economic landscape before investing. Casual evidence suggests that businesses are putting off projects they already had in the works, and the immediate goal should be to encourage businesses to undertake those projects in the immediate future, not 2-3 years from now.

To address the second and third problems, Congress should (a) shorten the time period for partial expensing to 15 months and (b) adopt a sliding scale for the amount of the investment that can be partially expensed. Suppose, for example, that Congress stipulated that firms making qualifying investments could write off 50 percent of expenses immediately, if the investment is 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. This would focus firms on making new investments now, rather than delaying. And by phasing down the expensing portion slowly over time, Congress would make much more credible its intention to keep the incentive temporary.

Other issues regarding a stimulus package

At least three additional issues bear on choosing the magnitude and nature of any tax stimulus program. The first, of course, is the likely depth and duration of the current economic decline. As a specialist in public finance issues, I will leave macroeconomic forecasts to the experts in that field.

Second, whatever the magnitude of the short-term problem, it is worth noting that a significant amount of economic stimulus has already been provided, including $40 billion in rebates during the summer, $40 billion in spending for defense, rescue and recovery, and the

airline bailout. In addition, the federal reserve has cut interest rates 9 times and by several hundred basis points since the beginning of the year. More stimulus is on the way, even if Congress does nothing. The tax cut passed last spring provides for about $70 billion in individual tax cuts during fiscal 2002.

Third, it would be appropriate to be realistic about the likely economic impact of the tax stimulus proposals being discussed. A rebate to households of, say, $20 billion, would only amount to 0.2 percent of GDP in stimulus even if the entire amount were spent, which seems unlikely. The proposed 30 percent partial expensing of new investments would reduce the user cost of capital by about 4.5 percent. Applying investment elasticities of between –1/3 and –2/3 suggests that investment in equipment and software would rise between 0.15 percent and 0.30 percent of GDP. The effect may be even more limited during times like the present—when firms already have significant cash-on-hand and significant excess capacity.

Appendix A: The Changing Budget Outlook: Causes and Implications

William Gale, Peter Orszag, and Gene Sperling[1]
October 11, 2001

After more than twenty-five years of deficits, the federal budget began to show cash-flow surpluses in the late 1990s. By May 2001, the official baseline projections even suggested that the publicly held debt would be eliminated over the coming decade. To be sure, the longer-term deficits in Social Security and Medicare were clouds on the fiscal horizon, and the methodology used to construct the official projections continued to exaggerate the likely surpluses. Nevertheless, as of spring 2001, the short- and medium-term budget outlook was relatively auspicious.

A scant five months later, the situation has deteriorated dramatically. The rapid and substantial deterioration in the budget outlook has important implications for both short- and long-term policy debates. This paper examines these changes, their causes, and some implications. Our main findings are as follows:

The budget outlook

- The projected unified surplus for fiscal year 2001 fell from $275 billion in May to $121 billion in October.[2]

- In May, the projected unified surplus for fiscal years 2002 to 2011 was $5.6 trillion, including $3.1 trillion outside of the Social Security Trust Fund. By October, those figures had fallen to $2.6 trillion, and about $50 billion, respectively. In other words, *virtually the entire projected non-Social Security surplus for the coming decade had disappeared by the time the decade was a week old*.

- A realistic budget assessment is even more pessimistic than these official figures suggest. The official figures omit the effects of any new stimulus package Congress may enact after the beginning of October, other items for which Congress has expressed strong support, a series of adjustments that generate more realistic baseline projections, and the long-term deficits in Social Security and Medicare.

Causes

- The tax legislation enacted earlier this year accounts for the majority (55 percent) of the deterioration in the 10-year official outlook over the last six months. The response to the terrorist attacks and the slowing economy have also played significant roles.

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[2] See Congressional Budget Office, *Analysis of the President's Budgetary Proposals for Fiscal Year 2002*, May, 2001, table 3, and Congressional Budget Office, *Monthly Budget Review*, Fiscal Year 2001, September 26, 2001.

Implications

- The long-run revenue impact of stimulus policies should be limited. This would reduce any adverse impact on interest rates.[3] But *even in the absence of an interest rate effect*, stimulus policies with significant long-term revenue costs could do substantial damage to long-term budget discipline, especially since the non-Social Security surplus is already virtually zero over the next 10 years.

- The ability to use the previously accrued surplus to finance emergency war efforts underscores the wisdom of having accumulated surpluses in the first place as a cushion against unexpected events.

- Under the current crisis circumstances, the bi-partisan Congressional agreement not to use Social Security and Medicare trust fund surpluses to finance current spending or tax cuts has sensibly been set aside to pay for the war. But the longer-term budgetary challenges facing the nation have only been deepened by the terrorist attacks. To meet these longer-term costs, budget discipline is essential.

- The underlying fiscal situation has changed dramatically. Policy-makers need to rethink the basic framework of tax and spending policy, including the advisability of allowing the previously enacted tax cut to be phased in as scheduled or at all.

