The Administration's Economic "Stimulus" Proposals

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Senator Dorgan, Ms. Pelosi, and Members of the Committee, thank you for inviting me to testify this morning on the Administration's recent economic stimulus plan. As you know, that plan consists primarily of a new tax cut for dividends (and capital gains), and acceleration of most (but not all) of the provisions from the 2001 tax cut that were scheduled to take effect in future years. My testimony makes four basic points:

- Even according to the Administration's own analysis, the proposals would have a negligible effect on economic activity during 2003 and would reduce job growth after 2004. In the short term, the plan would have only a modest impact because it is not targeted to boosting demand for goods and services; in the long term, any positive effects would be offset by the expansion in the budget deficit and associated reduction in national saving.

- The package is fiscally irresponsible, with a budget cost through 2013 of more than $925 billion (including debt service), and a long-term cost that exceeds one-quarter of the 75-year actuarial deficit in Social Security. These costs are in addition to the other substantial tax cuts already enacted or proposed by the Administration; collectively, the tax cuts amount to between 2 and 3 times the size of the actuarial deficit in Social Security over the next 75 years. Especially in the face of the coming retirement of the baby boomers, it would be reckless to adopt policies that would exacerbate the projected long-term budget imbalance.

- The package would provide a tax cut of $100 or less to almost one-half of tax filers, while providing an average tax break of $90,222 to those with more than $1 million in income. The tax cuts would also reduce the share of total Federal taxes paid by the top 1 percent of the income distribution, and would widen the already substantial disparities in after-tax income between those at the very top end of the income distribution and others.

- The dividend exclusion proposal would fail to achieve its ostensible goal of taxing corporate income once and only once. It would not address the component of corporate income that is not taxed (or is preferentially taxed), despite the fact that the non-taxation or preferred taxation of corporate income is arguably at least as

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significant a concern as double taxation. It would also undermine the political viability of true corporate tax reform and create costly new loopholes in the tax code.

My conclusion is that the proposals are poorly designed to address the problems facing the economy either today or in the long term. An alternative that was focused more on boosting demand in 2003 and promoting fiscal discipline thereafter would represent a much sounder approach.

<u>Issue #1: Effect on the economy in the short run and the long run</u>

In releasing the Administration's proposals on January 7, 2003, President Bush stated: "This growth and jobs package is essential in the short run; it's an immediate boost to the economy…They are essential for the long run, as well -- to lay the groundwork for future growth and future prosperity."[2] Yet the Administration's own economic analysis betrays the President's claims.

The Administration often claims that the proposal would create 2.1 million jobs over the next three years. However, according to the Council of Economic Advisers, the plan will create only 190,000 jobs in 2003 (relative to a decline in total employment of 1.8 million since the beginning of the recession in March 2001).

Table 1: Effect of Administration's plan on employment growth

	Employment growth (in thousands)
Administration's published estimate of additional employment growth during 2003 due to its plan	+190
Administration's published estimate of additional employment growth for 2003-2007 (average per year) due to its plan	+170
Implied effect on employment growth for 2005-2007 (average per year) due to Administration's plan[3]	-80
Note: Total non-farm employment, March 2001-December 2002	-1,752

Source: Council of Economic Advisers, "Strengthening America's Economy," January 7, 2003; Bureau of Labor Statistics; and author's calculations

[2] "Taking Action to Strengthen America's Economy," Chicago, Illinois, January 7, 2003, available at www.whitehouse.gov.

[3] The CEA table shows an increase in employment growth from the proposals of 190,000 in 2003 and 900,000 in 2004. The table also shows an <u>average</u> increase in employment growth for 2003-2007 of 170,000. The implication is that total employment growth for 2003-2007 is 850,000 (=170,000*5). Since employment growth is estimated to increase by 1,090,000 in 2003 and 2004 (=190,000+900,000), the implication is that employment growth must decline by 240,000 in 2005 through 2007 (=1,090,000-850,000). Only if employment growth declines, relative to the baseline, by a total of 240,000 in 2005 through 2007 would the average employment growth for 2003-2007 be consistent with the figure shown in the CEA table. The average decline in employment growth for 2005 through 2007 must therefore be 80,000 (=240,000/3).

Furthermore, the CEA analysis implies that the proposal would lead to a decline in the number of jobs created (relative to no policy changes) in 2005 through 2007 (see Table 1).[4] It is thus difficult to see how the Administration's own analysis is consistent with the President's claims. Similarly, in describing its analysis, the Council of Economic Advisers itself claims that enacting "the President's proposals would have a significant effect on the rate of long-term economic growth."[5] Yet the analysis itself implies the effect on job growth would be *negative* after 2004.

