Economic Stimulus:
Principles and Options

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ECONOMIC STIMULUS: PRINCIPLES AND OPTIONS

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EXECUTIVE SUMMARY

The events of September 11th have taken a toll on the economy as well as the nation. With the country now closer to the brink of recession, President Bush and Congressional leaders have agreed to craft an economic stimulus package in an effort to spark the faltering economy.

In general, the design of a stimulus package should be focused on two objectives. First, it should have a rapid impact that injects spending into the economy, shores up business and consumer confidence, and assists those most vulnerable to an economic slowdown as quickly as possible. At the same time, however, an economic stimulus package should recognize the importance of fiscal discipline over the long-term to economic growth. Thus, measures to stimulate the economy should be limited in time, so that as the economy recovers, the budget can come back into substantial surplus.

If the stimulus is sizeable but comes too late–in other words, after the economy has started to recuperate–it can do harm to the economy by creating new inflationary pressures without much offsetting benefit. If tax cuts or other stimulus measures do not generate new spending while economic performance is sub-par, they are an ineffective waste of budgetary resources.

This report assesses a variety of stimulus proposals in light of their impacts on the economy and the degree to which they have a stimulative effect. The cost estimates attached to each proposal are preliminary. The estimates were prepared by the Democratic staff of the Joint Economic Committee or taken from published estimates by the Joint Committee on Taxation, to facilitate discussion of alternative proposals estimated on a consistent basis.

Overall, measures that increase consumer incomes directly are likely to have the greatest impact on short-run consumer spending, and therefore will stimulate the economy most quickly and effectively. Spending proposals have an important place in any stimulus package, because they can often be implemented fairly quickly, can be turned off when they are no longer needed, and can be targeted to those most affected by the recession.

Proposals involving spending on safety net programs such as Unemployment Insurance and the Food Stamp Program benefit those likely to be hurt most by a recession and decline automatically in size as the unemployment rate and the poverty rate fall during recovery. Discretionary spending proposals on infrastructure programs or for purposes such as revenue sharing with states are even easier to reduce, simply by appropriating fewer funds in years when the need is less.

The relative merits of alternative tax stimulus proposals depend heavily on their likely effects on short-term consumption. Consumer spending was the key reason that the economic slowdown prior to September 11th was not a full-scale recession. Now that consumer confidence is shaken, consumer spending is much more likely to fall. While some tax stimulus options would target business investment, it is highly questionable whether businesses will want to undertake new investment while business inventories remain high, capacity utilization is low, and consumer demand looks so weak. Boosting consumption would give business more reason

to invest and actually could provide a greater stimulus to investment than a cut in the effective tax rate on investment. Moreover, investment incentives are usually targeted to particular types of capital or particular industries, creating preferences that are not necessarily justified given a general slowing of the economy.

One way to encourage greater short-term consumption would be to direct more of any new tax cut toward lower-income households who out of necessity spend larger fractions of their income. Because only households who paid federal income taxes received the recent tax rebate, many lower-income families who work and pay payroll taxes were left out.

The events of September 11th have increased pressures to spend more of the short-run federal budget, and have made it more appropriate to allow some budget deficit in the near term. The long-term pressures on the government budget due to the impending retirement of the baby boomers have not gone away, however.

Eventually, money spent on stimulus now should be offset in the future, in order to maintain the long-run growth of the economy and allow us to meet our future needs. Further, if a stimulus package is seen as committing large amounts of public funds out in the future (long after the economy will have recovered), markets will react by pushing longer-term interest rates up. This in turn would have a depressing effect on *current* economic activity. Therefore, implementing permanent policies for the sake of short-run stimulus is likely to prove counter-productive.

A way to "pay for" the short-run stimulus package over time (and after the economy recovers) is by "freezing" portions of the tax cut a few years from now, at a less-than-fully-phased-in level. Such a strategy would preserve the long-term strategy of maintaining fiscal discipline, while reducing a portion of the recently enacted tax cut for the two percent of Americans with the highest incomes.

INTRODUCTION: THE NEED FOR STIMULUS

The terrorist attacks of September 11 have affected our nation in a wide variety of ways. One significant effect has been a sharp blow to our economy. While our long-term growth prospects remain strong, it now looks as though the country may go through a period of economic weakness and rising unemployment before we regain our economic footing and once again are growing strongly. A well-designed economic stimulus package can play an important role in mitigating that weakness and promoting a rapid recovery. In the short run, such a package may well push the budget into deficit. But as long as we are careful to enact an economic stimulus package that has its maximum impact in the short run and does not undermine long-term fiscal discipline, we can afford to take the measures necessary to defend the country and get the economy moving again.

The economy was already weak at the time of the terrorist attacks. Growth in GDP had been slowing, and was only 0.3 percent in the second quarter. The unemployment rate, which had been close to 4 percent for all of 2000, had increased to 4.5 percent in the spring and then to 4.9 percent in August. Factory operating rates plunged to their lowest levels since 1983, as producers of computers, semiconductors, and communications equipment are operating with more idle capacity than ever before. Domestic and foreign demands for U.S.-produced capital goods plummeted in the second quarter of the year.

Some observers predicted that a turnaround in economic activity was imminent, but the shock to the economy from the terrorist attacks dashed hopes for a quick revival. Comprehensive government statistics on the state of the economy are published with a lag, but there was abundant evidence that economic activity stalled in the immediate aftermath of the attacks. The latest unemployment report, based on data from the week of the attacks and therefore not representative of any subsequent effects, showed a sharp drop in payroll employment of almost 200,000 jobs. Since September 11, businesses have announced more than 100,000 layoffs, and new claims for unemployment insurance have surged. Moreover, preliminary estimates indicate that retail sales declined in September by far more than most analysts had predicted.

The consensus forecast anticipates that the economy will contract in the third and fourth quarters. Recovery is expected in 2002, but the shock to business and consumer confidence has been substantial, and the downside risks, particularly for household spending and exports, are real. Ongoing surveys of households report that a majority of consumers expect job and income prospects to worsen.

The key to achieving a rapid recovery is to bolster incomes. When cash-strapped households cut back on their spending, businesses will face falling sales and will be reluctant to invest. That would further lower incomes, initiating a downward spiral of economic activity. The traditional remedy in such a case is economic stimulus. The Federal Reserve has been providing such stimulus through the year with a succession of interest rate cuts. But the President and the Congress are nearing agreement that more stimulus will be required. We have already taken actions to provide some of that stimulus through emergency recovery spending and

the actions taken to assist the airline industry. These measures alone will provide and additional $40 billion of spending in 2002.

At this point, there is still a lack of hard information as to how much additional stimulus is needed. Yet, for it to be most effective, the stimulus must be decided upon and implemented as rapidly as possible. As a result, a stimulus package will necessarily entail risks that the amount of federal government support will turn out to have been insufficient, on the one hand, or too generous on the other. If the stimulus is too small, it would fail to keep the economy from slipping into the downward spiral. If the stimulus were too large, it could boost demand so much that prices would rise and the inflation rate would move upward. In that case, the Federal Reserve would be under pressure to reduce, if not reverse, its stimulus much sooner than anyone had expected, leaving it to work against the fiscal stimulus and further disrupting economic activity. The fiscal stimulus should be crafted so as to minimize those risks.

PRINCIPLES FOR A STIMULUS PACKAGE

In general, the design of a stimulus package should be focused on two objectives. First, it should have a rapid impact that injects spending into the economy, shores up business and consumer confidence, and assists those most vulnerable to an economic slowdown as quickly as possible. At the same time, however, an economic stimulus package should recognize the importance of fiscal discipline over the long-term to economic growth. Thus, measures to stimulate the economy should be limited in time, so that as the economy recovers, the budget can come back into substantial surplus. If we allow the cyclical budget deficit that we are likely to face in the short-term to turn into a long-term structural deficit we will have done ourselves a disservice. To abandon long-run budget discipline would not only be a disservice to future generations; it would also be a disservice to ourselves because financial markets would impose a price on us today in the form of higher interest rates that would undermine the positive effects of any stimulus we were trying to provide.

In particular, a stimulus package should adhere to the following principles:

- Adequate size. Any stimulus package should be large enough to have an impact on a $10 trillion economy. A bipartisan report by the Senate and House Budget Committees laying out principles for economic stimulus recommends further action that would bring the total amount of stimulus in 2002 up to about $100 billion (1 percent of GDP). This is the figure that Federal Reserve Chairman Alan Greenspan and former Treasury Secretary Robert Rubin have recommended to the Congress. More may turn out to be required if the economy does not respond quickly, but too large an immediate injection could overstimulate the economy and increase inflationary pressures.

- Rapid impact. The bulk of the stimulus should be felt in the next two or three quarters when the economy is weak. More often than not, economic stimulus in the past has not been implemented until the economy was already recovering. Stimulus that comes too late forces the Federal Reserve to raise interest rates in order to keep demand from growing so fast as to generate inflation.

- Short duration. Stimulus proposals should be designed to phase out rapidly. Because of the enduring importance of long-term fiscal discipline, stimulus proposals should not

have significant multi-year budgetary effects. Thus permanent tax cuts or new infrastructure spending that spends out slowly are not attractive candidates for stimulus, whatever their overall policy merits. Safety net programs such as Unemployment Insurance, on the other hand, are designed to be counter-cyclical, contracting as the economy improves. Increases in these programs are therefore a better choice for providing fiscal stimulus without significantly boosting spending when stimulus is no longer needed.

- Maximum effectiveness. Stimulus proposals should maximize the amount of short-term economic activity created per dollar of outlays or revenue lost. For example, a tax cut for low- or moderate-income households who are likely to spend nearly all of the extra income is more effective as stimulus than a similarly sized tax cut for higher-income households who are more likely to save a substantial portion of it. Similarly, increased government outlays to provide unemployment benefits for those who lose their jobs are likely to be spent quickly.

This report assesses a variety of stimulus proposals in light of these criteria. It does not recommend any particular proposal or package of proposals; rather, it tries to give the pros and cons of each proposal and to discuss the extent to which proposals are or are not consistent with the principles laid out above. In addition, the report considers specific proposals only in light of their potential impacts on the economy. It does not assess their merits on the basis of other criteria; nor does it address proposals whose primary purpose does not relate to economic stimulus. For example, we may assume that the costs of providing for national security and for countering terrorism will be large in the coming years, but those costs are not addressed here. How much should be spent on security is not an issue that can be or should be assessed primarily on economic grounds, although to preserve the health of the economy we may eventually need to adjust other spending or tax policies to accommodate needs in this area.

