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Senate Republican Leadership Stimulus Plan Retains Ineffective And Costly Proposals

by Joel Friedman and Robert Greenstein

Republican Senators Pete Domenici, Trent Lott, Charles Grassley, and Christopher Bond presented an "alternative" stimulus plan on November 26 as part of the fledgling negotiation process to reach agreement on a package of tax cuts and program increases to stimulate the economy.

- This Senate Republican leadership proposal retains some of the more costly and ineffective stimulus provisions that have been proposed, notably the repeal of the corporate Alternative Minimum Tax and the acceleration of income-tax rate reductions in the 28 percent bracket.

- Further, the alternative eschews one of the most effective and badly needed types of stimulus measures — fiscal relief to states to ease the need for states to cut programs or raise taxes during an economic downturn — and instead would cause states to lose additional tax revenue and to have to institute larger budget cuts or tax increases in the months ahead.

- While providing generous tax cuts to business that would likely have little stimulative effect, the plan offers only modest assistance to unemployed workers.

The Senate Republican alternative also includes a proposal that would cancel for one month the Social Security payroll tax paid by workers and their employers. A payroll tax holiday is unlikely to yield much stimulus relative to its $38 billion cost. Claims that the holiday can be implemented quickly appear overly optimistic, and it would not provide much assistance to low-income workers, particularly when compared to the supplemental rebate for low- and moderate-income families — a provision that is part of all other stimulus plans, including the House-passed package, but is missing from the Senate Republican alternative.

Overall, the Senate Republican alternative, with a ten-year price tag of $142 billion, is a relatively expensive package — costing nearly twice as much over ten years as the Senate Finance Committee plan. (See table on page 3.) Moreover, $43 billion of this cost occurs after 2002, when most economists predict the economy to be recovering from the recession. Costs incurred after 2002 offer no near-term stimulus and would place more pressure on the budget — an unwise policy, particularly in the light of the recent acknowledgment by the Administration's Budget Director that the budget will be in deficit for the next several years.

Payroll Tax Holiday Unlikely to be Effective Stimulus

The one innovation in the Senate Republican alternative is a month-long payroll tax holiday. The proposal applies to both the employee and employer shares of the payroll tax, so the tax-cut benefits this measure would provide would be divided among employees and employers. Thus, it is as much a tax cut for business as for workers. Overall, the proposal does not appear to live up to the claims of its supporters; it is likely to be relatively ineffective as a stimulus measure.[1]

- It is extremely unlikely that this tax holiday could be implemented in time to boost Christmas spending or in January, as some of the proposal's supporters have suggested. According to a recent analysis issued by several associations of payroll managers, it may in fact take a number of months to implement this proposal. To be effective, stimulus should be delivered sooner rather than later.

- The proposal does not offer significant benefits to low-income workers — a group that is most likely to spend any extra funds, thereby giving a needed boost to the economy — particularly when compared with the supplemental rebate proposal. Workers earning the minimum wage, for instance, would receive about $50 from the payroll tax holiday but would receive six times as much from the rebate. (If they are married and their spouse does not work, the rebate would be 12 times as great as the payroll tax holiday.)

- The share of the payroll tax holiday that benefits business will have little effect in stimulating the economy, because it does not require firms to undertake new investment to receive the tax cut. Unless tied to new investments, business tax breaks tend to be retained by companies or distributed to owners and shareholders in the form of higher dividends, rather than spent on new investments. Indeed, Federal Reserve data show that from the end of 1999 to the middle of 2001, holdings of liquid financial assets by nonfarm, nonfinancial corporations rose by more than $100 billion (a 17 percent increase). Injecting more cash into these companies without linking it to new investment, as the payroll tax holiday will do, is unlikely to have much effect in stimulating the economy.

- The half of the payroll tax cut that would go to individual taxpayers would be distributed to higher-income taxpayers to a greater degree than the tax rebates issued last summer, and the lion's share of those rebates appears to have been saved rather than spent. This reality, along with the fact that half of the tax

[1] Robert Greenstein and Peter Orszag, "Attractions of Payroll Tax Holiday Diminish Upon Closer Examination," Center on Budget and Policy Priorities, December 4, 2001.