Despite the internal inconsistencies between the Administration's rhetoric and the CEA's analysis, the basic results are not surprising:

- In the short run, the key economic difficulty is that the nation is not fully using the capacity it has available to produce goods and services. In December 2002, the capacity utilization rate computed by the Federal Reserve Board of Governors was 75.4 percent, significantly below its average of 81.5 percent for the past three decades.[6] The primary macroeconomic issue in the short run is therefore to boost demand for the goods and services that firms could produce given current capacity. From that perspective, the Administration's package is poorly designed, since it fails to target the middle-class and lower-income families who would be more likely to spend any tax cut. According to data from the Tax Policy Center, the 69 percent of tax filers with incomes below $50,000 would receive just 13 percent of the total tax cut in 2003 under the Administration's plan.[7]

- In the long run, the key to economic growth is to expand the capacity of the nation to produce goods and services. That capacity, in turn, depends on national saving. Yet the Administration's plan will expand the budget deficit and thereby *reduce* national saving.[8] Only if the economic benefits of the policy changes generating the deficits

[4] Depending on the details of the CEA model specification, such a decline could reflect a simple Keynesian effect (since tax cuts that had been scheduled for 2006 were instead accelerated to 2003) or a more sophisticated impact on capacity (since the tax cuts will reduce national saving and therefore income in the future).
[5] Council of Economic Advisers, "Strengthening America's Economy," January 7, 2003.
[6] See http://www.federalreserve.gov/releases/G17/Current/default.htm.
[7] By contrast, the House Democratic stimulus plan would deliver 58 percent of its total tax cut to these filers.
[8] The reduction in national saving reduces the nation's future income. That is the fundamental cost of a failure of long-term fiscal discipline: All else being equal, it reduces the capital owned by Americans and the nation's income over time. For example, Gale and Orszag (2002) show that the deterioration in the fiscal outlook since January 2001, all else being equal and not including the Administration's most recent proposal, will reduce income in 2012 by the equivalent today of $1,500 per household per year. See William G. Gale and Peter R. Orszag, "The Economic Effects of Long-Term Fiscal Discipline," Urban-Brookings Tax Policy Center, December 2002. In recent months, Administration officials and others have argued that budget deficits do not affect interest rates. Gale and Orszag (2002) address this issue in detail. The important point to realize is that focusing solely on the connection between interest rates and deficits obscures the more important point: Unless an increase in the budget deficit is entirely offset by an increase in private saving, it must produce either a reduction in domestic investment or an increase in borrowing from abroad. All else equal, it must therefore reduce the capital stock owned by Americans and reduce future income.

more than offset the losses imposed by reduced national saving would the net effect be positive. I am not aware of any studies that have yet examined the net effect of the new proposal (including the adverse effect on national saving), but existing studies on the 2001 tax cut suggest that the net impact from the (negative) effect on national saving and the (positive) effect on incentives from that tax cut is small and, if anything, likely to be negative.[9]

Issue #2: Effect on the budget

The Administration's package is fiscally irresponsible, with a budget cost through 2013 of more than $925 billion (including debt service). This most recent package is just one of many tax cuts that the Administration has embraced: In addition to the 2001 tax cut (which sunsets in 2010), the Administration has stated that the 2001 tax cut should be made permanent and that the looming Alternative Minimum Tax problem should be addressed (albeit after the 2004 election). With debt service, making the 2001 tax cut permanent would cost about $735 billion over the next 10 years. Even a relatively modest reform to the Alternative Minimum Tax could cost $500 billion. All together, the Administration's proposals could therefore cost more than $2 trillion through 2013 -- and even more after taking into account a Medicare prescription drug benefit, higher real discretionary spending (including for defense and homeland security), and possibly Social Security reform. The costs shown in Table 2 are in addition to the cost of the enacted 2001 tax cut.

Table 2: Costs of Administration tax proposals (in addition to enacted 2001 tax cut)

	FY 2003-2013
New Administration "stimulus" proposal	*$674 billion*
Debt service	$250 billion
*Remove sunset on 2001 tax legislation**	*$680 billion*
Debt service	$55 billion
*AMT reform (estimate)***	*$500 billion*
Debt service (estimate)**	$75 billion
Total***	$2.2 trillion

*Does not incorporate interactions between new dividend proposal and cost of removing the 2001 sunset.
** Based on estimate from House Budget Committee, Democratic Staff. For other details on the AMT and reform options, see Leonard E. Burman, William G. Gale, Jeff Rohaly, and Benjamin H. Harris, "The Individual AMT: Problems and Potential Solutions," Urban-Brookings Tax Policy Center, September 2002
*** Does not include Medicare prescription drug benefit, discretionary spending adjustment, Social Security reform, or other possible costs.