I. Evolution of the budget baseline

In estimates published by the Congressional Budget Office in May, the projected unified budget surplus was $5.6 trillion for the next 10 years (Table 1). That figure fell to $3.4 trillion in the CBO estimates released in August, and then to $2.6 trillion in a bi-partisan estimate released on October 4 by the House and Senate Budget Committees (hereafter referred to as the "October baseline").

Because the Social Security Trust Fund has been relatively unaffected by these changes, the changes in the rest of the budget have been proportionally much larger. The 10-year non-Social Security surplus has virtually disappeared, falling from $3.1 trillion in May to $846 billion in August and to $53 billion by October.[4] Under the October baseline projection, the non-Social Security budget is expected to run a deficit of $370 billion over the next five years, with deficits of about $125 billion projected for 2002 and for 2003.

[3] 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.

[4] The "non-Social Security" balance is slightly different from the "on-budget" balance because the latter excludes the Postal Service in addition to Social Security. The August projection for the on-budget surplus between 2002 and 2011, for example, was $847 billion – slightly larger than the projection for the non-Social Security surplus. Our estimate of the non-Social Security surplus in the October baseline is predicated on the assumption that the projected Social Security surplus did not change from the August to the October baseline.

What accounts for these changes? The vast majority of the decline from May to August is due to the tax cut enacted last spring. The tax cut was estimated to reduce revenues between 2002 and 2011 by $1.275 trillion, and create interest costs of $383 billion.[5] The total cost of the tax cut—$1.658 trillion—accounts for almost three-quarters of the deterioration in the projected surplus through August. Changes in economic and technical assumptions explained slightly more than 20 percent of the reduction between May and August, and increases in government spending (plus their interest costs) had a very small effect (5 percent of the total deterioration).

It is worth emphasizing that the budget situation had deteriorated substantially even before the terrorist attacks on September 11. The combination of the tax cut, the slowing economy and small changes in discretionary spending were sufficient to reduce the overall 10-year surplus by $2.2 trillion, and push the non-Social Security baseline budget into a deficit of $10 billion for 2001, with deficits also projected for 2003 and 2004.

The terrorist attack implies a further deterioration in the federal budget outlook for three reasons. First, in the short run, the federal government has already committed substantial resources to defense, rescue, and recovery efforts, as well as the airline bailout, and additional stimulus measures seem likely. Second, the attack seems likely to have slowed the economy, which would result in lower revenue and higher spending. Third, the longer-term policy response to the attacks is likely to involve changes in the nature and level of government spending.

The vast majority of the decline in the 10-year budget projection from August to early October -- which does not incorporate the tax cuts that have been proposed as part of an additional stimulus package -- is due to increased spending since the attacks. This spending includes additional defense expenditures, the projected cost of an emergency anti-terrorism bill that was passed, and assistance for the airline industry. The rest of the decline in the projected surplus since August is due to economic and technical adjustments, mostly reflecting the slowdown in the economy.

All told, the tax cut accounted for 55 percent of the change between May and October, the spending response to the terrorist attack accounted for 21 percent, economic and technical changes accounted for 20 percent, and new discretionary spending not related to the attacks accounted for just 4 percent (see Table 2).

II. Adjusting the baseline

The Congressional Budget Office is careful to point out that its budget baseline reflects one definition of continuing "current policy" into the future. The baseline is in no way intended to be a prediction of *likely* budget outcomes.[6] To obtain a more reasonable measure of likely budget outcomes, one must consider additional items. For example, the October 4 budget committee estimates include a list of "consensus" items and others that have been passed by one or both Houses of Congress, but that have not been enacted into law and therefore are not

[5] We obtained this estimate using the Congressional Budget Office's interest rate matrix.
[6] Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2002-2011*, January, 2001, p. 5.

reflected in the official forecasts. The budgetary implications of passing these items are shown in Table 3. They total an additional $1.5 trillion in reduced surpluses, inclusive of interest payments.

If just those items were enacted—and no other changes were made—the unified budget surplus would fall to $1.1 trillion over the next decade. The non-Social Security surplus would be in *deficit* to the tune of $1.4 trillion, and the budget aside from Social Security and Medicare's Part A trust fund, which Congress has voted in the past not to invade, would face a deficit of $1.85 trillion. The balance outside all the retirement trust funds would be a deficit of $2.3 trillion.[7]

III. The budget outlook beyond the next decade

The Social Security and Medicare trust fund balances and projected revenues fall far short of what would be needed to meet future liabilities under current policy. This longer-term imbalance is temporarily masked by the asymmetry in unified budget accounting practices that counts assets for these programs but not liabilities. Placing the assets off-budget – which would cause the projected surplus over the next ten years to become negative – represents an improvement, but still ignores the fact that the accruing assets are insufficient to finance the projected liabilities. An alternative way of recognizing these entitlement liabilities is to extend the planning horizon, to include the future years in which the liabilities come due and thus can no longer be ignored, even under the cash accounting method.