Comparison of Senate Republican Leadership Alternative and the Senate Finance Committee Plans

(in billions of dollars)

	Senate Republican Alternative*		Senate Finance Committee**	
	2002	10-year	2002	10-year
Bonus depreciation	26.2	11.9	14.9	2.3
Repeal corporate AMT	9.0	22.0	—	—
Five-year carry back of losses	—	—	4.6	0.1
Supplemental rebates	—	—	14.2	14.2
Payroll tax holiday	38.0	38.0	—	—
Accelerate enacted tax cuts	12.8	53.7	—	—
Unemployment insurance	8.1	11.0	14.9	20.1
State fiscal relief	—	—	4.7	5.1
COBRA and Medicaid	—	—	6.9	10.2
National Emergency Grants	4.0	5.0	—	—
Expiring tax provisions	—	—	1.0	3.1
New York and distressed areas	—	—	1.8	5.3
Other	—	—	3.7	11.3
TOTAL	98.1	141.6	66.5	71.7

*There are no official cost estimates of the Senate Republican leadership alternative. The figures in the table reflect cost estimates that were reported in the media as well as Joint Committee on Taxation and Congressional Budget Office estimates of identical or largely similar proposals.

**Joint Committee on Taxation, "Comparison of Estimated Budget Effects of H.R. 3090, As Passed By the House of Representatives And As Scheduled for Consideration on the Senate Floor," JCX-85-01, December 5, 2001. Estimates are adjusted to reflect a modification made by the Manager's Amendment to the financing mechanism for the unemployment insurance provisions. Other modifications made by the Manager's Amendment, such as the addition of spending for homeland security, are not reflected; official cost estimates for these changes are not available.

reduction would be provided in a windfall to businesses, suggests that the bulk of the tax reduction from a payroll tax holiday, as well, would be saved.

Inadequate Assistance for the Unemployed

The Senate Republican leadership embraced a Senate Finance Committee proposal to provide an additional 13 weeks of unemployment benefits for those who exhaust their regular benefits. Given the upsurge in the number of unemployed workers who have recently exhausted their benefits, this provision will be an essential component of any final stimulus package. In terms of other assistance for the unemployed, however, the proposals by the Senate Republican leadership fall well short of what is needed.

- The Senate Republican leaders rejected two significant temporary improvements in unemployment benefits contained in the Finance Committee stimulus plan. These provisions would make more part-time and recently employed workers eligible for benefits when they are laid off and provide for a modest increase in unemployment benefits.

- The Senate Republican leaders continue to support the Administration's approach of using National Emergency Grants to address the problem of helping people maintain health insurance coverage after they lose their jobs. This program would be neither an effective nor an expeditious way to provide health insurance to unemployed workers, and the Administration's approach would exclude many low-income workers.[2] Overall, the $5 billion allocated to NEGs would assist only a fraction of the unemployed. The Senate Finance Committee package, by contrast, includes several provisions that would help many more unemployed workers, including those with low incomes, maintain health insurance coverage.

Expanded unemployment insurance benefits are a highly effective economic stimulus. In a recent analysis, Nobel Prize winning economist Joseph Stiglitz and Brookings Institution senior fellow Peter Orszag noted that "in a recession, the primary problem is that the nation's firms face a reduction in demand for their products — not that they lack available workers, equipment, or anything else needed to produce goods and services."[3] Increasing unemployment benefits addresses this critical demand problem by boosting consumer spending and thereby helping other workers keep their jobs. In fact, by increasing aggregate demand, increased unemployment benefits are more effective in providing economic stimulus and reducing layoffs than most corporate tax cuts.[4]

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[2] Sandra Clark, "Do Proposals to Increase Funding for National Emergency Grants Provide an Effective Way to Meet the Health Insurance and Other Needs of Laid-off Workers?," Center on Budget and Policy Priorities, revised November 27, 2001. Under the Administration's plan, NEG funds could only be used to help unemployed workers who can purchase health insurance through their former employers (known as COBRA); workers ineligible for COBRA typically have lower incomes or worked for small firms. Further, not all COBRA-eligible workers would receive assistance under the Administration's plan because of the limited amount of funds being provided.

[3] Peter Orszag and Joseph Stiglitz, "Tax Cuts Are Not Automatically the Best Stimulus: A Response to Glenn Hubbard," Center on Budget and Policy Priorities, November 27, 2001.

[4] Peter Orszag, "Strengthening Unemployment Benefits Would Be Much More Effective in Saving Jobs than Most Corporate Tax Cuts," Center on Budget and Policy Priorities, November 14, 2001.

Individual Tax Cuts More Tilted to Upper-Income Taxpayers

While short-changing workers who have lost their jobs, the Senate Republican alternative would dedicate a considerable share of its tax-cut benefits to upper-income workers. The Senate Republican proposal would accelerate the reduction in the 27 percent tax rate to 25 percent. With a cost of $53.7 billion, this is the largest item in the package. Only the top one-quarter of taxpayers would benefit from this proposal, and the top five percent — those with incomes of over $150,000 — would benefit the most. This upper-income group would net $1,300 in 2002 and nearly $4,000 over the next four years from this proposal. A married couple with two children and an annual income of $66,550 or less, on the other hand, would receive no benefits from this proposal.