NEW SPENDING AND TAX CUTS ALREADY IN PLACE

The combination of tax cuts enacted in June of this year, emergency spending and aid to the airline industry will amount to about $40 billion in fiscal stimulus in FY 2001, and over $100 billion in fiscal stimulus in FY 2002, about 1 percent of expected GDP in that year (see Table 1).

Supplemental spending. Congress has approved $25 billion in additional spending for defense and education beyond that agreed to in the budget resolution.

Emergency spending. Congress has approved $40 billion in emergency spending through the Emergency Supplemental Appropriations Act for Recovery From and Response to Terrorist Attacks on the United States (H.R. 2888). The Act provides an immediate $10 billion to cover a response to the attacks, repairs to facilities, and increased anti-terrorist and other security efforts. It makes another $10 billion available 15 days after the White House informs Congress of a plan for its use, and provides that the remaining $20 billion will be incorporated into FY 2002 spending bills.

Table 1

Fiscal Policy Changes Already Enacted

Fiscal Year:	2001	2002	Total Impact 2001-2011[1]
Spending Increases (billions of dollars):			
Additions to FY 2002 Discretionary Spending[2]	–	10	25
Emergency Anti-Terrorism Supplemental	–	25	40
Airline Assistance	–	6	15
Total Spending Increases:	–	41	80
Tax Changes (billions of dollars):			
Revenue Reductions Resulting from the Economic Growth and Tax Relief Reconciliation Act of 2001[3]	-41	-71	-1,349
Outlays for Refundable Tax Credits Included in the Economic Growth and Tax Relief Reconciliation Act of 2002	4	6	92
Total (Net) Revenue Reduction:[3]	-37	-65	-1,256

Sources: Joint Economic Committee (JEC) - Democratic Staff
Congressional Budget Office (CBO), "The Budget and Economic Outlook," August 2001.

Notes: 1. Includes only amounts specified in appropriations bills or the tax act. Does not include any allowances for carrying funds forward beyond amounts appropriated. Also excludes debt service impacts on new spending.
2. Estimate reflects $25 billion in supplemental appropriations for spending on defense and education. Outlays for 2002 based on CBO's composite outlay rate for discretionary spending
3. Based on estimates given in table 1-4 of "The Budget and Economic Outlook," Congressional Budget Office, August 2001. Amounts shown are net of effects of corporate tax payment data changes.

Airline assistance. Congress has also approved a package to assist the airline industry overcome their short-term financial problems–The Air Transportation Safety and System Stabilization Act (H.R. 2926). The package includes $5 billion in immediate cash assistance, $10 billion in loan assurances, as well as some relief from liability arising from terrorist actions and money for increased security. The $5 billion is designed to offset the revenue losses suffered due to the temporary grounding of all flights and the ongoing flight reduction, while the $10 billion is meant to help the industry secure longer term financing for continuing operations.

Tax relief. The final installment of the advance refunds of 2001 taxes was sent out in September. In all, some $38 billion was paid out as tax rebates in July, August, and September while an additional $2 billion in tax relief came through reduced tax withholding in the final quarter of FY 2001. About $70 billion in tax cuts is scheduled to take place in FY 2002. Those cuts will be spread throughout the year through reduced withholding and smaller quarterly payments.

As Table 1 demonstrates, there is substantial fiscal stimulus already in place, and most of the stimulus enacted so far will come through tax reductions rather than through spending increases. The $41 billion in tax rebates that went out this summer turn out to have been well-timed to help the economy in the short run. Tax cuts already passed for next year will have a total net impact of about $71 billion in FY 2002 and Congress now has enacted a total of about $41 billion in new spending for FY 2002. Together, the tax and spending stimulus already in place for FY 2002 will equal just over 1 percent of expected GDP.

Although the recently enacted spending increases will have some effect in 2003 and later, unless these spending increases are incorporated into baseline spending for specific programs, they will have little impact on the overall economy over the next ten years. The tax cut, however, will total over $1.3 trillion over the next 10 years, or about 1 percent of GDP per year in 2003 through 2010.

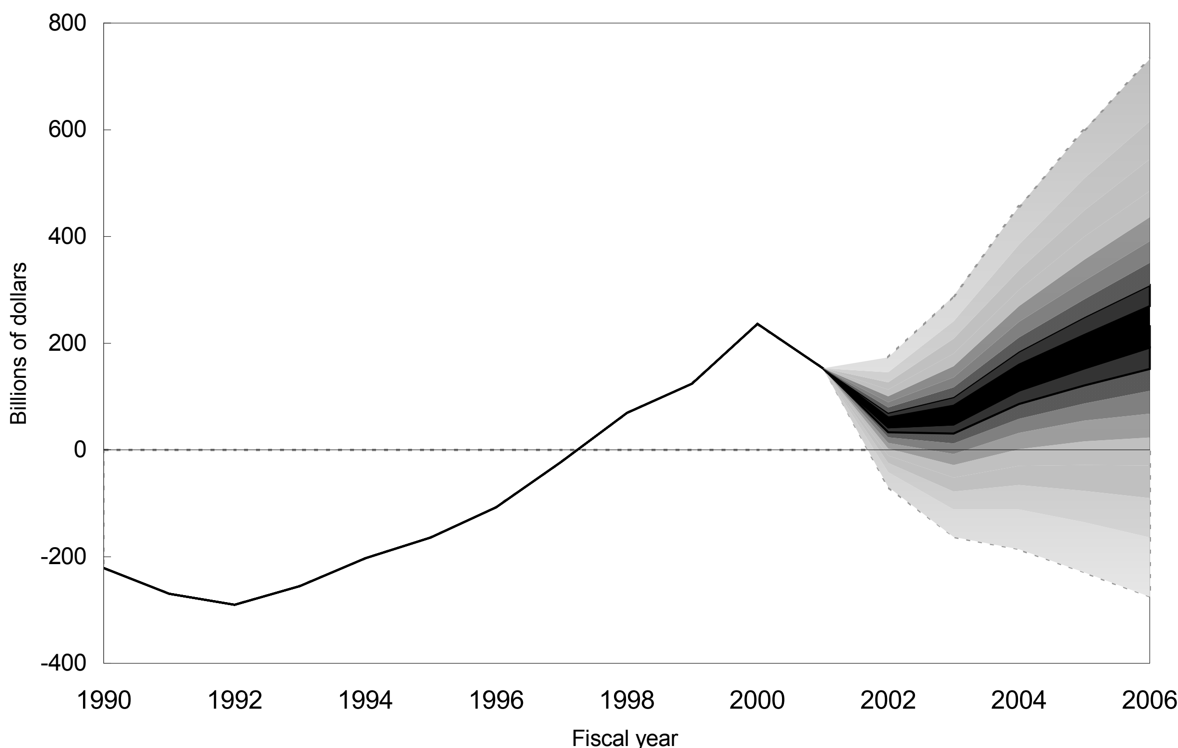
IMPACT ON THE BUDGET

Tax cuts and a weakening economy had already worsened the budget outlook between January and August, when the Congressional Budget Office released its Budget and Economic Update. Subsequent events have further eroded projected budget surpluses, especially over the next few years. The bipartisan report of the House and Senate Budget Committee chairmen and ranking members estimates that the surplus in 2002 has fallen to $52 billion as a result of economic weakness and actions taken to date. This is a baseline figure and does not include a wide variety of other possible claims on the surplus, including policies in the budget resolution that have not yet been enacted. Thus a stimulus package of the size we are describing would most likely put the budget into deficit in 2002.

It is worth emphasizing that there is considerable uncertainty surrounding such a budget estimate. The JEC Democratic staff, together with the Budget Committee staff, have updated the

Congressional Budget Office's January analysis of the economic and technical uncertainty underlying their budget forecast. Based on CBO's past forecasting record, there is a fairly wide probability distribution of outcomes around the $52 billion surplus estimate for 2002. For example, there is roughly a 50 percent chance that with no further change in policy the surplus would be somewhere between $2 billion and $100 billion, but a 50 percent chance that it could be larger than $100 billion or smaller than $2 billion (see Figure 1). Once again, these are estimates for the current baseline, and do not include the effects of any stimulus action or other claims on the budget beyond actions that have already been taken.

Figure 1.
Uncertainty in the Senate Budget Committee Budget Surplus Projections



Source: Joint Economic Committee - Democratic Staff, calculations using data from the Senate Budget Committee and the Congressional Budget Office.

PREVENTING LONG-RUN ECONOMIC DAMAGE

The primary goal for a stimulus package is to stimulate new consumer spending as soon as possible, in order to shore up the demand for goods and services and keep the economy running at something close to its potential. If the stimulus is sizeable but comes too late–in other words,

after the economy has started to recuperate–it can do harm to the economy by creating new inflationary pressures without much offsetting benefit. If tax cuts or other stimulus measures do not generate new spending while economic performance is sub-par, they are an ineffective waste of budgetary resources.

Economists usually consider monetary policy a more effective stabilization tool than fiscal policy. It is easy for the Fed to implement a new interest rate quickly, as well as to reverse past changes when the economy recovers (although even monetary policy operates with some lag). Fiscal policy is typically harder to implement quickly, and can be harder to reverse when conditions improve. It has the advantage, however, that it can be directed to specific sectors of the economy that may be in need. The appropriate monetary policy depends on the environment set up by fiscal policy: the Fed has more room to maneuver when fiscal policy represents an appropriate response–that is, when tax and spending policies are not overly stimulative or restrictive. In the 1980s, for example, monetary policy was forced to be more restrictive with higher interest rates as fiscal policy was particularly loose, featuring very large on-going deficits.