The use of long-term planning horizons is now standard for Social Security and Medicare. In the context of an aging population and rapidly rising medical care expenditures, such a long-term horizon is the only way to get an accurate picture of the fiscal balance of these programs, and hence the government's budget as a whole. To take these and other factors into account, analysts have estimated the long-term "fiscal gap" under different policies. The fiscal gap is the size of the permanent increase in taxes or reductions in non-interest expenditures (as a share of GDP) that would be required now to keep the long-term ratio of government debt to GDP at its current level. Over an infinite planning horizon, this requirement is equivalent to assuming that the debt-GDP ratio will not explode. The fiscal gap gives a sense of the *current* budgetary status of the government, taking into account long-term influences.

Last fall, the CBO estimated a fiscal gap of 0.8 percent of GDP through 2070.[8] Long-term estimates are subject to considerable uncertainty, and their precise magnitudes are less

[7] Government pension funds for military and civilian workers are structured similarly to Medicare and Social Security in that the pensions represent obligations that are accruing to current workers. The pension trust fund is currently running surpluses in the on-budget portion of the budget of about $469 billion over the next decade. Congressional Budget Office, *The Budget and Economic Outlook: An Update*, August, 2001, table 1-9.

[8] Congressional Budget Office, *The Long-Term Budget Outlook*, October, 2000, table 5. Auerbach and Gale (2001) extend the CBO analysis and estimate a permanent fiscal gap -- what would be needed to prevent the national debt from exploding in the long run, rather than just through 2070 – of 3.33 percent of GDP. The permanent gap is so much larger because the budget is projected to be in substantial deficit during the years approaching 2070 (and those that follow). See Alan J. Auerbach and William G. Gale, "Tax Cuts and the Budget Outlook," Policy Brief No. 76, Brookings, April 2001.

important than the fact that the nation does face long-term budget pressures. Fundamentally, long-term estimates are inherently uncertain – and even more uncertain than short-term estimates. But the added uncertainty should not lead us to ignore long-term issues. Indeed, the serious consequences of a relatively bad long-term outcome should spur policymakers to take precautions now. Also, note that the sources of uncertainty differ in the long and short runs. Over the next ten years, the primary factor affecting surpluses will be the economy. Over the longer term, the demographic pressures of an aging population will play a more important role, although economic performance will remain relevant. The magnitude of this demographic shift is uncertain, but its occurrence is not.[9]

IV. Implications

The analysis above has several immediate policy implications. First, the budget outlook suggests that the long-run revenue impact of stimulus policies should be limited. Partly because the budget situation has already deteriorated so rapidly, a stimulus package with substantial long-term revenue costs could do more harm than good by raising interest rates, which would restrain business and housing investment and interest-sensitive consumption. But even in the absence of any effect on interest rates, tax cuts with significant long-term revenue losses would do significant damage to the long-term budget outlook.

Second, the rapid deterioration of the budget projections over the past six months underscores the benefits of surpluses as a cushion against unexpected events. The budget surpluses of the late 1990s meant that the nation was much better positioned to meet the costs of the recent terrorist attacks and the economic slowdown than otherwise would have been the case. As Ari Fleischer, President Bush's press secretary, has noted, the nation was fortunate to enter this period having money available from the surplus to work fighting terrorism and reinvigorating the economy.[10] The benefits of preserving projected surpluses for unexpected contingencies have been highlighted by recent events.

Third, under the current crisis circumstances, the Social Security "lock-box" (as well as the Medicare "lock-box") has sensibly been set aside. That is a necessary step right now, to pay for the war. But the longer-term budgetary challenges facing the nation have, if anything, only been deepened by the terrorist attacks. To meet these longer-term costs, budget discipline is essential. The primary way to reduce the future burdens imposed by Social Security, Medicare, and other government programs is to raise national saving, which is the sum of government saving and private saving. Budget surpluses, which represent government saving, are one of the most auspicious approaches to raising national saving. The key point is that policy-makers must re-establish some guiding principle for budget discipline, as has been provided by the Social Security lock-box over the past few years. Indeed, the October 4 bi-partisan Congressional statement sets the goal of restoring the Social Security lock-box.

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[9] Because the CBO estimate is based on budget projections from last fall, the estimated fiscal gap would be even larger if the budget revisions since then were included.

[10] See Richard Stevenson, "In Rapid Shift, a Budget Surplus Is Expected to Turn Into a Deficit," *New York Times*, October 1, 2001, page A1.

Fourth, the budget outlook is affected by the need to respond to the terrorist attacks. There is significant talk now of a return to bigger, more active government. The first few weeks after the attacks showed new government initiatives for defense, rescue and recovery spending, an airline bailout, a push for new federal authority to regulate airport security, and expanded powers of law enforcement. All of these items have budgetary implications.

