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OBSERVATIONS ON A STIMULUS PACKAGE

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While there are growing indications that a stimulus package is likely to be needed, caution is in order. A stimulus package that is not well designed could do more harm than good. A package that worsens the already deteriorating long-term budget outlook by reducing revenues or increasing expenditures on an ongoing (rather than temporary) basis would exert upward pressure on long-term interest rates. That would both undercut efforts to stimulate the economy now and place fiscal policy in more difficult straits in years ahead. The combination of the weakening economy, the large tax cut enacted in June, and anticipated ongoing increases in defense, counter-terrorism, intelligence, and aviation security costs has radically altered the medium- and long-term fiscal pictures. Nothing in a stimulus package should aggravate this situation over the long term.

Consequently, a fiscal package should adhere to two key principles: 1) it should be temporary, with all measures terminating as the economy recovers and with permanent tax cuts and spending increases rejected; and 2) it should be effective and efficient as a stimulus, with measures that do not meet this criterion excluded regardless of their desirability on other grounds. The second principle means that stimulus measures should infuse resources into the economy quickly. It also means the package should include a particular focus on low- and moderate-income households, since they consume (rather than save) a larger share of any new funds that they receive than affluent households do.

In designing a package, policymakers should first decide on the overall cost of the package and then adhere to this limit. That should help prevent the package from becoming a vehicle for other items.

Taxes

Proposals for permanent corporate income tax rate cuts and capital gains cuts fail both criteria. A permanent corporate rate cut would have large out-year costs and exert upward pressure on long-term interest rates, which would undercut any stimulative effect it otherwise might have. New analyses from both Brookings and the Center on Budget and Policy Priorities show that a corporate rate cut would be highly inefficient as a stimulus and would materially worsen the long-term budget picture. Former Treasury Secretary Robert Rubin has strongly recommended against such a step. Capital gains cuts are similarly ill-advised. If temporary, a capital gains cut could cause a sell-off of stocks and further depress stock prices. If permanent, the long-term revenue loss would place upward pressure on long-term interest rates. A new Congressional Research Service report notes: “a capital gains tax cut appears the least likely of any permanent tax cut to stimulate the economy in the short run; a temporary capital gains cut is unlikely to provide any stimulus.”

The most desirable tax proposal, as Secretary Rubin has noted, appears to be a rebate focused on low-and middle-income households that includes (rather than excludes) the millions of workers who pay payroll but not income taxes. Focusing on these households — and timing the rebate to coincide with the Christmas shopping season — should increase the share of the rebate that is spent rather than saved. If business tax cuts also are considered, they should be limited to temporary incentives for new investments; there is disagreement among analysts, however, about the effectiveness of such measures, and there is risk such measures would not prove temporary but would become new "tax extenders" that are renewed when they are scheduled to expire.

The most effective stimulus package would couple short-term stimulus measures with a measure to offset the package's cost by deferring or cancelling one of more elements of the big tax cut that are not scheduled to take effect until a future year. While this appears to be politically unrealistic at this time, it's worth noting that it would be sound policy. Not only would it improve the long-term budget forecast, but as Secretary Rubin has noted, it also would make the package more effective as a stimulus because it would exert downward pressure on long-term interest rates. Freezing the tax rate at its current 38.6 percent level would save $100 billion over ten years and serve this purpose well.

Spending

***Unemployment Insurance*:** With a minority of the unemployed receiving unemployment benefits, UI needs bolstering. At least two types of provisions should be included, with both being fully federally funded and slated to expire after a period such as 12 months. These provisions would: 1) improve coverage by ensuring that the most recent earnings are used in determining an unemployed worker's eligibility and benefit levels and also by ensuring that part-time workers who have been laid off and meet all other UI qualifications — such as mothers with young children who work three or four days a week — are not declared ineligible simply because they are not available to work full time (note: these reforms merit being made permanent, but that should be done outside of the context of a stimulus package); and 2) make additional weeks of benefits available to unemployed workers who have exhausted their first 26 weeks of benefits and can't find a job, if the national unemployment rate rises to 5.5 percent (the additional weeks of benefits would be triggered if unemployment reaches this level; the number of weeks of added benefits should vary to some degree based on how high a state's unemployment rate is). Other unemployment insurance improvements also may warrant consideration. In addition, states will need some additional funds for unemployment insurance administrative costs, which rise when the economy turns down.