The events of September 11th have increased pressures to spend more of the short-run federal budget, and have made it more appropriate to allow some budget deficit in the near term. But this new loosening of the purse strings does not mean that there should no longer be any fiscal restraints. The long-term pressures on the government budget due to the impending retirement of the baby boomers have not gone away. If a stimulus package is seen as committing large amounts of public funds out in the future (long after the economy will have recovered), markets will react by pushing longer-term interest rates up. This in turn would have a depressing effect on *current* economic activity. Thus, implementing permanent policies for the sake of short-run stimulus is likely to prove counter-productive.

In the long run, the vitality of our economy will depend on our capacity to produce output and generate income. Economists stress the crucial importance of maintaining an adequate level of national saving, in order to fund the investment that must take place if the economy is to grow. Over-committing future years of the public budget in the name of stimulus will not only undermine the short-run effectiveness of the policy, but will also worsen our longer-run economic prospects by making it more likely that national saving will fall short of what is needed. Such over-commitment need not take the form of policies that are explicitly characterized as permanent; policies that are labeled “temporary” and yet are simply hard to “turn off” in practice are dangerous in this regard, too.

Thus, an appropriate fiscal policy response must be effective at stimulating consumption optimally in the short run, while maintaining a sufficient degree of fiscal responsibility over the longer run.

SPENDING PROPOSALS

Spending proposals have an important place in any stimulus package, because they can often be implemented fairly quickly, can be turned off when they are no longer needed, and can be targeted on those most affected by the recession. Proposals involving spending on safety net programs such as Unemployment Insurance and the Food Stamp Program decline automatically

in size as the unemployment rate and the poverty rate fall during recovery. Discretionary spending proposals on infrastructure programs or for purposes such as revenue sharing with states are even easier to reduce, simply by appropriating fewer funds in years when the need is less. This section looks first at proposals that would provide federal funds directly to families and individuals through benefit programs, and second at proposals that would produce some economic stimulus while helping to build public infrastructure. Third, proposals to help states and localities hit by the recession are examined.

The cost estimates attached to each proposal are very rough, and were prepared by the Democratic staff of the Joint Economic Committee to facilitate discussion of alternative proposals estimated on a consistent basis. The spending estimates are based on the assumption that unemployment will rise by about one percentage point and income growth will be flat or slightly negative over the next two quarters. Some recovery is assumed by the second half of 2002, with a return to a sustainable growth path by the end of that year. These assumptions are consistent with the views currently being expressed by most economic forecasters, but actual economic performance could be either better or worse than this. If stimulus is not put in place quickly, or if it fails to spark a rapid recovery, additional spending or tax cuts beyond the time frame considered here may become appropriate.

Note that the cost estimates attached to the proposals are very rough preliminary estimates. Also, only proposals that would have their primary impact in FY 2002 have been included. This excludes some proposals that have some substantial merits from a policy perspective, but whose primary costs would occur after the period in which stimulus is expected to be needed.

Additionally, the proposals that are included have been specified so as to confine most of their costs to the FY 2002 window. As a result, the estimates presented here are sometimes lower than other analysts have suggested for similar proposals that would be in effect over a longer period. Finally, we have not included any proposals for small program changes that would cost less than $100 million, nor have we included funds that would be appropriated in FY 2002 but that would be likely to be spent out over a much longer period.

I. Federal Spending on Programs for Families and Individuals

This section focuses on proposals that would provide federal benefits specifically to people and families affected by an economic downturn. These proposals have been divided into three major categories: expansions in Unemployment Insurance; expansions in health care coverage for the unemployed; and patching the social safety net. The "safety net" category includes proposals that pertain to cash assistance, food aid, and housing assistance. Table 2 summarizes the costs of potential spending proposals in these areas.

Table 2

Federal Spending on Programs for Families and Individuals
Spending Proposals Fiscal Year 2002

	Estimated Costs
Expand Unemployment Insurance (UI) Coverage and Benefits	
Expand UI Coverage	
Count earnings from the most recent quarter of work	$0.7 billion
Cover former full- or part-time workers now looking for part-time work	$0.5 billion
Temporarily Supplement Unemployment Benefits	
Provide a temporary federal supplement to UI benefits	
$25 per week for each unemployed worker	$5.5 billion
$25 per week or 15% of basic benefit-which ever is larger	$7.0 billion
Extend Unemployment Insurance Benefits for an Additional 13 weeks	$8.0 billion
Provide Federal UI Funds to States for Program Administration	$0.5 billion
Expand Health Insurance Coverage for Unemployed Workers and Their Families	
Subsidize COBRA Coverage	$4.0 billion
Extend Medicaid Coverage for Low-Income Unemployed Workers	$3.0 billion
Temporarily Increase the Federal Medicaid Match Rate	$4.5 billion
Patch the Safety Net for Low-Income Families Hit by the Recession	
Provide More Income to Needy Families	
Establish a new TANF contingency fund	$0.5 billion
Re-establish the TANF supplemental grant program	$0.3 billion
Pass through all child support payments collected on behalf to TANF recipients to those recipients	$2.0 billion
Expand Food Aid for Needy Families	
Temporarily reinstate benefits for able-bodied unemployed persons without dependents	$1.0 billion
Temporarily increase benefit levels in the Food Stamp Program	$2.5 billion
Raise the asset level allowed in the Food Stamp Program	$0.2 billion
Expand the WIC program to serve all those anticipated to be eligible under an economic downturn	$0.3 billion
Increase Housing Subsidies to Serve More Needy Families	
Expand the Section 8 housing subsidy program to provide and additional 100,000 housing vouchers	$0.6 billion
Provide additional assistance to fund short term rent, utilities and mortgage assistance for low income households through the FEMA Emergency Food and Shelter Program	$0.1 billion

Source: Joint Economic Committee (JEC) - Democratic Staff

Note: All cost estimates are preliminary estimates. Refer to text for specific policy assumptions.

1. Expand Unemployment Insurance Coverage and Benefits

Unemployment Insurance (UI) is considered one of the most important anti-recessionary government resources when unemployment rises. Its impact is automatic and immediately counter-cyclical. During periods of increasing unemployment earnings drop, dampening consumer spending (which is two-thirds of total spending). UI benefits partially replace these lost earnings. When the economy is expanding, the taxes on earnings that fund the UI state trust funds act as a damper on earnings growth, and thus on increased spending.

To encourage workers to seek employment, UI benefits are set at a portion of previous earnings (anywhere from 50 to 70 percent). Employers with a higher proportion of workers who receive benefits are penalized with higher levies, to discourage employers from using the UI system to support workers routinely laid-off and rehired. Recipients must be actively looking for work and must have been attached to the workforce. Benefits are limited to 26 weeks. States with high unemployment levels can access the Extended Benefits program, which provides for an additional 13 weeks of coverage when one of three specific high unemployment criteria is met.

A. Expand UI Coverage

The current UI system does not cover most low-wage and part-time workers. In 1999, only 38 percent those unemployed received benefits. The GAO found that while two fifths of unemployed high-wage earners get UI, less than 20 percent of low-wage ($8.00 an hour or less) earners do. And even though nearly one in five workers is employed part-time (35 hours a week or less) they are not covered in most-states – in fact, 30 states explicitly exclude those looking for only part-time work for UI coverage.

Two options that could expand coverage for low-income workers:

- **Count earnings from the most recent quarter of work in calculating eligibility**. Currently, many states do not count the most recent earnings, which prevents some unemployed workers who had not been employed for many previous quarters from receiving benefits. This proposal could provide benefits to more than 300,000 workers in FY 2002. Estimated FY 2002 cost: $700 million

- **Cover former full- or part-time workers now looking for part-time work**. This could also extend coverage to an additional 350,000 or more unemployed workers in FY 2002.Estimated FY 2002 cost: $500 million.

B. Temporarily Supplement Unemployment Benefits

Unemployment Insurance benefits are generally substantially lower than the amounts workers earned while employed, and are available only for the first 26 weeks of a spell of unemployment. In periods of high unemployment Extended Benefits may also be available for an additional 13 weeks, although there are few states with unemployment rates likely to be high enough during the next year to trigger Extended Benefits under current law.

Federal funds could be used to supplement unemployment insurance benefits temporarily to provide some immediate stimulus during a recession. Unemployed workers are likely to spend any additional income they receive immediately, since they are generally facing substantial reductions in their regular income. Possible proposals include:

- **Provide a temporary federal supplement to UI benefits**. Providing a federal supplement of $25 a week for each unemployed worker for the duration of FY 2002, for example, would cost roughly $5.5 billion (depending on unemployment rates and on the proportion of the newly-unemployed who qualify for unemployment benefits). Providing a supplementary benefit of $25 a week or 15 percent of the basic benefit, whichever was larger, would cost a bit more–roughly $7 billion–with the extra funds going to workers who normally earn higher wages.

- **Extend Unemployment Insurance Benefits for an Additional 13 Weeks**. Providing an extra 13 weeks of unemployment insurance benefits during a recession for those who have exhausted their first 26 weeks of benefits (without requiring the current EB program to be triggered) would cost roughly $8 billion during FY 2002 (again depending on unemployment rates and the duration of unemployment). However, since relatively few workers have currently been unemployed for close to 26 weeks, most of the impact of this proposal would be felt in the second quarter of calendar year 2002 or beyond. Extensions beyond 13 weeks would have larger potential impacts in FY 2003 than in FY 2002.

C. Provide Federal UI Funds to States for Program Administration

States administer the UI program, but are required to keep reserves for the program in federal accounts. Releasing some of the almost $40 billion currently held in these federal accounts to states for administrative purposes could accelerate the implementation of any program changes enacted, and could provide some stimulus by allowing states to hire additional workers to process UI claims. As unemployment rates rise in a recession, such additional workers become necessary if benefits are to be paid in a timely manner. The costs of this proposal would depend, of course, on the amounts released. States could probably use up to $500 million in FY 2002 without simply replacing state funds that have already been allocated for UI administration.

2. Expand Health Insurance Coverage for Unemployed Workers and Their Families

As unemployment increases, many Americans will be at increased risk of losing their health insurance coverage. COBRA gives employees and their families the option of continuing their group health insurance coverage in case of certain events; termination of employment, reduction in hours, death of the employee, and divorce or separation. If an employee is terminated or their hours are reduced, they can continue coverage for 18 months. In all other events, they can continue it for 36 months.