Finally, whatever one's view of the affordability of the tax package enacted last spring, it was passed before the nation realized it would need to finance a new war. After "the dust has settled" on the first round of stimulus packages, and the policy debate turns to focusing on longer-term issues, it will be clear that the underlying fiscal situation has changed dramatically – as the analysis above highlights. Policy-makers will therefore have to rethink the basic framework of tax and spending policy, including the advisability of allowing the previously enacted tax cut to be phased in as scheduled.

The potential savings from freezing parts of the tax cut are substantial. According to the Joint Committee on Taxation, for example, just freezing the 38.6 marginal tax rate would save roughly $100 billion between 2002 and 2011 (excluding debt service savings).[11] 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 reduction in average tax rates (since the tax rates applying at lower levels of income would decline). More expansive freezes of the tax cut will likely be necessary to preserve fiscal discipline over the longer term.

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[11] 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.

Table 1
The Changing Baseline Budget: May, August, October 2001

($ Billions)

Ten-Year Baseline Budget Surplus, 2002-2011

	Unified Budget	Social Security Budget	Non-Social Security Budget	Non-Social Security, Non-Medicare Budget
May 2001[1]	5629	2485	3144	2751
August 2001[2]	3397	2551	846	442
October 2001[3]	2604	2551	53	-351

Five-Year Baseline Budget Surplus, 2002-2006

	Unified Budget	Social Security Budget	Non-Social Security Budget	Non-Social Security, Non-Medicare Budget
May 2001[1]	2002	1020	982	782
August 2001[2]	1082	1036	46	-162
October 2001[3]	666	1036	-370	-578

[1]Congressional Budget Office. "An Analysis of the President's Budgetary Proposals for Fiscal Year 2002." May 2001.
[2]Congressional Budget Office. "The Budget and Economic Outlook: An Update." August 2001.
[3]House Budget Committee and Senate Budget Committee. "Revised Budgetary Outlook and Principles for Economic Stimulus." October 4, 2001.

Table 2
Sources of Change in the Unified Budget Baseline, 2002-2011
May, August, October 2001

($ Billions)
[Percent of Change]*

	May-August		August-October		May-October	
Economic and Technical Changes	-460	[20.6]	-144	[18.2]	-604	[20.0]
Legislative Changes						
Tax Act						
Revenue Loss	-1275	[57.1]	0	[0]	-1275	[42.1]
Debt Service	-383	[17.2]	0	[0]	-383	[12.7]
Subtotal	-1658	[74.3]	0	[0]	-1658	[54.8]
Outlays						
New Spending	-83	[3.7]	-413	[52.1]	-496	[16.4]
Debt Service**	-34	[1.5]	-236	[29.8]	-270	[8.9]
Subtotal	-117	[5.2]	-649	[81.8]	-766	[25.3]
Total Change in Surplus	-2232	[100.0]	-793	[100.0]	-3025	[100.0]

*Percentages may not sum to 100 due to rounding.
**For the August-October changes, this may include debt service on economic and technical changes.

Sources: Congressional Budget Office. "The Budget and Economic Outlook: An Update." August 2001. Congressional Budget Office. "An Analysis of the President's Budgetary Proposals for Fiscal Year 2002." May 2001. House Budget Committee and Senate Budget Committee. "Revised Budgetary Outlook and Principles for Economic Stimulus." October 4, 2001, and authors' calculations using the CBO interest rate matrix.

Table 3
Implications of Other Possible Claims on the Budget, 2002-2011
as of October 2001

($ Billions)

	Cost	Remaining Surplus/Deficit
October 2001 Baseline Unified Surplus	-	2604
- Social Security Trust Fund	2551	53
Other Possible Claims on the Budget		
- Budget resolution policies[1]	67	-14
- Budget Resolution Reserve Fund policies[2]	431	-445
- House- and Senate-passed bills[3]	225	-670
- Natural disasters	55	-725
- Permanent extension of expiring tax provisions	142	-867
- Elimination of EGTRRA sunsets	113	-980
- Alternative Minimum Tax	208	-1188
- Debt Service on Possible Claims	258	-1446
- Medicare (Part A) Trust Fund	404	-1850
- Government pensions	469	-2319

[1]One-year extension of tax provisions expiring in 2001; veterans programs; other revenue policies; all other resolution policies.
[2]Prescription drugs; farm bill; expanded health coverage; Home Health, student loans, Family Opportunity Act.
[3]Faith-based initiative (House-passed); railroad retirement (House-passed); energy (House-passed); Patients Bill of Rights (Senate-passed); elementary and secondary education (Senate-passed).

Sources: House Budget Committee and Senate Budget Committee. "Revised Budgetary Outlook and Principles for Economic Stimulus." October 4, 2001. Congressional Budget Office. "An Analysis of the President's Budgetary Proposals for Fiscal Year 2002." May 2001, and authors' calculations using the CBO interest rate matrix.