The Administration claims that despite these massive tax cuts, fiscal discipline could be restored by restraining non-defense discretionary spending. Yet to offset the costs of the tax cuts would require a reduction of almost 40 percent in non-defense discretionary spending for fiscal years 2003-2013 relative to the Congressional Budget Office baseline.[10] That baseline already assumes an unrealistically low level of

[9] See the discussion in Gale and Orszag (2002).
[10] The August 2002 CBO baseline projects that domestic and international discretionary spending would total $4.256 trillion for FY 2003-2012. To compute a 2013 figure, I multiplied the 2012 level by the

discretionary spending in the out-years, especially in light of homeland security needs.[11] The required 40 percent reduction would be relative to this already-low baseline level.[12] The size of the required reductions underscores the implausibility of the claim itself: The Administration's plan would impose a substantial cost on the budget, and spending restraint could not come close to offsetting the cost.

In evaluating these budget costs, it is important to appreciate the scale of the budget difficulties already facing the nation. The aging of the baby boomers and lengthening life spans generally will place increasing pressure on the Federal budget in years to come.[13] Especially in the face of the coming retirement of the baby boomers, it would be reckless to adopt policies that would exacerbate the projected long-term budget imbalance. To put the Administration's most recent "stimulus" proposal in context, the revenue loss in 2012 would amount to more than 0.2 percent of GDP (and possibly more than 0.25 percent of GDP depending on the details of the proposal). Saving that amount of revenue (relative to GDP) over the next 75 years would address more than one-quarter of the actuarial deficit in Social Security.

Table 3: Costs of Administration tax proposals

	As percent of GDP, in present value, over next 75 years
Cost of new Administration tax cut proposal	0.2*
Cost of 2001 tax cut if made permanent	1.5-1.9**
Total cost	1.7-2.1
Social Security actuarial deficit	0.72

* Conservative estimate. Precise figure will depend on details of proposal and is likely to be higher than 0.2 percent of GDP.

** Based on Auerbach, Gale, Orszag, and Potter (forthcoming)

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percentage growth between 2012 and 2011, and obtained an estimate of $491 billion. Adding that 2013 estimate to the FY 2003-2012 total produces a baseline figure for FY 2003-2013 of $4.747 trillion. The non-debt-service cost of the new "stimulus" proposal, the removal of the sunset, and a modest AMT reform amounts to $1.854 trillion for FY 2003-2013. The required reduction is then obtained by division (1.854/4.747=.39).

[11] See Alan J. Auerbach, William G. Gale, Peter R. Orszag, and Samara Potter, "Budget Blues: The Fiscal Outlook and Options for Reform," in Henry Aaron, James Lindsay, and Pietro Nivola, *Agenda for the Nation* (Washington: Brookings Institution, forthcoming).

[12] As a result, meeting the cost of the tax cuts shown in the table above solely through reductions in non-defense discretionary spending would require a reduction in non-defense discretionary spending from approximately 3.5 percent of GDP in 2003 to 1.7 percent of GDP in 2013. (The 1.7 percent of GDP figure assumes that the required 39 percent reduction for FY 2003-2013 was applied on an equal percentage basis in each individual year.) For perspective on that figure, note that non-defense discretionary spending averaged 3.94 percent of GDP between 1962 and 2001 (author's calculations based on CBO data from "Historical Budget Data," Table 8, available at www.cbo.gov).

[13] The Congressional Budget Office projects that Federal expenditures on Social Security, Medicare, and Medicaid will rise from about 9 percent of GDP in 2012 to 15 percent by 2040 and 21 percent by 2075, the last year of the long-term projections. Congressional Budget Office, "A 125-Year Picture of the Federal Government's Share of the Economy, 1950-2075." Long-Range Fiscal Policy Brief, revised July 3, 2002. By way of comparison, *total* Federal spending averaged 20 percent of GDP over the last 40 years and was 18.4 percent of GDP in 2001.

In other words, *the long-term cost of the Administration's new stimulus package amounts to more than a quarter of the 75-year actuarial deficit in Social Security.* Combined with the cost of making the 2001 tax cut permanent, the total tax cuts proposed by the Administration amount to between 2 and 3 times the actuarial deficit in Social Security over the next 75 years (see Table 3).

<u>Issue #3: Distributional effects</u>

Many Administration officials have been advertising the package as providing an average tax cut of $1,083, suggesting to many Americans that they would receive a tax cut of this size.[14] Other officials have been highlighting the fact that the tax cut provided to the top 1 percent of tax filers in 2003 is smaller than the share of income taxes they pay. Finally, the White House claims that the proposed tax cut will provide benefits to "everyone who pays taxes -- especially middle-income Americans."[15] These claims raise three important issues.