Unfortunately, however, many unemployed people cannot afford to continue to pay their health insurance premiums while they are unemployed. Premiums for those who are unemployed are typically higher than for workers, because those who are no longer employed are not receiving employer subsidies. Further, low-income workers frequently lack health insurance even when

they are employed, and such workers will not be eligible for health insurance coverage under COBRA. Specific proposals to address these problems include:

- **Subsidize COBRA coverage** for unemployed workers and their families. If the federal government picked up 50 percent of the cost of health insurance premiums for unemployed workers who chose to extend their health insurance coverage under COBRA, for example, the costs would be roughly $4 billion in FY 2002, depending on the extent to which unemployed workers elected to take up such coverage. Even with a 50 percent match rate, however, some workers would not be able to afford premiums for COBRA while unemployed. This cost estimate assumes that such workers with incomes below 200 percent of the poverty line would have their full premium paid by Medicaid. This estimate also assumes that the COBRA subsidy would last for 12 months or until the end of FY 2002, whichever came first. The estimate could be substantially higher if the period of benefit receipt were expanded.

- **Extend Medicaid coverage for low-income unemployed workers** and their families. The costs of this proposal would depend on exactly how it was implemented, and on whether the federal government paid the full costs of the expansion or simply agreed to match spending by states which granted Medicaid coverage under the proposal. If benefits were extended to all families with a member losing a job in FY 2002 and with incomes below 200 percent of the poverty level, for example, and if the federal government picked up the full costs of such benefits during the period of unemployment, total costs in FY 2002 would be (very) roughly $3 billion (again depending on the level and duration of unemployment). Picking up costs for such families for as long as they remain eligible in terms of income (rather than ending eligibility when unemployment ends) could cost substantially more. It would also introduce substantial inequities between low-income workers who had experienced a spell of unemployment and those who had been employed continuously in jobs without health insurance or with unaffordable insurance costs.

Note that the proposals estimated here would apply only to people losing a job in FY 2002, and would provide benefits only during 2002. Many other proposals for expanded health care coverage exist, and most would provide benefits over a longer period. The period covered in these proposals was deliberately kept short to conform to the principle that extra spending should be concentrated during the period when the economy was expected to need stimulus. These estimates assume that recovery will be well underway by the end of 2002.

An additional Medicaid proposal put forward by the Center on Budget and Policy Priorities would focus on helping states meet the temporary rise in Medicaid costs that will result from the economic downturn, by temporarily increasing the federal Medicaid match rate. Their specific proposal is as follows:

- **Temporarily increase the federal Medicaid match rate**. Because Medicaid match rates depend in part on recent state income levels, and many states experienced strong income growth in the period immediately before the current economic downturn, more than half the states will see a reduction in their federal match rate for Medicaid spending in 2002. This will impose additional fiscal stress in states where revenues are already falling and

where Medicaid expenditures are likely to increase as unemployment rises. A temporary increase in match rates, effective for FY 2002 only, could help states provide needed medical services to unemployed and low-income workers, as well as to the elderly and the disabled. If the federal match rate were increased in 2002 by one percentage point for all states, with a further two percentage points for states with unemployment rates over the national average, for example, the total cost in FY 2002 would be roughly $4.5 billion.

3. Patch the Safety Net for Low-Income Families Hit by the Recession

Many "safety net" programs exist to help low-income families, but these programs face increasing strains in periods of high unemployment and high poverty rates. Recessions increase hardships for families at risk for many different types of social problems, and these increased risks translate into increased needs social programs. Many such programs are either discretionary in nature or are funded through block grants, and thus do not automatically increase spending when needs increase. An appropriate and useful form of stimulus spending, therefore, would be to increase the amounts spent on these programs as the slowdown in the economy increases the need for the services they provide. A return to lower spending levels as the economy improves will occur automatically in programs such as TANF and The Food Stamp Program, and should be relatively easy to implement in most of the discretionary spending programs.

A. Provide More Income to Needy Families

The major program providing cash aid to needy families with dependent children, the Temporary Assistance to Needy Families (TANF) program, became a block grant to states under the 1996 welfare reform bill. Under that bill, a contingency fund was established to deal with increased needs during recessions, but required large increases in state funding before any federal contingency funds could be received. That contingency fund expired on Sept. 30, 2001. There was also a supplemental grant available for states experiencing increases in their low-income populations, but that has also expired.

In a recession states may need access to more funds for needy families than are allowed for under the block grant, however. Providing more contingency funds to states to pay benefits would be highly stimulative, because benefit recipients are very low-income and will almost certainly spend any benefits received immediately. Proposals to expand funding for the provision of benefits to welfare recipients include:

- **Establish a new TANF contingency fund.** Allow states that have spent their full block grant funds on eligible programs and have exhausted their reserve funds to draw upon a federal contingency fund to pay benefits for newly-eligible recipients for the remainder of FY 2002. States would be required to match federal benefit payments at their Medicaid program match rates. This fund could be set to expire after one year, to be replaced by a new approach to contingency funding in the normal TANF reauthorization process. If state caseloads rose by an average of 10 percent as a result of the economic downturn, roughly $500 million in additional FY 2002 funding would be needed in the contingency fund to meet all likely state calls upon the fund.

- **Re-establish the TANF supplemental grant program.** Extending this program, which provides supplemental grants to the 17 poorest states, for one year would cost about $300 million in FY 2002.

- **Pass through all child support payments collected on behalf of TANF recipients to those recipients**. The Federal government, along with some states, now withholds all or part of the child support payments collected on behalf of welfare recipients and former welfare recipients, in order to pay the costs of Child Support Enforcement programs (which serve both welfare recipients and other custodial parents.) If the federal government picked up both the federal and state costs of Child Support Enforcement for TANF recipients, these families would receive more total income. Passing through these payments to the families would also give non-custodial parents more incentive to make the payments, which now are frequently of little actual benefit to the children they are supposed to support. This proposal would cost roughly $1 billion in additional federal costs in FY 2002, and roughly another $1 billion to reimburse states for their Child Support Enforcement costs.

B. Expand Food Aid for Needy Families

The Food Stamp Program (FSP) is the only assistance program that serves almost all low-income persons and families, without regard to their characteristics. Under the welfare reform package enacted in 1996 benefits for able-bodied unemployed persons without dependents were eliminated, but the FSP is still extremely responsive to changes in the unemployment rate and as a result provides an excellent offset to cyclical changes in the economy. Food stamp benefits are almost always spent within 30 days of being issued, making FSP expansions an effective way to stimulate the economy in the very near term. Proposals to expand the Food Stamp Program include:

- **Temporarily reinstate benefits for able-bodied unemployed persons without dependents.** Food stamp benefits were eliminated for this group in 1996 out of concerns that many such recipients might be abusing the system or simply refusing to work. In periods of high unemployment, however, some non-disabled persons with low educations or other barriers to employment may have trouble finding jobs even if they are willing to work. Extending food stamp eligibility to this group temporarily during the economic downturn would cost about $1 billion in FY2002.

- **Temporarily increase benefit levels in the Food Stamp Program**. Food stamp benefits are quite low–about 81 cents per person per meal. They are based on the Thrifty Food Plan (TFP), a low-cost food budget estimated by the Dept. of Agriculture. Some analysts have argued that the methodology used to calculate the TFP is out of date, and fails to reflect food costs realistically in an era in which few families have much time to invest in preparing meals. Additionally, increases in food stamp benefits are easy to implement–most states could raise benefit payments in 30 to 60 days with few administrative costs. An increase in food stamp benefits to 110 percent of the Thrifty Food Plan amount could be a fast, temporary form of stimulus. Such an increase would cost about $2.5 billion in FY 2002.

- **Raise the asset level allowed in the Food Stamp Program.** In order to qualify for food stamps, families must not have significant assets that could be drawn upon to meet their needs. This asset test, which allows only $2000 in assets for most households, can be a barrier to participation for some needy persons who do not want to give up everything they own in order to become eligible. The amount of assets allowed has not been increased in some time, with the result that the real value of allowed assets has declined over time as prices have increased. Raising the amount of assets a family can own and still receive food stamps to $5000 would expand FSP eligibility. This proposal could be hard to repeal after the economy recovered, but food stamp eligibility will fall in any case during an economic recovery. The cost of such an asset-limit increase would be about $200 million in FY 2002.

In addition to the FSP, a smaller but also very important food supplement program is the Special Supplemental Nutrition Program for Women, Infants and Children (WIC). WIC is a discretionary funding program that provides food and nutritional supplements to low income pregnant and nursing women and their very young children. Funding levels for WIC proposed by the Administration and included in the House Appropriations bill were based on much lower estimates of unemployment than are now anticipated. To serve all eligible participants, WIC spending would have to be increased. Specifically, some have proposed:

- **Expand the WIC program to serve all those anticipated to be eligible under an economic downturn.** WIC participation rises during economic downturns, as more women and children become sufficiently needy to qualify for benefits. The appropriations levels currently proposed for this year would be insufficient to fund benefits for all those eligible if unemployment rates rise. If there were a substantial increase in unemployment rates in FY 2002, perhaps to the range of 5.5 to 6 percent, as many as 500,000 additional persons might become eligible for the program. Meeting the needs of all these new eligibles would cost about $300 million in FY 2002.

C. Increase Housing Subsidies to Serve More Needy Families

Many areas of the country are already experiencing an acute shortage of affordable rental housing for extremely low-income families. These problems are likely to worsen as low-wage earners become unemployed during an economic downturn. If these families can no longer afford to pay the rent on the units in which they currently live, they are at risk of becoming homeless. Making additional rental subsidies available to low-income families can help to prevent this. Additional short-term assistance to families in particularly hard-hit areas could also be effective in preventing homelessness. Specific proposals include:

- **Expand the Section 8 housing subsidy program to provide an additional 100,000 housing vouchers.** These vouchers could be distributed to jurisdictions that have already used 95 percent or more of the vouchers currently available to them. Many of these jurisdictions have long waiting lists for housing assistance, guaranteeing that the additional rental subsidies would be used immediately. This proposal would cost about $600 million in FY 2002.

- **Provide additional assistance to fund short term rent, utilities and mortgage assistance for low income households through the FEMA Emergency Food and Shelter Program**. The FEMA Emergency Food and Shelter Program provides assistance to persons and families in areas experiencing emergencies, including severe economic need. They are well-positioned to distribute such emergency funding through their national network of non-profit social service and faith-based organizations. They could distribute an additional $100 million in emergency shelter aid in FY 2002.

