

The Bush Stimulus Plan: Analysis and Alternatives

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The economy is facing slow growth and a “jobless” recovery – 308,000 jobs were lost in February alone – as well as a return to federal budget deficits in the hundreds of billions of dollars and drastic budget shortfalls in almost every state.¹ In addition, the U.S. faces mounting costs from fighting “The War on Terrorism” and the military campaign and protracted rebuilding efforts in Iraq. Most economists, politicians, and policy analysts agree that a stimulus plan is needed to jump-start the economy in the very near future, but a wide range of (often contradictory) proposals have been put forth to accomplish this objective.

The Bush Administration has offered a stimulus plan that relies heavily on moving forward income tax rate cuts that are scheduled to occur in the future and exempting dividend income from the federal individual income tax. The basics of the plan are as follows:

1. Elimination of Individual Taxation of Dividend Income

Under this proposal, the majority of dividend income paid out on corporate stocks to individuals would be completely exempted from federal taxation starting in 2003. Currently, dividend income is taxed the same as income from most other sources, such as wages. This proposal would make it more difficult for states to tax dividend income since most states base their income tax systems on the federal government’s tax definitions and reporting standards.

2. Acceleration of Upper-Income Income Tax Rate Cuts

In 2003, the top four individual income tax rates would be reduced from 27%, 30%, 35%, and 38.6% to 25%, 28%, 33%, and 35%.

3. Acceleration of Middle- and Upper-Income Marriage Penalty Relief

In 2003, the standard deduction for joint filers would be twice the size of the standard deduction for single filers and the start of the 25% tax bracket for joint filers would be set equal to twice that for single filers. Marriage Penalty relief for low-income working families through the Earned Income Tax Credit (EITC), which is scheduled to take effect in 2008, would **not** be accelerated.

4. Acceleration of the Expansion of the 10% Tax Bracket

The 10% tax bracket would be expanded from applying to the first \$6,000 of federal taxable income for a single filer to \$7,000, and from \$12,000 to \$14,000 for joint filers, starting in 2003. This bracket would be indexed for inflation starting in 2004 (instead of 2009).

5. Acceleration of Child Tax Credit Increases

The Child Tax Credit would be increased from \$600 per child to \$1,000, starting in 2003. The increase in the portion of the Child Tax Credit that is refundable, which is scheduled to take effect in 2005, is **not** accelerated.

¹ See the Congressional Budget Office (CBO) website at www.cbo.gov and the Office of Management and Budget at www.whitehouse.gov/omb for some detailed projections and breakdowns of the President’s proposed budget. Information and analyses of state fiscal issues can be found on the Center for Budget and Policy Priorities website at www.cbpp.org/statecrisis.htm.

6. Temporary Alternative Minimum Tax (AMT) Relief

The AMT was designed to prevent high-income individuals from avoiding large portions of their tax bills through various loopholes by mandating a minimum level of tax that must be paid for each income level. This proposal would increase the AMT exemption by \$4,000 for single filers and \$8,000 for joint filers through 2005. This proposal does not address the expected long-term explosion of tax filers who will be subjected to the AMT. It is estimated that 36 million taxpayers will fall under the AMT by 2010.

7. Increase Expensing Limit for Small Businesses

This proposal would increase the maximum amount of investment that can be deducted from current business taxes (instead of amortized) from \$25,000 to \$75,000 in 2003. The expensing limit would phase out dollar-for-dollar with income starting at about \$325,000 instead of \$200,000 as under current law. This threshold would be indexed to inflation after 2003.

The estimated cost of each of these provisions, as well as the distributional impacts are described in the table below. Overall, the Bush Stimulus Plan would cost \$98 billion in 2003 and at least \$670 billion over ten years. (Congressional Budget Office estimates put the 10-year cost of the Bush plan as high as \$726 billion.) The bottom 60% of the U.S. population in terms of income would receive 8% of the total tax cuts in 2003, while the top 20% would receive 78% of the benefits.

Cost and Distributional Effects of the Bush Stimulus Plan

	Cost of Plan (\$ in billions)		Estimated Share of Benefits by Income Group, 2003		
	2003	2003 - 2013	Bottom 60%	Top 20%	Top 1%
Eliminate Individual Taxation of Dividends	\$20	\$364	5%	84%	42%
Accelerate Upper- Income Tax Rate Cuts	\$29	\$64	< 1%	94%	54%
Accelerate Middle- and Upper-Income Marriage Penalty Relief	\$19	\$58	6%	81%	4%
Accelerate Expansion of the 10% Bracket	\$5	\$48	27%	40%	< 2%
Accelerate Child Tax Credit Increase	\$16	\$91	29%	35%	0%
Temporary AMT Relief	\$8	\$29	n/a	n/a	n/a
Increase Expensing Limit for Small Businesses	\$2	\$16	n/a	n/a	n/a
TOTAL	\$98	\$670	8%	78%	28%

Source: Tax Policy Center, *Tax Provisions in the President's Economic Stimulus Proposals*, www.taxpolicycenter.org.