The tilt toward upper-income taxpayers diminishes the effectiveness of the proposal as short-term economic stimulus. First, research has shown than those with higher incomes are more likely to save (and not spend) an additional dollar in income than low- and moderate-income families. Tax cuts only generate the needed stimulus if they are spent, not saved. Second, according to the Joint Committee on Taxation, more than three-quarters of the $53.7 billion cost of accelerating the implementation of the 25 percent rate would be incurred *after* fiscal year 2002 — that is, when the economy is in recovery — undermining its rationale as effective short-term stimulus.

Corporate AMT Repeal Is Ineffective Stimulus

The Senate Republican plan retains the Administration's proposal that would permanently repeal the corporate Alternative Minimum Tax. This business tax break is poorly designed as a stimulus measure, providing no incentive to spur new business investment. But only new business investment is stimulative. In a recent analysis, Brookings Institution senior fellows William Gale and Peter Orszag estimate that in 2002, approximately 90 percent of the tax reductions from eliminating the corporate AMT would consist of tax cuts on profits from *old* investment — that is, investments made in years before 2002 — rather than new investment.[5] The Brookings analysis concludes that repealing the corporate AMT consequently would do little to provide short-term stimulus.

While the Senate Republican alternative does not include the widely reported provision of the House bill under which the Treasury would write large checks to corporations that have accumulated AMT credits, these corporations would still be able to claim most of these credits in later years under the Senate Republican plan. This is why there is little difference in cost over ten years between the Senate Republican and the House corporate AMT provisions. Under the House corporate AMT provision, these corporations would gain $24 billion in tax breaks over

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[5] William Gale and Peter Orszag, "Evaluating President Bush's Tax Stimulus Package," Brookings Institution, October 9, 2001.

ten years. Under the Senate Republican's provision, these corporations would secure $22 billion in tax breaks. The same corporations — such as IBM, General Motors and General Electric — that would benefit under the House bill would reap substantial benefits under the Senate Republican's corporate AMT repeal proposal as well.

Furthermore, like the proposal to accelerate rate reductions, the appropriateness of repealing the corporate AMT as a stimulus proposal is further undermined by the fact that in the Senate Republican alternative, about 60 percent of the ten-year cost of repeal would occur after 2002, in years when the economy is expected already to have recovered from the current recession. The proposal would not only be ineffective at meeting the economy's short-term needs, but would worsen the long-term budget outlook.

Proposal Also Would Worsen State Fiscal Problems

The Senate Republican alternative also would deepen the fiscal problems facing states because it includes a provision that would result in states losing significant tax revenue. A business tax cut that is part of all the major stimulus packages — a provision that allows firms to write off immediately a portion of the cost of investments in new equipment and certain other items — would result in 46 states losing revenues. Forty-four of these states conform their state's corporate and individual income tax rules to the federal rules in such a way that enlarging the depreciation deductions at the federal level automatically causes these deductions to grow larger at the state level as well. Two other states would lose revenues because of other effects this tax cut would have on their state tax codes. Since states already face budget shortfalls, instituting a federal tax cut that causes states to lose additional revenue will necessitate states cutting programs or raising taxes to a still-greater degree to meet balanced budget requirements. These budget-tightening actions by states would further dampen economic activity and offset part of the stimulative effect that a federal stimulus package aims to have.

Under the Senate Republican alternative, states would lose approximately $3.5 billion in revenue in 2002 and similar amounts in each of the next two years as result of this provision, for a three-year revenue loss of nearly $10 billion. In contrast, states would lose only $2 billion for one year under the depreciation provision in the Senate Finance Committee plan. More important, the Finance Committee bill provides $5.1 billion in state fiscal relief, offsetting the impact of its depreciation tax cut and providing needed support to state budgets. The Senate Republican alternative eliminates the $5.1 billion in state fiscal relief provided in the Senate Finance Committee measure. Although state and local governments would, because they are large employers, receive some benefit from the payroll tax holiday in the Senate Republican proposal, this benefit would offset only a modest fraction of the revenue loss that the plan's depreciation provision would cause them to incur.[6]

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[6] Federal Funds Information for States estimates that states would save about $600 million in tax payments from the payroll tax holiday. See FFIS, "Impact of Social Security Tax Holiday on States," Issue Brief 01-61, November