II. Federal Spending on Infrastructure and Investment

There are many infrastructure and investment proposals that make economic sense and that would provide positive economic returns if funded. As a source of economic stimulus, however, these proposals often have the drawback that it takes time to plan and implement good infrastructure investments. As a result, money appropriated now may not have a direct economic impact until some considerably later date–possibly after the need for stimulus has lessened. For that reason, proposals to fund extremely urgent projects or those that were already in the pipeline but that are in danger of losing funding during an economic downturn are likely to be the most successful in providing immediate stimulus. This section focuses primarily on such proposals. Although many other infrastructure proposals could potentially be justified on policy grounds, we have not included proposals where we believe that most actual spending would occur outside FY 2002 window.

1. Renew Federal Aid for School Construction

The Department of Education's National Center for Education Statistics has estimated that more than three-fourths of the nation's schools need to invest money in repairs or renovation. In addition, elementary school enrollments have increased by 12 percent over the past decade, and many districts need to construct new schools or significantly expand existing ones. The National Education Association estimates that nationally more than $300 billion is needed for school construction and repair.

Most school construction is financed at the state and local levels. But as local budgets get tighter during an economic downturn, school districts may be forced to cut back on needed school repairs and building. Further, some districts already lack the fiscal capacity they would need to keep up with their needs for safe classroom space. As school construction slows, we can expect that jobs in the construction industry will be lost.

Although most federal support for school construction has come indirectly through tax incentives, additional tax breaks for school construction bonds would not be an efficient way to get funds to schools immediately. In FY 2001, however, Congress approved $1.2 billion in direct federal funding for school renovation and repair. These funds were distributed to high-need districts that lacked the resources to pay for urgent repairs and renovation, but FY 2002 funding for the program was not included in the Administration's budget. Renewing this aid could provide some economic stimulus to these high-need districts.

- **Renew funding to provide for urgent repairs and renovations in high-need school districts**. Funding provided to high-need school districts under the FY 2001 appropriation

could be renewed for FY 2002. Such funds could be distributed fairly quickly, and once received by school districts would typically be spent almost immediately, since they are reserved for urgent repairs. A small amount of additional funding could go to the Dept. of Education to expedite the distribution of the funds to appropriate school districts, under the criteria which they have already established. As much as $1.5 billion could probably be distributed in FY 2002 to fund short-term, urgent projects.

2. Provide Additional Federal Funding and Loan Guarantees for Low-Income Housing

Government spending on the construction of low-income housing can be highly stimulative, since it typically provides relatively large numbers of jobs while also resulting in much-needed affordable housing for lower-income people. However, it generally has the drawback that it takes a substantial amount of time for any new money appropriated to translate into new construction projects. As a consequence, the resulting economic stimulus may occur too late to help the economy in the short run, and may contribute to overspending down the road. The current weakness of the economy, however, has meant that many housing projects that have already been planned and in some cases even started have been brought to a halt, as private and state and local funding sources have tightened their budgets. An infusion of money from the Federal government now could save these projects and the jobs and new housing units that they represent.

- **Provide additional funding and loan guarantees for low-income housing projects currently in the pipeline**. Additional funding for low-income housing could be distributed through HUD's HOME program, which funds the construction of low-income rental housing, the rehabilitation of existing rental housing stock, and the provision of mortgages to low-income households. It is uncertain how much money could actually be spent on construction or other activities that would occur this fiscal year, but if the requirement for local matching funds were waived, many currently pending projects could be started immediately. If no match were required for these additional funds and HUD were directed to expedite their release, it is likely that at least $2 billion could be distributed and spent in FY 2002 for qualifying projects that have already completed at least preliminary construction plans.

- **Provide additional funding for the Public Housing Operating Fund.** Public housing is the core federal program for serving extremely low-income families, many of whom are elderly and working poor. The Operating Fund allows housing authorities to pay for ongoing operations, including maintenance and utilities. Housing authorities have long lists of ongoing maintenance needs and projects in need of funding. Additional funding could accelerate these projects, including addressing immediate and significant maintenance problems, such as replacement of old heating systems and the provision of new roofs. The Operating Fund is typically spent very quickly, and it is estimated that about $1 billion in funding could be usefully spent in FY 2002.

3. Strengthen Rail Transportation as an Alternative to Aviation

The disaster recovery and stimulus measures passed so far have already included a substantial package of aid to airlines and measures to improve the safety of air transport. Some have argued that rail transport should also be strengthened, both for security reasons and to help support the tourism industry as increasing numbers of consumers have become reluctant to fly. Since Sept. 11th, Amtrak ridership has been up by about 17 percent nationally relative to the same period last year. Unfortunately, most of Amtrak's passenger routes remain unprofitable, and GAO estimates that the system is almost $300 million away from achieving operating self-sufficiency. Under current law, Amtrak is required to become self-sufficient in its operating budget by Oct. 2002 or face liquidation. The system also needs major capital improvements which cannot be funded out of its current budget. If the rail system is to become a viable alternative to air transportation, it will need substantial federal funding.

Table 3

Federal Spending on Infrastructure and Investment **Spending Proposals Fiscal Year 2002**	**Estimated Costs**
Renew Federal Aid for School Construction	
Renew Funding to Provide for Urgent Repairs and Renovations in High-Need School Districts	$1.5 billion
Provide Additional Federal Funding and Loan Guarantees for Low-Income Housing	
Provide Additional Funding and Loan Guarantees for Low-Income Housing Projects Currently in the Pipeline	$2.0 billion
Provide Additional Funding for the Public Housing Operating Fund	$1.0 billion
Strengthen Rail Transportation as an Alternative to Aviation	
Upgrade the Security and Safety of Rail Transport	$1.5 billion
Upgrade the Rail System to Accommodate Increased Traffic	$1.6 billion
Increase Funding for Highways and Mass Transit	
Increase Funding for Highways and Highway Maintenance Projects Currently Planned or Underway	$3.0 billion
Increase Federal Funding for Existing Mass Transit Projects	$1.0 billion
Fund Additional Currently-Authorized Water and Waste-Water Infrastructure Projects	$1.0 billion

Source: Joint Economic Committee (JEC) - Democratic Staff

Note: All cost estimates are preliminary estimates. Refer to text for specific policy assumptions.

Whether federal investments in rail transport are justified on security grounds is not the question that must be asked in considering expenditures solely from the point of view of economic stimulus, however. As noted elsewhere, to provide effective economic stimulus, expenditures must be usable within the very near future–capital improvements that are authorized this year but not actually made for several more years will have no stimulative effect during the current downturn, and if not offset elsewhere in the budget may cause overspending at a later date when the economy is in recovery. On the other hand, spending on Amtrak, if it can be accomplished quickly, could have a particularly strong effect on the economy if it both produced jobs in the short run and improved the demand for tourism-related goods in the localities served by rail transport. To be effective in that latter goal, however, potential tourists must also be convinced that rail travel is safe. Two proposals for increased spending on railroads that might have some stimulative effect, therefore, are as follow:

- **Upgrade the security and safety of rail transport**. Amtrak estimates that in the wake of the terrorist attacks it needs about $500 million for new measures such as security cameras and guards in order to assure the safety of railroad passengers and workers. In addition, the system also has some substantial longer-standing safety and security concerns. Amtrak's CEO has estimated that about $1 billion is needed to ensure the safety of bridges and tunnels along the busy Northeast corridor, for example, where Amtrak's most successful routes are located. Most of these repairs could be undertaken quickly if money were available. One proposal, therefore, would be to allocate $1.5 billion to Amtrak in FY 2002 to upgrade rail safety and security.

- **Upgrade the rail system to accommodate increased traffic**. Amtrak's CEO has also warned that the state of the rail system's capital equipment is currently unsatisfactory. Some substantial work is needed simply to bring the existing track system into a state of "good repair," and more would be needed to complete the high-speed rail program in the Northeast corridor. Amtrak has estimated that it will need about $1.6 billion in FY 2002 to meet current needs and accommodate projected increases in traffic nationwide.

4. Increase funding for highways and mass transit. As with spending on rail transport, some spending on other surface transport may be needed to improve security. Such spending may also have some benefits for tourism and related industries, and in the longer run may serve to reduce transportation costs for a large variety of goods. This spending can only serve as a stimulus to the economy, however, if it occurs in a timely manner. Most states have a number of highway and transit projects in the pipeline; as with housing projects, the limiting factor is often the requirement for state or local matching for any federal funds used. Therefore, the suspension of match requirements for additional highway and transit funding to take place in FY 2002 may be necessary to facilitate rapid spending of any new funds allocated. Even with such a suspension, however, a realistic stimulus proposal must take account of how much states and localities can actually do in FY 2002.

It seems likely that at least as much as would be freed up by a temporary suspension of the match requirement could be spent fairly quickly. Using that as a rough estimate of useful funding levels leads to the following proposals:

- **Increase funding for highways and highway maintenance projects currently planned or underway.** We estimate that if state match requirements were relaxed for projects scheduled for FY 2002 completion, up to $3 billion in additional funding could be spent in FY 2002.

- **Increase federal funding for existing mass transit projects.** Mass transit projects are funded by the federal government under rules similar to those for highways, and a state match is required. We estimate that if matching requirements were temporarily suspended, an additional $1 billion could be spent in FY 2002.

5. Fund additional currently-authorized water and waste-water infrastructure projects.

Most federal funding of water projects takes place through appropriations to State Revolving Funds (SRFs), which are used to make loans to municipalities. FY 2001 appropriations for the clean water SRFs, the safe drinking water SRFs, and water-related grants totaled about $3.6 billion. While most states do have a backlog of not-yet-funded proposals, it is unlikely that all of that backlog can actually be spent-out in one year. We believe that $1 billion would be a realistic estimate of the amount of additional funding that could actually go out the door for such projects during FY 2002.