Appendix B:
Why the current stimulus package should have only temporary items

William Gale and Peter Orszag[1]
October 9, 2001

In the wake of the terrorist attack on September 11, Congress and the Administration are debating the best way to stimulate the economy through spending and tax changes. The general principle that a stimulus package should include only temporary items—that is, items that sunset after one year—has been endorsed by the Democratic and Republican leaders of the House and Senate Budget Committees.[2] In contrast, the Administration has proposed a series of options that would be permanent for firms and long-lasting (up to four years) for high-income individuals, but only temporary for low-income households. This note offers seven reasons why the most effective stimulus package would contain only temporary changes to tax or spending programs.

1. The economy is in a short-term downturn; long-run prospects remain strong.

The nature of the problem at hand is that the economy is experiencing a jolt, or temporary slowdown, and needs to return to its long-term course. No one is suggesting that the long-term course has been significantly altered from its previous path or that it should be. As Alan Greenspan noted in Congressional testimony on September 20, "as we struggle to make sense of our profound loss and its immediate consequences for the economy, we must not lose sight of our longer-run prospects, which have not been significantly diminished by these terrible events."[3] Thus, the right policy response would aim to get the economy back on its long-term path. It is hard to see why a temporary problem merits a permanent solution.

2. The best stimulus would generate the most new activity, at the least long-term cost.

The best way to stimulate the economy is to maximize the "bang for the buck" of any proposed policy change. The "bang" is the impact on the economy in the near term and should be maximized; the "buck" is the long-term cost of the policy and should be minimized. Policies that maximize the bang for the buck (a) focus on new household spending (such as through a household tax rebate) or (b) new business investment (such as through investment tax credits for new investment and/or accelerated depreciation of new investment). As the next two points indicate, temporary policies are a rare policy two-fer: they can have a bigger short-term effect and a smaller cost than permanent policies.

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[1] William Gale and Peter Orszag are senior fellows in the economic studies program at the Brookings Institution.

[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] Alan Greenspan, "The Condition of the Financial Markets," Committee on Banking, Housing, and Urban Affairs, U.S. Senate, September 20, 2001.

3. Temporary policies can have a bigger "bang" than permanent policies.

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. This point is not controversial. It is endorsed, for example, by Glenn Hubbard, the Chair of the President's Council of Economic Advisers. In a paper he co-authored with Kevin Hassett, Hubbard argued that, "Temporary investment incentives can have even larger short-run impacts on investment than permanent investment incentives…"[4]

4. Temporary items reduce revenues by less than permanent items.

This has two important implications. First, it means that a temporary incentive will have a smaller impact on long-term interest rates. That is important because any increase in interest rates created by a stimulus package would hurt investment, the stock market, housing, and other sectors of the economy, and thus offset some of the direct effects of the stimulus. Second, for any given overall cost and therefore any given impact on interest rates, a longer-term package will be less efficient in generating stimulus in the short run than a temporary one, since more of its incentives are loaded for a period well beyond the likely downturn and therefore less is devoted to the immediate period.

5. Focusing on temporary changes limits the potential inequities that may occur.

The Administration, for example, would like to give permanent tax cuts to businesses, long-lasting ones (up to four years) for high-income households, but only temporary one-year cuts for low-income households. These patterns are difficult to justify on equity grounds.

6. Focusing on temporary changes limits the potential dangers from inappropriate policies.

Allowing some permanent tax or spending changes opens the door to consideration of a wider array of permanent changes that have little or no stimulative effect. It is much more straightforward to limit the stimulus package to temporary items than to evaluate the costs and benefits of a wide array of potential permanent changes. Policy-makers should not divert attention from more immediate needs in order to debate the merits of various permanent changes in taxes or spending programs, when temporary changes are likely to be more stimulative in any case.

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[4] Kevin Hassett and R. Glenn Hubbard, "Tax Policy and Investment," in Alan J. Auerbach, Fiscal Policy: Lessons from Economic Research, MIT Press, 1997, p. 369. Hassett and Hubbard also note that policy-makers have difficulty effectively timing the applications of fiscal stimulus, and therefore argue that a temporary investment incentive could be applied at an inappropriate moment. That concern, however, raises questions about the Administration's support for investment incentives as part of it short-run stimulus package, rather than about the choice of a permanent versus temporary incentive as a stimulus tool. After all, a putative permanent investment incentive would begin at the same time as a temporary one would. From the point of view of stimulating the economy in the short run, the key question is which one would produce a larger effect over the next year or so.

7. Focusing on temporary changes avoids misleading or dishonest budget calculations.

The Administration has been proposing permanent changes but only reporting the one- or two-year costs. For example, eliminating the corporate alternative minimum tax would reduce revenue over the next 10 years by approximately $18 billion.[5] It is possible, however, that the Administration will want to count only the costs in the first year or two in determining the overall stimulus "budget." Limiting the stimulus package to temporary changes in tax or spending programs increases the chances that the accounting of the package will be transparent.

The conclusion, as both the Chairman and Ranking Members of the House Budget Committee and the Senate Budget Committee have emphasized, is that any stimulus package should contain only temporary items.