Health Insurance for Unemployed Workers: Temporary measures are needed to prevent unemployed workers from losing health insurance. Such measures could include: 1) cutting in half the hefty cost that jobless workers must pay for health insurance premiums under COBRA, by having the federal government subsidize half of COBRA premium costs; 2) increasing the federal matching percentage for a portion of state Medicaid costs — such as the costs for the families-with-children component of Medicaid — in recognition of the fact that many lower-income parents who are laid off will need Medicaid during the downturn but states will have difficulty responding to this need without instituting cuts in Medicaid or raising taxes, since states must balance their budgets even in recessions and many state budgets are now heading out of balance; 3) creating a new state Medicaid option, supported by an enhanced federal matching rate, to cover displaced workers who have low incomes but can not qualify for Medicaid because they do not fall into a "Medicaid category," such as low-income unemployed workers without children (Note: many of these workers will not qualify for COBRA and will need Medicaid either because COBRA does not cover workers laid off from small firms or because they will be unable to afford even subsidized COBRA premiums as a result of their low incomes); and 4) addressing problems in funding for the state Children's Health Insurance Program. The combination of a 26 percent cut in federal SCHIP funding that is slated to take effect in FY 2002 and the anticipated reversion of some SCHIP funds to the Treasury on September 30, 2002 may deter some states from meeting increased needs for SCHIP during the downturn.

Food Stamps: After unemployment insurance, the food stamp program is the most responsive program to changes in unemployment. Food stamp benefits are modest; the average benefit is 81 cents per person per meal. A temporary increase in food stamp benefits could be implemented in 30-60 days at virtually no administrative cost (it entails nothing more than a simple change in a few numbers in a state's computer system for determining benefit levels). The vast bulk of the increased benefits would be spent. (Food stamp benefits can not themselves be saved rather than spent. Most food stamp benefits are issued electronically and expire after a few months if not used. Most benefits are spent within 30 days of being issued.) This proposal is well-suited for stimulus purposes, would assist low-income unemployed workers, and also would have some benefits for the food and agricultural sectors.

Relief for States: Many states will have to raise taxes or cut spending by this winter because their budgets otherwise will fall out of balance. Such action by states would be not be desirable for the economy. The federal government should consider extending some temporary fiscal relief to states.

Items with More Modest Costs

WIC: The number of low-income pregnant women, infants, and young children participating in the highly acclaimed WIC program dropped by several hundred thousand when unemployment declined to 4%, but has rebounded in recent months as unemployment has mounted. WIC is not an entitlement, however, and WIC funding does not respond automatically to increases in unemployment and need. The President's budget and the pending FY 2002 appropriations bills were designed before the economy began to deteriorate significantly (and at a time when WIC participation was expected to be significantly lower than the levels it has now attained as a result of the increases in unemployment). The appropriations bills lack funds even to maintain current participation levels, let alone to meet the increased need anticipated in the months ahead. Under the House agriculture appropriations bill, states likely would have to remove or turn away more than 300,000 eligible women, infants, and children at nutritional risk in coming months. Under the Senate bill, which was designed to meet the need as it looked a few months ago, more than 100,000 could be turned away. The funding needed is about $100 million above the level in the pending Senate bill and about $200 million above the House level. WIC is a "fast spend" program; these funds would be spent quickly, making it a good candidate for inclusion in a stimulus package.

Low-Income Energy Assistance: Some $300 million that Congress appropriated earlier this year in the supplemental appropriations bill has not been distributed. It should be put out and possibly supplemented. With more people out of work, more families will need help with their heating bills. This program is one that generally "spends out" quickly. The additional funds could be targeted for use by the winter months when need is greatest.

TANF Contingency Fund: Under the 1996 welfare law, federal funding for states no longer rises automatically in recessions. A "TANF contingency fund" was included in the welfare law to address this problem, but the contingency fund expires on September 30, 2001. Simply extending the fund isn't sufficient: as governors have noted for several years, the contingency fund in the welfare law is fatally flawed and would be ineffective, since it requires a state to increase its state TANF funding by 33 percent in the middle of a downturn before it can receive a dollar in federal contingency funds. The contingency fund should be fixed and extended one year (after which it can be revised in the normal TANF reauthorization process). Funding for the TANF "supplemental grants" that 17 of the poorest states receive, also scheduled to expire on September 30, 2001, should similarly be extended. A recession is not the time to reduce states' TANF funding below current levels.

Other Items: Other modest items that warrant consideration are a temporary increase in funding for the Labor Department's dislocated workers program, which provides training and employment-related services to dislocated workers (and for which need increases in downturns) and possibly for the Social Services Block Grant, which provides flexible funding to states to meet needs for a broad range of services for low- and moderate-income families. Demand for these services also is expected to rise as unemployment mounts, and this program "spends out" quickly. Temporary improvements in the child support enforcement program to provide low-income custodial parents with more of the child support collected on their behalf also might be considered as a way to put more funds in these families' hands during the downturn.