III. Federal Aid to States and Localities

The slowing economy has reduced state revenue growth, in some cases quite sharply. State revenues increased only 2.6 percent in nominal terms over the between the second quarter of 2000 and the second quarter of 2001, compared with an 11.4 percent increase over the prior year. This has resulted in the lowest level of real revenue growth in eight years. So far, the slowdown in revenues is still mild compared with that seen in the last recession, but as the economy weakens further, revenues are likely to continue to fall. Corporate tax collections have taken the biggest hit so far, but all major components of tax revenue have slowed, including personal income taxes and sales taxes.

This slowdown in revenues has potentially major implications for state budgets for the upcoming fiscal year. Almost all states now have either constitutional or statutory requirements to maintain balanced budgets, requiring them to reduce spending as revenues slow. This makes it difficult for states to undertake counter-cyclical spending or tax programs themselves, and lessens their ability to respond to the needs of those residents particularly hard-hit by the recession. Seven states have already instituted across-the-board spending cuts, and others have implemented hiring freezes and targeted program reductions. Cities and other localities are facing similar budget dilemmas, as both state pass-throughs and revenues from their own sources fall.

Cutting state and local spending or raising taxes as we slide into recession is not a good idea, either from an economic perspective or from the perspective that many services provided by states and localities become even more needed as the economy slows. Almost all of our safety net programs, for example, are administered and often funded at the state or local level. State and local governments are also major employers, and declines in their budgets can translate directly into higher unemployment rates.

All of these concerns argue that some form of Federal revenue sharing with state and local governments could be an effective and useful way to provide fiscal stimulus. Several options are available. A very broad program could be implemented, with direct grants to states and localities based on size, for example. Or the program could be more targeted, with grants based on the extent to which a given state or locality has been affected by the economic downturn, or on the extent of its pre-existing need.

The advantage of a broader program is that it would be easiest to implement, and could potentially get large sums of money into the economy quite rapidly. States that are facing budget imbalances and potential spending cuts or freezes will presumably respond to additional revenues by spending more than they would have in the very short run. On the other hand, states and localities that are not yet in fiscal difficulties might be much slower to spend any new revenues or to reduce taxes accordingly.

The advantages of a more targeted approach are that states and localities that are the hardest hit by the downturn are the ones most likely to benefit from additional economic stimulus in the short run, and are also the areas where need is likely to be greatest. Setting up a program to measure need and allocate funds, however, could slow the release of federal revenues.

Examples of proposals that would embody these alternate approaches include:

- **Provide Federal revenue sharing funds to all states and federal jurisdictions based on population size.** This proposal would allocate a fixed amount of funding over states and similar jurisdictions based on the number of people living in each jurisdiction. The advantages of the proposal are that it would be easy to implement and the money could be released quickly, and each jurisdiction would be able to spend the funds according to its own priorities. The disadvantage would be that the funds would not be well-targeted to those who need them most, and states with lesser amounts of need might be slow to make use of their funds, reducing their stimulative impacts.

- **Provide Federal revenue sharing funds to states with high unemployment or poverty rates.** This proposal would make funds available to states based on their needs. This could be done in several different ways. For example, a given amount could be set aside, and states could apply for a share of the funds based on their specific needs. Cut-off points for eligibility could be established, and as changing state circumstances lowered or raised unemployment and poverty rates, grant sizes could be adjusted. Grants could be made on a quarterly basis to facilitate adjustment, and the program could be ended as soon as the national economy improved. This approach would have the advantage of greater flexibility and responsiveness to local conditions, but would potentially be cumbersome to administer. An alternative, more like the first proposal, would be to appropriate a single amount for FY 2002, and then distribute it across states under a formula based on unemployment and poverty rates.

- **Provide revenue sharing funds directly to cities or low-income localities**. City budgets are typically just as strained during downturns as are state budgets, and many of our nation’s poorest citizens live in inner-city areas. During an economic downturn, these

areas are likely to be particularly hard-hit. A third approach would be to provide revenue sharing funds directly to cities or to specific these jurisdictions such as Empowerment Zones, to fund services to the unemployed and to very low-income workers and families. Again, either a case by case grant-making strategy or a more general formula-based allocation could be used, although in the interests of timeliness a simpler distribution mechanism might be preferred.

No estimated costs have been given for these proposals, because revenue sharing proposals of all of these types could be funded at almost any level the Congress chose. In choosing a level, however, it is useful to consider how fast states and localities are likely to be able to spend any additional funding they receive.

TAX CUT PROPOSALS

The relative merits of alternative tax stimulus proposals depend heavily on their likely effects on short-term consumption. Consumer spending was the key reason that the economic slowdown prior to September 11th was not a full-scale recession. Now that consumer confidence is shaken, consumer spending is likely to fall. Tax cuts have been proposed as one way to restore consumer confidence, get more income into the hands of consumers, and boost consumer spending. This could be achieved both by cutting household taxes directly and by cutting taxes for businesses, thereby boosting investment and profitability, which may in turn help to preserve jobs and provide "trickle down" benefits to taxpayers who are not business owners.

Overall, measures that increase consumer incomes directly are likely to have the greatest impact on short-run consumer spending, and therefore will stimulate the economy most quickly and effectively. Business tax cuts will generally take longer to affect consumers, and their effects on investment may be largely offset by increases in the public debt, which will reduce the funds available for investment in the short run. For lower-income consumers, either approach is likely to be less effective than direct increases in spending on Unemployment Insurance, the Food Stamp Program, and other benefits that go directly to people and families likely to be hard hit by a recession.

This section looks first at tax cuts that would mainly affect families and individual taxpayers, and then at tax cuts aimed at businesses. As with the section on spending proposals, the estimates given are rough and focus primarily on the short-run stimulus that would be provided by each proposal, although for those proposals that would have substantial long-run costs as well the probable magnitude of those costs is also discussed.

Table 4

Tax Cut Proposals **Fiscal Year 2002**	**Estimated Costs**
Tax Cuts for Families and Individuals	
Provide Additional Tax Rebates to Families and Individuals	
Extend the recent tax rebate to also cover payroll taxes	$13.7 billion
Temporarily suspend payroll tax withholding	$47.0 billion
Reimburse states for a sales tax rebate	na
Accelerate Scheduled Income Tax Cuts	
Accelerate the increase in the child credit	*
Accelerate the tax rate reductions scheduled for 2006	
Accelerating the future cuts scheduled for 2006 to January 2002	$26.8 billion
Accelerating the future cuts scheduled for 2004 to January 2002	$11.8 billion
Reduce the Tax on Capital Gains	
Apply the lower capitol gains tax rates on assets held for 5 years to all gains	$ 0.5 billion
Tax Cuts for Businesses	
Reduce Corporate Income Tax Rates	
Permanently reduce corporate tax rates	
Reduce corporate tax rates by 10 percent for one year	$21.5 billion
Repeal the corporate alternative minimum tax	$25.4 billion
Provide a Tax Credit for New Investment	
Enact a temporary investment tax credit	$59.0 billion
Enact an incremental investment tax credit	na
Allow Full or Partial Expensing of New Investment	
Temporarily allow full expensing for all three- and five-year assets	$96.0 billion
Temporarily allow partial expensing for all assets with lives of 20 years or less	$39.3 billion
Temporarily increase expensing for small businesses	$ 0.9 billion
Extend New Operating Loss Carryback Period	
Allow 5-year carryback for net operating losses	$4.7 billion

Source: Joint Economic Committee (JEC) - Democratic Staff

Note: All cost estimates are preliminary.

I. Tax Cuts for Families and Individuals

Tax reductions at the personal level are potentially more effective at stimulating the economy in the near term than are business tax cuts, for several reasons. First, new government spending for infrastructure and security already will provide a big boost to national investment, so that the value added from business tax cuts and private investment may be relatively small, and such tax cuts would also involve a loss of revenue (public saving) that would offset much of the new private investment stimulated. Second, business tax incentives to stimulate extra private investment may not be very effective when businesses face low demand from consumers. Third, business tax cuts ultimately boost the incomes of households who own capital, who tend to be higher-income households who are least in need of assistance and also the least likely to spend all of their extra income.

The cost estimates for the following options are preliminary. Most estimates are from the Joint Committee on Taxation. Estimates for temporarily suspending payroll tax withholding and for accelerating scheduled increases in the child credit were prepared by the Democratic Staff of the Joint Economic Committee. Estimates for a temporary investment tax credit and temporary full expensing for new investment were supplied by the Democratic Staff of the Committee on Ways and Means.

1. Provide Additional Tax Rebates to Families and Individuals

An additional tax rebate could be an effective way to boost the economy through encouraging household consumption. A cut in personal taxes would not translate dollar for dollar into an increase in personal consumption, because households will save at least some of the additional after-tax income. Recent economic data indicate that a rather small fraction of tax rebate checks issued in August was spent immediately and instead the personal saving rate rose. A University of Michigan Survey of consumers taken in September found that most households used the tax rebate to pay down debt or increase savings rather than for new purchases. Moreover, just one-in-ten of those households thought that further tax cuts would be appropriate to improve the economy. With rebate checks still in the mail in September, however, it is much too early to tell just how much of the tax rebate households will eventually spend.

One way to encourage greater short-term consumption would be to direct more of any new tax cut toward lower-income households who out of necessity spend larger fractions of their income. Because only households who paid federal income taxes received this year's tax rebate, many lower-income families who work and pay payroll taxes were left out.

- **Extend the recent tax rebate to payroll taxes.** Some 96 million households received advance payment of the income tax cut for 2001 in the form of rebate checks sent out this summer. The rebates were limited to the amount of a taxpayer's income tax liability based on calendar year 2000 tax returns. Some 17 million households who filed tax returns received less than the full amount of the rebate because of this limitation, while an additional 34 million households did not qualify for any advance payment. Extending the tax rebate to families who work and pay Social Security payroll taxes but who did not qualify for a full rebate would benefit these 51 million households and cost about $14 billion. Because the rebate would be paid from general funds, it would not affect the Social Security trust funds.

  Such a rebate would be easy to administer if, as with the existing rebate, it were based on tax return information filed for 2000. This however, would miss some families who pay payroll taxes but do not file income tax returns. Information for those families would be available from W-2 forms, although processing of such documentation would have to be put on an accelerated schedule to get rebates to those families quickly. Extending the rebate to those households would increase the cost of the option.