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[5] Heidi Glenn and Warren Rojas, "Column A, Column B: Washington Orders Up $50-$75 Billion Stimulus," *Tax Notes*, October 8, 2001, page 170.

Appendix C: Stimulating the Economy Through Tax Policy: Principles and Applications[1]

William Gale, Peter Orszag, and Gene Sperling

October 5, 2001

Congressional and Administration leaders are now examining the appropriate fiscal policy response to the recent terrorist attacks. Since the attack, the Federal Reserve has provided liquidity to financial markets, and has reduced its key lending rate twice, by a total of 100 basis points. Congress and the President agreed on a $40 billion spending package for defense, rescue and rebuilding efforts, and an airline bailout of $5 billion, plus additional loan guarantees.

The key short-term fiscal issues are whether additional stimulus proposals would help and what form assistance should take. Spending initiatives aimed at quickly stimulating the economy–including the rapid clean-up and rebuilding of New York City and efforts to attenuate the costs of economic slowdown–will likely form part of any stimulus package. Tax cut proposals, however, have now taken center stage in the debate.

This paper focuses on the stimulus potential of alternative tax cuts. We do not address whether a stimulus *should* be provided. Rather, we examine the principles that will lead to the most effective tax stimulus, should policy makers choose this path, and then examine some recent proposals in light of those principles.

The most effective stimulus proposal would maximize its "bang for the buck." That is, it would direct as much of the tax cuts as possible to stimulating new consumer spending and/or new business investment in the short run; and it would do the least possible damage to long-term fiscal prospects and hence minimize any upward pressure on interest rates. Temporary rebates to individuals and temporary business subsidies for new investment fit these principles. A package with substantial long-term revenue costs, on the other hand, could do as much harm as good: It would raise interest rates, which would offset much of the direct benefits of any stimulus by reducing business and housing investment, as well as consumption that is affected by interest rates or stock market values. Many of the stimulus proposals currently being considered do little or nothing to address the need to stimulate the economy in the short-run, and would exacerbate long-term fiscal problems. Proposals to cut tax rates on capital gains or on corporate income are particularly problematic along these dimensions. Such proposals may be worth discussing in other contexts, but they clearly represent the wrong policy response at the current time.

I. Principles

The appropriateness and effectiveness of a tax stimulus depends on the underlying economic outlook—to indicate what is needed—and the budget outlook—to indicate the

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[1] This article will be supplemented periodically as new tax proposals are discussed in the policy arena. For further detail on these issues, see William Gale, Peter Orszag, and Gene Sperling, "Tax Stimulus Options in the Aftermath of the Terrorist Attack," Tax Notes, October 8, 2001.

financial constraints. The terrorist attack disrupted the workings of an already weakening economy, and many economists believe it pushed the economy into a recession. But the economy's long-term prospects remain strong. The 10-year budget outlook, which was relatively auspicious at the beginning of the year, has deteriorated rapidly due to the tax cut enacted this spring, the weakening of the economy before the terrorist attack, and the further weakening of the economy after the attack. The economic outlook thus suggests the need for policies that stimulate the economy in the short run. The budget outlook suggests that the long-run revenue impact of stimulus policies should be limited, so as to avoid exacerbating the nation's long-term fiscal challenges, which would raise interest rates and undermine the effectiveness of the stimulus. This reasoning suggests five principles for designing the most effective tax stimulus package. The first two relate to keeping the package focused on stimulating new behavior. The last three relate to maintaining budget discipline.

- Structure any business tax incentives to encourage new investment, not to provide a windfall for previous investment. This includes *temporary* provisions to provide accelerated depreciation, expensing, or tax credits for new investments in the near future.

- Design any household tax reductions to maximize effect on demand. Tax cuts should therefore be focused on low- and middle-income households who tend to have a higher propensity to spend out of their income than do high-income households. Timing any new tax cut for households to coincide with the holiday season may be an effective way to encourage it to be spent.

- Allow only temporary items. This will limit the long-term cost of the package and reduce the temptation for policy-makers to try to push through long-standing proposals that may or may not have merit for other reasons, but do little or nothing to stimulate the economy in the short run.

- Set an overall stimulus budget first. This will further reduce the likelihood of a run-away, "Christmas tree" spending and tax package. Fed Chairman Alan Greenspan and former Treasury Secretary Robert Rubin recently suggested a "budget" for the stimulus of $100 billion, including those items that have already been enacted since the attacks, and therefore new stimulus of roughly $50 billion. Subsequently, President Bush advocated new stimulus of $60 to $75 billion. (There appears to be some confusion as to the meaning of the overall stimulus ceiling. In our opinion, the overall stimulus budget should include all stimulus legislation proposed and enacted since September 11. It should cover all stimulus costs, as estimated by the Congressional Budget Office and Joint Committee on Taxation, over the next ten years.)

- Minimize the long-term costs. Combining short-term stimulus with long-term fiscal discipline provides more stimulative impetus to the economy than a stimulus package alone, since it restrains any increase in interest rates that could undermine the effectiveness of the stimulus.

