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# REPORT FINDS MOST ADMINISTRATION "GROWTH" PROPOSALS WOULD BE INEFFECTIVE ECONOMIC STIMULUS

By Andrew Lee and Joel Friedman

A recent analysis by Economy.com, an independent financial research group, finds that the principal tax cuts proposed by the Administration in its "economic growth" package would be inefficient as a means of stimulating the economy in the near term.[1] Given the continuing weakness in the economy, any tax-cut legislation enacted this year will be assessed in part on its ability to boost the nation's sluggish economy in the next year or so.

The Economy.com report notes that an efficient fiscal stimulus proposal is one that "increases demand most quickly at least cost to the Treasury"— that is, one that provides substantial "bang for the buck" now, while the economy is in need of stimulus. The Congressional Budget Office used the same standard when it evaluated stimulus proposals in a January 2002 report.

The Economy.com analysis calculates how much each dollar of lost tax revenue or increased spending would generate in terms of increased demand in the year after the benefit is provided. It finds that:

- The proposal to eliminate the taxation of corporate dividends is one of the least effective forms of economic stimulus, generating less than a dime of stimulus for every dollar of revenue lost. This tax cut represents more than half of the $726 billion cost of the Administration's "growth" package through 2013.

- Tax cuts that affect large numbers of moderate-income and middle-income households — such as accelerating the scheduled widening of the 10 percent tax bracket and the scheduled expansion of the child tax credit — would be relatively effective economic stimulus, boosting the economy by more than one dollar for each dollar of lost revenue. These proposals account, however, for less than one-fifth of the cost of the Administration's package through 2013.

- State fiscal relief is one of the most effective forms of economic stimulus. It would deliver more stimulus per dollar of cost than *all* of the tax-cut proposals under consideration, with the sole exception of accelerating of the widening of the 10 percent tax bracket.

- The single most effective stimulus measure is further extension of emergency federal unemployment insurance benefits. The current extension of these benefits runs only through May 31. Given the current state of the economy and the job market, these

[1] "The Need For Federal Government Aid to State Government," Economy.com, February 2003.

| "Bang for the Buck" For Economic Stimulus Proposals<br>*One Year Change in Real GDP Relative to Each Dollar of Federal Government Revenue Loss or Spending Increase* | |
|---|---|
| Extend Emergency Federal UI Benefits | $1.73 |
| Accelerate 10% Bracket | $1.34 |
| State Government Aid | $1.24 |
| Child Tax Credit Rebate | $1.04 |
| Marriage Tax Penalty | $0.74 |
| Alternative Minimum Tax Adjustments | $0.67 |
| Accelerate Reduction in Personal Marginal Tax Rates | $0.59 |
| Business Bonus Depreciation Expansion | $0.35 |
| Small Business Investment Writeoff | $0.24 |
| Dividend Taxation Reduction | $0.09 |
| Business Health Insurance Tax Credit | $0.05 |

*Source: Economy.com*

benefits almost certainly will need to be extended again. Nevertheless, an amendment to the Senate budget resolution to extend these benefits beyond May 31 and enhance them — and to pay for the modest cost by slightly scaling back the tax cut — was opposed by the Administration and narrowly defeated on a largely party-line vote on the Senate floor in late March.

**Short-Term Economic Stimulus**

In its report, Economy.com explains that the economy is operating below its potential. The economy is not creating enough new jobs, unemployment remains high, some manufacturing capacity is going unused, and commercial space vacancies are rising. Increasing short-term demand through fiscal stimulus could help to address these issues and speed economic recovery by helping the nation utilize more of its productive capacity.

The report indicates the degree to which various proposals would boost the economy over the next year. The results are presented in the table at the top of this page. The table shows, for example, that for every $1 in unemployment insurance benefits provided by extending the temporary federal unemployment benefits program, an estimated $1.73 in demand will be generated in the year ahead.

Of the proposals in the Administration's "growth" package, only two — accelerating the widening of the 10 percent bracket and accelerating the increase in the child tax credit — would generate more than a dollar of economic action for each dollar in cost. These provisions focus their tax-cut benefits primarily on lower- and middle-income households, which are more likely to spend these funds quickly than high-income households are.

In contrast, other provisions in the Administration's package would be relatively inefficient ways of providing short-term economic stimulus. These provisions — including accelerating the reductions in rates and eliminating the taxation of dividends — would fall far

short of "breaking even." In other words, $1 of lost tax revenue on these provisions would provide *less* than $1 of stimulus in the year ahead. The analysis finds that the dividend tax cut would be particularly ineffective — generating only 9 cents of additional stimulus in the coming year for each $1 of lost revenue.

The report shows also that state fiscal relief would be one of the most effective ways for the federal government to stimulate the economy. This is because such relief would forestall immediate state budget cuts and tax increases that would place a drag on the economy.

**Long-Term Economic Growth**

The Economy.com report focuses on the impact of the President's proposals on the near-term economic outlook. Some have suggested that the tax cuts in the Administration's "growth" package are justified because they will spur economic growth in the long term. Two recent studies of the long-term economic impacts of the Administration's proposals find, however, that they would likely have small — and possibly negative — effects on long-term economic growth.

Macroeconomic Advisers, a well-known economics consulting firm whose economic forecasting model is used by the President's Council of Economic Advisers, analyzed the Administration's economic "growth" plan and found that while it would provide some initial stimulus, it would have only a small impact on the economy over the long term.[2] Moreover, the report concluded that the long-run impact of the "growth" package on the economy is likely to be slightly negative.

The Congressional Budget Office recently released an analysis of the tax and spending proposals in the Administration's budget, including the "growth" package.[3] It stated that "the overall macroeconomic effect of the proposals in the Administration's budget is not obvious" and concluded that "regardless of its direction [positive or negative], the net effect on output through long-term changes to the supply side of the economy ... would probably be small."

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[2] "A Preliminary Analysis of the Administration's Jobs and Growth Proposals," Macroeconomic Advisers, January 10, 2003. It is worth noting that while Macroeconomic Advisers and other analysts find that the Administration's plan would provide some initial stimulus, the amount of stimulus is relatively small given the overall cost of the proposal. An analysis by the Joint Economic Committee Democratic staff, for example, finds that the Administration's plan would have some positive short-term effect (consistent with the Macroeconomic Advisers finding), but that an alternative approach that focuses on state fiscal relief, strengthening unemployment benefits, and temporary tax cuts targeted on middle- and lower-income households would provide significantly larger short-term stimulus than the Administration's proposal. See "Policies to Restore Full Employment and Promote Long-Term Growth," Economic Policy Brief, Joint Economic Committee — Democrats, March 2003.

Further, as noted above, the Macroeconomic Advisers report concludes that the short-term gains from the Administration's proposal would be reduced and ultimately reversed over the long run because the proposal would swell long-term deficits leading to lower national savings and investment. The alternative approach analyzed in the JEC report would have a much smaller effect on national savings because it would have virtually no cost after the first year and hence would have little effect on long-term deficits.

[3] "An Analysis of the Administration's Budgetary Proposals for Fiscal Year 2004," Congressional Budget Office, March 2003.

A principal reason these analyses conclude that the long-term impact of the Administration's proposals is likely to be small or negative is that over time, the positive incentive effects of the tax cuts are likely to be offset by the negative impact of reduced national savings. (National savings would be reduced because the tax cuts would swell long-term deficits. As a result of the reduction in national savings, the amount of funds available for investment would be lowered.) Because of these offsetting effects, the net impact of the Administration's tax cuts on the economy over the long term is likely to be small.