- **Temporarily suspend payroll tax withholding.** An alternative to a payroll tax rebate is a temporary payroll tax holiday. Employers could be instructed to temporarily suspend withholding of the payroll tax from workers' paychecks and their payments of the

employer portion of the tax. This would provide an immediate boost to household take-home pay and would lower short-term employment cost for businesses. Employers would continue to report the amounts that would have been withheld, and the Social Security trust funds would be reimbursed from general revenues for the amount of payroll taxes that would have been collected. Workers would continue to receive earnings credit on their Social Security records for the full amount of their covered earnings.

The cost of a payroll tax holiday would depend on the portion of taxes to which it applied and how long it would last. Suspending collection of one-half a percentage point of the 7.65 percent payroll tax levied on employees and employers for one year (reducing the combined rate from 15.3 percent to 14.3 percent) would cost about $47 billion in FY 2002.

- **Reimburse states for a sales tax rebate**. Economist and former member of the President's Council of Economic Advisors Alan Blinder has suggested a temporary sales tax rebate as a way to stimulate consumer spending. The federal government does not collect a general sales tax but could reimburse states for their reduced sales tax revenues if they agreed to cut tax rates. A rebate would benefit all consumers, even retirees and others without current earnings, and would directly stimulate consumption. A temporary reduction in taxes would cause people to shift spending forward in time, providing an added boost to consumption when it is most needed. It would get money in the hands of lower-income Americans, those who are most likely to spend it and most in need. But the administrative costs of a sales tax rebate would be substantial. States would need to establish a baseline to determine the reduction in the sales tax revenues. This is complicated because tax bases can differ across states and change over time. Some states have no sales tax. There also would be problems coordinating with local governments that also levy sales taxes.

2. Accelerate Scheduled Income Tax Cuts

The Economic Growth and Tax Relief Reconciliation Act enacted in June of this year provides for further cuts in individual income taxes beyond those that have already gone into effect. These include additional increases in the amount of the child tax credit, so-called marriage penalty relief, and further cuts in income tax rates for high-income taxpayers rates in 2004 and 2006. Some or all of these future cuts could be rescheduled to take effect immediately.

- **Accelerate the increase in the child credit**. The Tax Act increased the amount of the child credit from $500 to $600 per child beginning in 2002. The credit amount is scheduled to increase to $700 in 2005, $800 in 2009, and $1,000 in 2010. Low-income families can receive a refund if their credit exceeds their income tax liability. The refund is limited to 10 percent of earnings in excess of $10,000 (indexed for inflation beginning in 2002). The percentage is scheduled to increase to 15 percent in 2005.

  Increasing the credit amount to $700 and the refund rate to 15 percent of earnings this year would add about $5 billion to the cost of the child credit and would benefit the over 25 million families receiving the credit. Because the credit phases out for couples with incomes in excess of $110,000 ($75,000 for single, heads of households), most of the

credit would go to low- and moderate- income households. Increasing the refund rate to 15 percent of earnings immediately would allow more low-income families to receive a refundable credit. Because most taxpayers would not claim the additional credit for tax year 2002 until they filed returns in 2003, most of the cost would occur in FY 2003.

- **Accelerate the tax rate reductions scheduled for 2006**. The Tax Act lowered income taxes for all families by creating a new 10 percent bottom tax bracket, retroactive for the entire 2001 tax year, and reducing tax rates for families in higher tax brackets. The first installment of the cut in higher tax rates took place this year. Future cuts are scheduled for 2004 and 2006. Accelerating the future cuts scheduled for 2006 to January 2002 would cost about $27 billion in FY 2002 and $122 billion in 2002 through 2011. Accelerating only the tax cuts scheduled for 2004 to January 2002 would cost $12 billion in FY 2002 and $34 billion in total.

  Less than a quarter of families and individuals filing tax returns would benefit from accelerating the tax cuts. Moreover, about 60 percent of the $28 billion revenue drain from accelerating the 2006 cuts to 2002 would go to the less than 1 percent of tax filers who are in the very highest tax bracket. These families are the least likely to spend a substantial portion of any additional tax cuts. A further cut in the tax rates faced by higher-income households would do little to further the goal of stimulating short-run consumption.

3. Reduce the Tax on Capital Gains

A capital gains cut would not encourage new economic activity. Rather, it would encourage the sale of old assets whose investment has already paid off, possibly depressing the stock market values even further. It would disproportionately benefit higher-income households, who are least likely to consume their tax cut, are least in need of support when the economy is slowing, and are already receiving the bulk of the income tax cut already passed. Some economists argue that a capital gains tax cut reduces the cost of capital and so promotes capital formation, which is good for the long run. But the overall long-run effect of a capital gains tax cut on national saving could well be negative, if the reduction in public saving outweighs any positive effects on private saving. Moreover, a bleaker outlook for the government's longer-run financial position could cause long-term interest rates to rise, which would have a depressing effect on today's economy.

- **Apply the lower capital gains tax rates on assets held for 5 years to all gains**. Capital gains from the sale of assets held for more than one year are taxed at a maximum rates of 20 percent. Assets acquired after 2000 and held for at least five years will be taxed at a maximum rate of 18 percent. Capital gains for taxpayers in the 15 percent tax bracket are taxed at a 10 percent rate or 8 percent if held for at least 5 years, regardless of when they were acquired. Applying the 18 percent and 8 percent tax rates to all long-term gains, regardless of how long there are held or when they are acquired, would cost 0.5 billion in FY 2002 and over $10 billion in FY 2002-2011.

II. Tax Cuts for Businesses

While some tax stimulus options would target business investment, the current investment environment is not encouraging: business inventories remain high, capacity utilization is low, and consumer demand looks weak. Businesses are unlikely to commit to new investment under such conditions. Boosting consumption would give business more reason to invest and actually could provide a greater stimulus to investment than a cut in the effective tax rate on investment. Moreover, investment incentives are usually targeted to particular types of capital or particular industries, creating preferences that are not necessarily justified given a general slowing of the economy.

1. Reduce Corporate Income Tax Rates

Some have proposed including a reduction in the corporate income tax rate as part of an economic stimulus package, but a corporate tax cut is unlikely to encourage new economic activity. First, a cut in the corporate income tax rate is not targeted to new investment. The corporate income tax applies to current corporate profits, which come from income earned on past investments. Hence, much of the revenue loss of a corporate tax cut is a windfall gain to existing capital. Second, a cut in corporate taxes cannot help businesses that are currently suffering losses because those corporations do not currently pay taxes. Many of these businesses are the ones most in need of short-term assistance. Third, while in theory a corporate tax cut should lower the cost of capital for some firms and hence has the potential to encourage some new investment, in practice many businesses are not affected by the corporate tax rate.

A corporate tax cut would not benefit workers. The consensus among tax economists is that the burden of corporate taxation falls on capital, not labor, even after accounting for potential behavioral responses to the tax. This means that reducing the corporate tax raises the net-of-tax returns to capital owners, but does nothing to raise net wages. A tax cut that raises returns to capital owners is a tax cut that will not stimulate consumption very much, first, because it encourages saving rather than consumption by its price effect, and second, because it puts more money in the hands of higher-income households (capital owners) who tend to save large fractions of their income. A recent Brookings Institution analysis argues that an increase in stock values is not at all certain, and even if it does occur, the short-term stimulus would be very small relative to the policy's long-term costs.

- **Permanently reduce corporate tax rates**. A permanent corporate tax rate reduction would severely worsen the long-term budget outlook. Long-term interest rates would surely rise in response to this over-commitment of future public resources, and this could actually cause the net short-run impact of the tax cut on the economy to be negative.

- **Reduce corporate tax rates for one year.** A one-year, 10 percent cut in corporate tax rates would cost about $22 billion in FY 2002. A temporary corporate rate reduction would be even less likely to stimulate new investment than a permanent cut, because much of the payoff from new investment (in the form of taxable profits) would come later, outside the window of the tax cut. Thus, although the overall revenue loss from such a policy would be smaller than if the rate cut were permanent, a yet larger fraction of the revenue loss would be wasted on windfall gains to old capital. A temporary cut might

also ironically give businesses the incentive to postpone investment until after the lower rate expires, because investment-related tax deductions are worth more when the avoided liability is higher.

- **Repeal all or part of the corporate alternative minimum tax.** One way to reduce the effective tax rate on some corporations would be through reductions or repeal of the corporate AMT. Enacted in its present form in the Tax Reform Act of 1986, the AMT was intended to reduce tax sheltering activity. It operates parallel to the ordinary corporate income tax, with a broader base and a lower rate. Firms pay the higher of regular tax liability or AMT liability, but receive a credit for the AMT they pay, which can reduce regular taxes owed in future years. Reducing or eliminating the corporate AMT would raise returns to existing assets of large corporations without necessarily boosting new investment. With more generous depreciation allowances, for example, firms that stayed on the AMT would face a greater incentive to invest, but firms that would end up back on the regular corporate tax system might actually face less marginal incentive to invest, because their marginal tax rate would have increased (even though their average tax rate would fall). Small businesses would not benefit at all from AMT relief, because the Taxpayer Relief Act of 1997 already exempted small firms. Large firms also received substantial relief in 1997 when AMT depreciation allowances were made more generous.

  Permanent repeal of the corporate alternative minimum tax would cost about $25 billion in FY 2002 if corporations received full refunds for their unused AMT credits.

2. Provide a Tax Credit for New Investment

An investment tax credit would allow firms to receive a tax credit for some portion of the purchase cost of new capital investment. All businesses could use the credit. Generally all new capital investment except investment in long-lived assets such as building, would qualify for the credit.

The credit provides an immediate benefit to profitable businesses that make qualified new capital investments. Firms that do not have profits in the year they make new investments, and thus do not have current tax liabilities against which to use the credit, would receive a deferred benefit. They could carry forward the unused credit to years in which they again earn profits.

Even though an investment tax credit would apply only to new capital purchases, it would not be limited to purchases that businesses would not have made in the absence of the credit. Thus, some portion of the benefits from the credit would go to firms that would have made the same investments even without the credit.