II. Tax cuts for households

Another rebate for consumers

Declines in consumer confidence, spending, and employment have led to calls for a second round of consumer rebates to directly bolster consumer demand. Economic research suggests that households tend to immediately spend between 20 percent and 70 percent of any temporary income tax cuts they receive. Although it is too soon to fully evaluate the impact of the rebate checks distributed this summer, the checks appear to be generating only a small increase in consumption. In August, personal after-tax income rose by 1.9 percent, in significant part due to the rebate, but personal spending only rose by 0.2 percent. A survey undertaken by the University of Michigan in August and September found that only 19 percent of respondents said that they were going to spend their rebates.

To make another round of rebates more effective as a stimulus, policy-makers could target the rebates to lower and middle income households. Economic 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. Furthermore, roughly 30 million lower and moderate income households did not receive a rebate earlier this year, even though they pay federal payroll and excise taxes. To better target such households, the rebates should be based on employee Social Security and Medicare payroll taxes. (Although the rebate would be *based* on payroll taxes, it should be financed through general revenues.) To maximize the stimulative impact and minimize administrative hassles, the rebates could be set as one amount for anyone with earnings in calendar year 2000 over a minimum level.

Another way to stimulate the spending potential of any rebate may be to time the rebate checks for the holiday shopping season. Holiday purchases of presents for friends and family are highly seasonal. 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. Vendors -- who have already experienced one rebate round -- may now be particularly astute about marketing sales and deals based on the rebates.

Accelerate the previously legislated tax cuts

Another proposal for household tax cuts is to 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. This proposal is problematic for several reasons.

First, and most importantly for its stimulative impact, the acceleration is not well-targeted to generating additional spending in the short run. The vast majority of the costs of accelerating the rate reductions would occur after 2002: The acceleration would also reduce revenue in 2003, 2004, 2005, and 2006. Since most of the cost would *not* go to providing stimulus in 2002, when it is needed most, the proposal does not maximize its bang-for-the-buck. A temporary one-year tax cut would generate the same stimulus in 2002 at much less cost. (There is also a good chance that, when any accelerated tax cuts become operative in years between 2003 and 2006, the

economy will already be growing rapidly. Thus, the proposal could very likely fall prey to the familiar pattern of the federal government's stimulating the economy at times when it does not need to be stimulated.)

Furthermore, the accelerated rate cuts would only apply to high-income households -- those who are in the top 25 percent of the income distribution. Most taxpayers are in the 15 percent bracket. The tax rate cut for such taxpayers has already been implemented through the addition of a new 10 percent bracket at income of up to $12,000 for married couples, and no further changes are scheduled before 2008. The majority of taxpayers would thus receive no benefit from the accelerated rate reduction. As noted above, 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. 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.

The proposal has two other shortcomings. First, the equity of giving tax cuts to those in the highest-income groups, while ignoring those in lower-income groups (who are most likely to be the ones losing their jobs in a downturn), is questionable. Second, preliminary estimates suggest that accelerating the rate cuts would "bust the stimulus budget" figures noted by the President, Chairman Greenspan, and former Secretary Rubin.

In terms of longer-run considerations, 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. Regardless of one's views about whether the tax cut passed last spring was sound fiscal policy at that time, it is clear that the nation's finances are now much worse off than they were then. 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).

III. Business tax cuts

Incentives for new business investment

An alternative set of proposals would aim to stimulate business investment. This could include an investment tax credit or accelerated depreciation schedules (or expensing, a form of accelerated depreciation) for new investments. Of the business-oriented tax proposals currently under discussion, such temporary investment incentives are the most consistent with the principles delineated above. These incentives would provide a relatively strong bang-for-the-buck because they are targeted on new investments and because they are temporary, thus minimizing the impact on interest rates. As discussed below, these features place them in sharp contrast to corporate income tax rate cuts.

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.

The precise form of a temporary investment incentive should reflect administrative and other issues. For example, some practitioners believe that accelerated depreciation or partial expensing may be slightly easier to implement than an investment tax credit. Moreover, whatever their form, it is also important to note that such incentives are not fool-proof. Their impact on investment may be limited, especially when firms already have significant cash-on-hand, there is excess capacity, and aggregate demand is falling. The various concerns should serve to reduce expectations about the impact of temporary incentives for business investment. None of them suggest, however, that either a permanent incentive for investment or a corporate tax rate cut would be more effective as a stimulus.

Corporate tax rate cuts

Some commentators and business leaders are advocating reductions in the tax rate on corporate income as the best method for stimulating the economy. Advocates claim the tax cut would raise stock market values (thereby stimulating consumer spending), reduce costs of goods to households, and increase investment. A corporate tax rate cut, however, is ill-suited to address the nation's short-run economic challenges.