Long-term Costs of Proposal Worsen Budget Outlook

Finally, the Senate Republican alternative is an expensive proposal, costing nearly 50 percent more than the Senate Finance Committee plan in 2002 and nearly twice as much over 10 years. Of particular concern is the $43 billion cost of the Senate Republican proposal after 2002, which primarily reflects the impact of its permanent tax cuts, such as the repeal of the corporate AMT, and the acceleration of tax rate reductions. This added fiscal burden offers no near-term stimulus to the economy, which most economists believe will be out of recession well before the end of 2002. Rather, these additional costs — which provide benefits only to higher-income taxpayers and profitable corporations — would worsen an already deteriorating budget outlook over the next several years.

According to recent projections by the Administration's Budget Director, Mitchell Daniels, the budget including Social Security will be in deficit through 2004. This dramatic turnaround in the nation's finances is due primarily to the tax cut enacted this summer, the weakening economy, and added defense and security costs following the events of September 11.[7] Additional multi-year or permanent tax cuts would only worsen the budget outlook, increasing the debt and placing more upward pressure on long-term interest rates.

The long-term implications of the Senate Republican alternative are more worrisome than even the cost estimates imply, because some of its provisions have the potential to result in even greater revenue losses over time. For instance, the Senate Republican alternative includes a proposal that allows businesses to write off immediately (or "expense") 20 percent of the cost of new investments made in equipment and certain other items over the next three years. Having the provision in effect for three years not only weakens its effectiveness as economic stimulus — since firms will be able to delay investment decisions for a year or two, while they wait for the business climate to improve, and still get the tax break — but raises the concern that this tax cut will never be allowed to expire. By keeping this provision in effect long after the economic slowdown has ended, the original rationale for sunsetting the proposal will likely have faded by the time the provision is scheduled to expire. By then, this tax break may have come to be viewed as a standard feature of the tax code, making it more likely that Congress will continue it, just as numerous other expiring corporate tax provisions are routinely extended each year. If this

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2001. States also would likely receive slightly higher revenues from businesses as a result of the payroll tax holiday. Businesses deduct labor costs, including payroll taxes, from their income for tax purposes. By not paying the payroll tax for a month, businesses would have lower deductions and thus higher taxable incomes. Although states would generate somewhat higher revenues from the month-long holiday, these added revenues would be far less than the revenue losses associated with the plan's expensing proposal.

[7] Richard Kogan and Robert Greenstein, "The Disappearing Surplus," Center on Budget and Policy Priorities, December 3, 2001.

provision becomes part of the regular package of "tax extenders," its future costs will be very large — exceeding the $11.9 billion cost of the temporary provision by at least 15-fold.[8]

Conclusion

The Senate Republican alternative fails to meet the criteria of an effective stimulus package. It continues to rely on proposals found in the House-passed and Administration packages that would be largely ineffective as stimulus, such as repeal of the corporate AMT and acceleration of rate reductions. The alternative includes a new proposal to provide a month-long payroll tax holiday; but this proposal — the benefits of which are shared by businesses and workers — seems likely to generate substantially less stimulus than its advocates claim, especially considering that it may not be possible to implement the holiday for several months and that the half of the benefits would go to businesses regardless of whether the businesses made new investments or retained their workers. In addition, the payroll tax holiday offers only a small benefit to low-income workers, especially in comparison to the supplemental rebate that is included in all other stimulus packages but missing from the Senate Republican plan.

Finally, although the Senate Republican alternative proposes additional weeks of unemployment benefits for those who exhaust their regular benefits, it fails to include other important assistance for the unemployed contained in the Senate Finance Committee plan. The alternative also rejects proposals for fiscal assistance to the states. Leading economists have identified additional benefits for the unemployed and fiscal relief for states as two of the most effective stimulus measures that Congress can adopt.[9] Overall, the Senate Republican alternative is likely to yield only modest near-term stimulus and would burden the budget with unnecessary costs in future years and thereby worsen the already deteriorating long-term budget outlook.

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[8] There are no official estimates of a permanent extension of this proposal. However, Joint Tax Committee estimates indicate that if the 30 percent bonus depreciation in the House bill were to remain in effect for the next ten years rather than expiring after three years, its cost would be $265 billion over the coming decade — or nearly 15 times the $18 billion that is shown as the cost of such a provision if it is scheduled to expire after three years.

[9] See testimonies of William Gale and Peter Orszag, both of whom are senior fellows at the Brookings Institution, before the Senate Budget Committee, October 25, 2001.