First, the use of averages can be misleading. As Robert Reich is fond of pointing out, the average of himself and Shaquille O'Neal is a man about 6 feet tall. Averages are also misleading with regard to the Administration's proposal. Under that proposal, 78.4 percent of income tax filers and 71.1 percent of income tax payers would receive less than $1,000 (see Table 4). By contrast, the average tax cut in 2003 for those filers earning more than $1 million would amount to $90,222.

Table 4: Size of tax cut under Administration's proposal

Size of tax cut received, 2003	Percent of income taxpayers	Percent of income tax filers
$100 or less	37.5%	49.3%
$500 or less	60.0%	68.6%
$1,000 or less	71.1%	78.4%

Source: Urban-Brookings Tax Policy Center and author's calculations

Second, comparing the share of the tax cut received to the share of income tax paid in 2003 is problematic for three reasons:

- It is misleading to examine only the share of income taxes paid, since the top 1 percent pays a significantly smaller share of all Federal taxes than its share of income taxes. In 2003, the top 1 percent of tax filers would pay 36.7 percent of income taxes, but only 24.8 percent of all Federal taxes in the absence of the Administration's proposal (Table 5). Since the top 1 percent would receive 28.8 percent of the Administration's proposed tax cut in 2003, it would receive a larger share of the tax cut than its share of Federal taxes paid. As a result, the share of total Federal taxes

[14] See, for example, "Taking Action to Strengthen America's Economy," Chicago, Illinois, January 7, 2003, available at www.whitehouse.gov.

[15] http://www.whitehouse.gov/infocus/economy/

paid by the top 1 percent would decline if the Administration's proposal were enacted.

- The Administration's proposal becomes more regressive over time, since the provisions primarily affecting the middle class are overwhelmingly temporary (reflecting merely the acceleration of several provisions from the 2001 tax cut) whereas the major provision primarily affecting higher earners (the dividend tax proposal) would be permanent. For example, in 2010, the top 1 percent of tax filers would enjoy 44 percent of the tax cut – almost twice their share of Federal taxes paid and substantially more than their share of income taxes paid. Focusing solely on 2003 is misleading.

- Finally, measuring the progressivity (or lack thereof) of a tax cut by comparing the share of the tax cut to the share of taxes paid is a flawed approach when the proposal is changing the level of overall revenue and the tax system is progressive. To see why, consider the elimination of a progressive tax system. By definition, since taxes would be eliminated, everyone would receive a share of the tax cut equal to his or her share of taxes paid. The net result, however, would be to make the after-tax distribution of income more unequal – since the tax system would no longer be partially offsetting the inequality in pre-tax income. The most insightful measure of the progressivity of a tax cut is therefore the percentage change in after-tax income. If higher earners enjoy a larger percentage increase in after-tax income than lower earners, then the change is regressive. As Table 5 shows, the top 1 percent would experience a 3.7 percent increase in after-tax income in 2003; the bottom 80 percent would experience a 1.0 percent increase. The proposal is thus very regressive even in 2003 – and more so in 2010.

Table 5: Distributional implications of Administration proposals

	Share of income taxes paid, 2003	Share of total Federal taxes paid, 2003	Share of Admin. tax cut, 2003	Share of Admin. tax cut, 2010	Change in after-tax income, 2003
Bottom 80 percent	16.8%	30.5%	21.3%	15.5%	+1.0%
Top 1 percent	36.7%	24.8%	28.8%	44.2%	+3.7%

Source: Urban-Brookings Tax Policy Center and author's calculations

On a related note, the Administration's claims about the effects of the tax cut on the elderly and small businesses would also be extremely easy to misinterpret. The reality is:

- More than two-thirds of elderly tax filers (67.3 percent) would receive a tax cut of $500 or less.

- More than half (51.6 percent) of tax returns with small business income would receive a tax cut of $500 or less.[16]

Furthermore, the proposal would divert capital from the small business sector and put upward pressure on interest rates. The loss in revenue entailed by the proposal may also ultimately force reductions in government programs that disproportionately assist the elderly, as well as middle-income and lower-income families.