A corporate tax rate cut is a poor stimulus for three reasons. First, it is an inefficient way to stimulate new investment because it provides a windfall to the income earned on investments made in previous years. Firms would benefit if they are profitable, even if they are making no current investments or are reducing their current investments. Second, the corporate tax rate cut provides little, if any, immediate assistance to firms that are currently facing losses and therefore are not currently paying corporate income taxes. These are, however, the firms that are disproportionately in need of assistance during the downturn. Third, permanent reductions in corporate tax rates are expensive – a 10 percentage point decline in the corporate tax rate reduces projected surpluses by about $900 billion over the next decade, including about $700 billion in tax revenue losses and $200 billion in additional interest on the public debt. This decline in the surplus would put upward pressure on long-term interest rates, which in turn would erode most or direct positive effects of a corporate tax cut on the stock market and on new investment.

Some have claimed that cutting the corporate rate would raise stock values and thus stimulate consumer spending. This chain of reasoning is problematic for several reasons. First, even if it were valid, the corporate tax rate cut would imply a very small short-term stimulus relative to its long-term cost. Our estimates suggest that consumption would rise by $36 billion to $60 billion in the next year, or between 4 and 7 percent of the 10-year cost if interest rates did

not adjust. Other tax reductions noted above could achieve a much larger short-term stimulus per dollar spent.

As noted above, however, the decline in the surplus would raise interest rates. Separate estimates of the relationship between the budget and interest rates by President Clinton's Council of Economic Advisers (CEA) and Harvard Professor Martin Feldstein (chairman of the CEA under Ronald Reagan) imply that the cut in corporate tax rates would cause interest rates to rise sufficiently to wipe out almost all of the stock market effect claimed by advocates, and hence also eliminate almost all the effect on consumer spending.

A second claim is that the tax cuts would be immediately passed along to consumers in the form of lower prices for goods and services. But most evidence suggests that the corporate tax is borne by owners of capital in general or owners of corporate capital, not by consumers. In addition, recall that firms that are currently losing money do not pay corporate income taxes. Thus, if savings were passed to consumers, survival would become even more difficult for those firms already hit hardest by recent events.

A third claim is that corporate tax rate cuts would raise investment by reducing the cost of capital investment. This argument is correct as far as it goes, but it ignores several critical factors. For example, for a tiny fraction of the cost of a corporate tax rate cut, a temporary investment tax credit (ITC) could generate the same or larger incentive to undertake new capital investment during the next year. The ITC is cost-effective because it only subsidizes new investment, while the corporate tax cut reduces burdens on both new investment and current income (which is the return to old investments). Also, because the ITC would be temporary, revenue losses would not extend into the future and the impact on interest rates would be much smaller. Accounting for all of these factors, a permanent corporate tax rate cut costs between 10 and 30 times the amount of a temporary ITC that generates the same reduction in the cost of new capital investment over the next year. (Other forms of temporary tax incentives for new investment would similarly be much more cost-efficient than a corporate tax rate cut.)

Some claim that a corporate tax cut would generate new investment by raising corporate cash flow. But from the end of 1999 to the middle of 2001, non-financial, non-farm corporations raised their liquid financial assets by $100 billion and their total financial assets by $700 billion. This increase did not stop a significant decline in investment earlier this year, but it does show that the decline was not due to any shortage of cash on hand.

A final claim is that corporate tax rate cuts would help reduce layoffs. Such an effect seems unlikely. After all, corporate income tax cuts do not help firms that are already losing money, and these are the firms most likely to lay off workers.

<u>Capital gains tax cuts</u>

Another proposal would reduce the maximum tax rate on long-term capital gains from 20 percent to 15 percent. Whatever its merits in other contexts, a capital gains tax cut has several crucial drawbacks under current circumstances.

A *permanent* capital gains tax cut is poorly designed to address the short-term economic problems at hand. Lower tax rates on capital gains are typically supported as a way to raise saving, but what the economy needs right now is more spending, not more saving. Lower capital gains rates are also claimed to raise economic growth, but the effect is probably tiny and certainly many years in the making. In contrast, what the economy needs right now is a short-term boost. In addition, a capital gains tax reduction is not an efficient way to stimulate *new* investment, because the tax cut would apply to capital gains on *existing* assets, and those gains are a return to prior investment. Finally, capital gains tax cuts would reduce long-term revenue and exert upward pressure on long-term interest rates.

A *temporary* reduction in capital gains tax rates is perhaps even more problematic, since it would encourage people to sell their stocks now. If people took the revenue from their asset sales and reinvested in the market, there would be little effect on any economic aggregate. If instead they spent their realized gains on consumption goods, the result could reduce stock market values, which could hurt consumer confidence and business investment.

IV. Conclusion

The current economic and budget outlook suggests the need to focus on policies that stimulate the economy in the short run and do not damage the long-term fiscal outlook. Policies that are not consistent with these principles will generate weaker economic stimuli than those that do. There are limits, however, to the effects of any type of tax cut in stimulating economic activity, particularly in times of uncertainty when people and firms are delaying major economic decisions.