- **Enact a temporary investment tax credit.** Unlike a temporary corporate tax rate cut, a temporary investment tax credit might be a more effective short-run stimulus. More firms would invest now rather than wait and see if the economy improves. In many cases they would speed-up investment that they had planned to make in the future. The downside to a temporary credit is that, because of this investment speed-up, there could be a sharp drop off in new investment when the temporary credit expires. However, if the credit has the

intended effect of boosting the economy, firms may be more willing to make investments two and three years down the road when the credit expires that they would have been if sluggish economic growth had continued.

The cost of a temporary investment tax credit depends on the size of the credit and the range of investments to which it would apply. A 10 percent credit that applied to all new investment except structures, and which lasted through the end of calendar year 2002 could cost as much as $59 billion in the first year and $80 billion in total including the cost of unused credits carried forward into future years.

- **Enact an incremental investment tax credit.** It is tempting to modify an investment tax credit to try to only subsidize investment that would not have otherwise occurred. A recent analysis by the Brookings Institution suggests that one way to target the credit to minimize the windfall gains and to generate more stimulus per dollar spent is to allow the subsidy to occur only above some firm-specific investment threshold. For example, the credit could apply only to annual investment above 80 percent of the firm's average investment over the past three years. The difficulties in designing and administering an incremental credit that targets only additional investment have stymied similar proposals in the past.

3. Allow Full or Partial Expensing of New Investment

An alternative to an investment tax credit would be to allow firms to deduct the full or partial cost of new investment in the year they make the investment. Under current law, firms deduct the cost of new investment over a number of years. The length of time depends on the type of asset purchased--typically three or five years for a wide range of assets that wear out rather quickly such as cars, buses, and trucks, and certain "high-tech" investments such as computers; twenty years or more for assets that have a long useful life such as buildings and other structures.

Allowing firms to deduct the full or partial cost of assets in the year they make the investment (expensing) would provide firms with an immediate cash infusion. Full or partial expensing would only benefit firms who face corporate tax liability, and thus would not stimulate current investment for firms that are not currently profitable.

- **Allow temporary full expensing for all three- and five-year assets**. An option to allow all firms to temporarily deduct in the first year the full cost of new investment that they would normally depreciate over three or five years (thus excluding purchases of new buildings and structures), could cost about $96 billion. Because firms would not be able to claim future depreciation deductions for these assets, revenues would be higher in subsequent years than they otherwise would have been, and the long-term cost would be small.

- **Allow temporary partial expensing for all assets with lives of 20 years or less**. Allowing businesses to deduct 30 percent of the value of new capital assets in the year they purchased the asset would cost considerably less than full expensing. If the option only applied to assets that taxpayers would normally depreciate over 20 years and if

expensing was in effect for three years, the cost in FY 2002 would be about $39 billion, and the three year cost would be about $96 billion. Because businesses would not be able to claim depreciation deductions in future years for the portion of the assets that were expensed, revenues would be higher than they otherwise would have been after FY 2004. Thus, the cost of the proposal is estimated to be about $18 billion over FY 2002-2011.

- **Temporarily increase expensing for small businesses**. Under current law "small businesses" (businesses with less than $200,000 of investment in one year) can deduct the full cost of new investment of up to $24,000 in the year they make the investment, rather than spreading out the deduction over a number of years. Beginning in 2003, small businesses can immediately deduct up to $25,000. Temporarily raising that investment limit would provide an investment incentive to small businesses, at relatively little cost. For example, temporarily raising the limit to $35,000 for two years and increasing the overall investment limit to $325,000 would cost about $0.9 billion in FY 2002 and $1.4 billion in FY 2003. Again, because firms would not be able to claim future depreciation deductions for the portion of investments that were expensed, future revenues would be higher. The estimated cost of the option is under $300 million for FY 2002-2011. While this would help small businesses, it would not provide much stimulus to the economy as a whole.

4. Extend Net Operating Loss Carryback Period

One way to help businesses that are not currently turning a profit and hence do not currently owe taxes is to extend loss carrybacks. Present law allows corporations to deduct their current losses from prior taxable income, going back a maximum of two years. (In practice this means the firm receives a refund for a portion of taxes previously paid.) They can also carry forward their losses up to 20 years ahead. There is currently some discussion about possibly extending the length of the loss carryback period (prior to 1997 it was three years, not two).

Extending the loss carryback period would help formerly profitable businesses with current losses, firms that might otherwise be likely to layoff workers. It would not have a large long-term revenue loss because firms that could deduct current losses now, generally would have been able to carry forward those losses and deduct them in the future when they returned to profitability.

- **Allow 5-year carryback for net operating losses**. A two-year temporary extension of the loss carryback period from 2 years to 5 years would cost about $4.7 billion in FY 2002 and $3.5 billion in FY 2003. The option would require appropriate changes to the corporate alternative minimum tax to allow the full benefits from the loss carrybacks. Because firms presumably would have been able to deduct those losses in the future when they once again had profits, there is little long run cost to this option. The estimated cost over FY 2002-2011 is just under $500 million.

CONCLUSION

Running a budget deficit in the immediate future, while our country recuperates from the terrorist attacks and works to offset the threat of recession, is entirely necessary and appropriate. The merits of each proposal as they relate to the goal of providing effective and immediate economic stimulus are critical. Before any specific set of new proposals is enacted, however, it is important to consider how these proposals might effect the economy in the long run.

Beyond the next year or two, after the economy has recovered and probably adapted to a new mix of consumer demand, public saving will need to rise. At that point the federal government will be starting with a higher level of public debt than previously anticipated, while the retirement of the baby boomers will be that much closer–less than a decade away. Some "catching up" relative to prior budget goals will be desirable.

Fortunately, boosting public saving a few years away from now does not require raising taxes at that point. The income tax cut that has already been enacted is scheduled to phase in slowly from now until 2010, with the bulk of the revenue loss occurring in later years. The benefits of the tax cut also become increasingly skewed, with larger shares of the cut going to upper-income households over time. Thus, a relatively easy way to "pay for" the short-run stimulus package over time (and after the economy recovers) is by "freezing" portions of the tax cut a few years from now, at a less-than-fully-phased-in level. Such a strategy would preserve the long-term strategy of maintaining fiscal discipline, while reducing the scheduled tax cut only for the highest income Americans.

I. Freeze Some Further Cuts In Income Tax Rates

The Economic Growth and Tax Relief Reconciliation Act of 2001 created a new 10 percent tax bracket for a portion of taxable income that was previously taxed at 15 percent, beginning in calendar year 2001. The Act also reduced other income tax rates in a series of steps beginning in July of 2001. The 28 percent tax rate was reduced to 27 percent in that year and eventually will drop to 25 percent in calendar year 2006 and later. The 31 percent tax rate was reduced to 30 percent and eventually will fall to 28 percent in 2006. The 36 percent tax rate was reduced to 35 percent and will fall to 33 percent in 2006, while the top 39.6 percent tax rate was reduced to 38.6 percent and will fall to 35 percent in 2006.

The cut in the top marginal income tax rate benefits very few taxpayers, yet accounts for a disproportionate share of the cost of the tax cut. The latest IRS data show that in tax year 1998, of the just over 100 million taxable returns filed, only 753 thousand (or just seven-tenths of one percent) had taxable income high enough to be subject at all to the top marginal rate. Fewer than 2 percent of taxpayers had sufficient taxable income to reach the 36 percent bracket. Estimates by the Joint Committee on Taxation of the President's original tax cut proposal, which was similar to the version eventually enacted, showed that reducing the very top marginal rate alone accounted for 42 percent of the total cost of the rate cuts.

All taxpayers with income tax liability, including those in the highest brackets, benefit from reducing the marginal tax rate from 15 percent to 10 percent on some portion of taxable income. For example, for married couples the new lower rate applies to the first $12,000 of taxable income, yielding a tax cut of $600 (5 percent of $12,000). Furthermore, taxpayers in higher tax brackets have already received the additional one percentage point cut in rates that went into effect this year.

- **Freeze the top tax rate at 38.6 percent**. Freezing the top marginal rate at its current 38.6 percent level would increase future revenues by about $90 billion over 2004-2011, and would affect fewer than 1 percent of all households filing tax returns. Taxpayers in the top bracket would still benefit from the one percentage point reduction in their marginal tax rate that went into effect this year, plus the maximum benefits from the reductions in the lower marginal tax rates.

- **Freeze the top two tax rates at 38.6 percent and 35 percent**. Limiting the reductions in the top two tax rates to the one percentage point already enacted would raise $106 billion in 2004-2011. This would affect fewer than 2 percent of all households filing tax returns.

II. Freeze Further Cuts in The Estate and Gift Tax

The Tax Act also gradually raises the effective exemption amount for the estate and gift tax from $675,000 in 2001 to $3.5 million in 2009, reduces the top estate and gift tax rate in a series of steps from 55 percent in 2001 to 45 percent in 2009, and completely repeals the estate tax in 2010. Of course because the entire Act sunsets after 2010, the estate tax is back in 2011. Permanently freezing the cuts in the estate tax at the levels scheduled to take effect in 2006 would raise significant revenues and still provide substantial tax relief.

- **Freeze the Estate and Gift Tax at Its 2006 Level**. By 2006 the effective exclusion for the estate tax would be $2 million per person ($4 million for a married couple), already a significant increase over the $675,000 per person exclusion effective for 2001. With a year-2006 freeze, the top estate tax rate would stay at 46 percent rather than falling to 45 percent in 2007 and outright repeal in 2010. With a year-2006 freeze, the prior-law Federal credit for state estate and gift taxes would remain repealed, having been replaced by a deduction for state taxes. One estimate from the Democratic staff of the House Ways and Means Committee suggests that freezing the estate tax at 2006 values could raise more than $35 billion in 2006-2011.

Just as with the top marginal rate freeze, an estate tax freeze would not take away a penny of the tax reduction for the vast majority of taxpayers. Any estate with value above the current-law exemption but below $2 million would be completely unaffected by the freeze. Only estates above $2 million (or $4 million for married couple) would see some reduction in their estate tax cut. But those estates are a very small fraction of taxable estates. For example, tax data indicate that in 1999, only 3,283 estates—about 6.6 percent of all taxable estates—had a value of $5 million or more. Note that all taxable estates, including those above $2 million (or $4 million), would benefit from the still-higher exemption under the freeze proposal, because only the portions exceeding $2 million (or $4 million) would be taxable.