Issue #4: The taxation of corporate income once and only once

My final topic focuses specifically on the dividend tax proposal that is intended to tax corporate income once and only once.[17] Two points are important to emphasize about this proposal:[18]

- First, most corporate income in the United States is not taxed twice. A substantial share of corporate income is not taxed at the corporate level, due to shelters, corporate tax subsidies and other factors.[19] Recent evidence suggests growing use of corporate tax shelters.[20] Furthermore, half or more of dividends are effectively untaxed at the individual level because they flow to pension funds, 401(k) plans, and non-profits.[21] Although data limitations make definitive judgments difficult, the component of corporate income that is not taxed (or is preferentially taxed) appears to be at least as large as the component that is subject to double taxation. That is, the non-taxation or preferred taxation of corporate income is arguably at least as big of a concern as double taxation.

- Second, under the Administration proposal, firms would maximize shareholders' after-tax returns by sheltering corporate income from taxation and then retaining the

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[16] For further discussion of the effects on small businesses, see Andrew Lee, "President's Radio Address and Other Administration Statements Exaggerate Tax Plan's Impact on Small Businesses," Center on Budget and Policy Priorities, January 18, 2003.

[17] The provision would represent a significant tax cut for both dividends and capital gains on corporate stocks. In simplest terms, under the Administration's proposal, dividends paid out of corporate earnings that were already taxed at the corporate level would not be subject to the individual income tax. In addition, earnings that were already taxed at the corporate level and that were retained by the corporation would generate a basis adjustment for shareholders. Such a basis adjustment means that, when the stock is ultimately sold, the increase in stock price due to retained earnings taxed at the corporate level would not generate a capital gains tax liability at the individual level.

[18] This section draws heavily on William G. Gale and Peter R. Orszag, "The Administration's Proposal to Cut Dividend and Capital Gains Taxes," *Tax Notes*, January 20, 2003.

[19] Robert McIntyre, "Calculations of the share of corporate profits subject to tax in 2002." January 2003.

[20] Mihir Desai, "The Corporate Profit Base, Tax Sheltering Activity, and the Changing Nature of Employee Compensation," NBER Working Paper 8866, April 2002.

[21] William G. Gale, "About half of dividend payments do not face double taxation," *Tax Notes*, November 11, 2002. Although taxes are due on pensions and 401(k) plans when the funds are paid out or withdrawn, the effective tax rate on the return to saving in such accounts is typically zero or negative because the present value of the tax saving due to the deduction that accompanies the original contribution is typically at least as large as the present value of the tax liability that accompanies the withdrawal. Also note that a substantial share of capital gains on corporate stocks is never taxed because of the basis step-up at death.

earnings -- the same strategy that maximizes shareholders' after-tax returns under current law. Despite the Administration's claims to the contrary, the proposal therefore does not eliminate, and may not even reduce to a significant degree, the incentives that exist under the current tax system to shelter corporate income from taxation and then to retain the earnings.[22]

The bottom line is that the Administration's proposal does the "easy" part of tax reform: it cuts taxes. It fails, however, to do the difficult part of any serious tax reform effort: broadening the tax base and eliminating the share of corporate income that is never taxed (or taxed at preferential rates). That difference is what distinguishes "tax reform" from "tax cuts."

The approach proposed by the Administration would also undermine the political viability of true corporate tax reform. Any such reform would have to combine the "carrot" of addressing the double taxation of dividends with the "stick" of closing corporate loopholes and preferential tax provisions, but the Administration's proposal simply gives the carrot away. Burman (2003) and Gale and Orszag (2003) discuss modifications to the Administration's proposal that would represent a more balanced approach to changing the system of taxing corporate income.[23]

Conclusion

In conclusion, the Administration's stimulus proposal is not likely to be effective at boosting economic growth in either the short run or the long run; it is fiscally irresponsible; and it is unfair. It would consume resources that could be put to much better use, at a time when we can not afford more reckless tax cuts that fail to address the pressing problems facing the nation.

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[22] Modifying the Administration's proposal to achieve true tax reform – which would tax corporate income once and only once at a non-preferential rate, and eliminate the incentives for corporate tax sheltering as well as double taxation – would require taxing dividends and accruing capital gains at the full corporate tax rate to the extent such capital gains or dividends reflected income not already taxed at the corporate level. The implication is that for the Administration's proposal to achieve its ostensible goals, it would have to be modified to include an increase in the effective marginal tax rate on dividends and an increase in the effective tax rate on accruing capital gains. See William G. Gale and Peter R. Orszag, "The Administration's Proposal to Cut Dividend and Capital Gains Taxes," *Tax Notes*, January 20, 2003.

[23] Leonard E. Burman, "Taxing Capital Income Once," Urban-Brookings Tax Policy Center, January 2003, and William G. Gale and Peter R. Orszag, "The Administration's Proposal to Cut Dividend and Capital Gains Taxes," *Tax Notes*, January 20, 2003.