The administration's stimulus proposal has been criticized as tilting heavily in favor of the wealthy, proceeding too slowly to serve as an effective short-term stimulus, and causing large, long-term deficits. Recently, a group of over 400 economists, including this one and 10 Nobel Prize winners, published a petition in *The New York Times* voicing these concerns.² Further criticism has come from Congressional Democrats as well as prominent Republicans, such as Sen. John McCain and Federal Reserve Chairman Alan Greenspan, and business groups like The Business Roundtable and The Committee for Economic Development.

² See www.epinet.org/newsroom/stmt/index.html for the petition, list of signatories, and reactions.

In order to make sense of the stimulus debate, Lawrence Mishel, President of The Economic Policy Institute, has put forth a list of five criteria for an effective stimulus plan.³

1. A stimulus package should generate growth and jobs.

With factories, machinery, and workers idle and inventories accumulating, policies designed to spur business investment directly are likely to be ineffective. According to Dr. Mishel, what is missing from the economy is consumers. Businesses will not expand production unless they see strong signs that there is a demand for their products. Real interest rates are currently near zero and capital is plentiful. If business leaders saw enough increased demand to sell their inventories, they would be able to increase production and employment easily, spurring economic growth.

The Bush proposal focuses on the supply side through expanded business write-offs and tax cuts that lean heavily toward the wealthy, who save much larger shares of their income than lower- and middle-income individuals. Cuts in income taxes for wealthy individuals result in smaller increases in consumer spending than tax cuts for lower- and middle-income individuals, who are more likely to spend most of the additional income. Consequently, there is not likely to be a very large immediate boost to the economy from the Bush Stimulus Plan. In fact, the Congressional Budget Office estimates that there would likely be no positive economic impact if the current Bush Stimulus Plan were enacted, and the proposal could even produce a net drag on the economy. Tax cuts would be more effective at stimulating demand, and the resultant increases in business investment and employment, if they were geared toward the lower end of the income scale.

2. A stimulus package should be fiscally responsible.

The main objective of any stimulus program should be to “prime the pump” so that the private sector starts rolling again and leads the economy back to strong economic growth. But no stimulus plan should put the government’s long-term budget in jeopardy. Ideally, the federal government would run modest deficits during recessions, times of war, or other large-scale crises, and pay off the accumulated debts during periods of robust economic expansion. By cutting taxes and raising government spending in a responsible and focused way during recessions, the government can help to stimulate demand enough to push the private sector into expanding again.

Under the Bush plan, the bulk of the tax cuts do not take effect until after a recession or “soft patch” is likely to be over and the economy has returned to a healthy growth rate. With permanently lower tax revenues – and likely enormous increases in federal spending from war and its aftermath – the federal debt will grow massively over the coming decade, as it did in the 1980s following the Reagan tax cuts and concurrent military buildup. Aside from passing off this debt to future generations, hundreds of billions of dollars a year – money that could be used for improving education, enhanced homeland security, rebuilding Iraq and Afghanistan, ensuring the solvency of Social Security as the Baby Boomers retire, and so on – will be needed just to pay the interest on these additional liabilities.

Many economists also are concerned that ballooning deficits will drive up interest rates and “crowd out” private investments, as the government must try to attract capital away from private uses. Higher interest rates would depress business investment and consumer purchases such as housing and automobiles, putting a severe drag on long-term economic growth. Though the Bush Administration has begun to downplay the link between larger deficits and higher interest rates,

³ Economic Policy Institute, *Generating Jobs and Growth: An Economic Stimulus Plan for 2003*, www.epinet.org/briefingpapers/bp_2002_12_stimulus.html.

many notable economists, including Princeton's Paul Krugman and Harvard's N. Gregory Mankiw, have asserted that the link is very real.⁴

The Committee for Economic Development, a blue-ribbon panel of corporate CEOs and civic leaders, recently estimated that the Bush Stimulus Plan would raise the 10-year federal budget deficit by \$2.7 trillion and lead to annual deficits a decade from now in the \$500 billion range.⁵ These estimates led the Committee to conclude that the proposed massive tax cuts should be postponed because “[d]eficits matter – they lead to less investment, less productivity and a lower future standard of living.”

It should be noted that none of these deficit estimates include projections of costs spent on rebuilding Afghanistan or the war with Iraq and resultant occupation and rebuilding expenses. Yale University Economist William Nordhaus recently estimated that a “best case” scenario – a very brief war, no disruptions of oil supplies, and a peaceful rebuilding process – would cost the U.S. government several hundred billion dollars over the next decade. A “worst case” scenario – a protracted war, civil unrest in Iraq and elsewhere, major disruptions of oil supplies, etc. – could cost the U.S. as much as \$2 trillion when direct and indirect costs are taken into account.⁶

3. A stimulus package should take effect quickly.

For a stimulus plan to jolt the economy out of a slump and quickly return millions of unemployed and underemployed workers to full-time, decently-paying jobs, some of the components should deliver an immediate impact with others taking effect shortly thereafter, perhaps within six months or a year. Only 15% of the Bush Stimulus Plan takes effect within a year. More immediate injections into the economy would result from a stimulus plan that included tax rebates to lower- and middle-income workers and direct government spending or transfers to states, like Minnesota, that are in precarious fiscal situations so that devastating cuts in services can be avoided.

Facing a \$4.2 billion projected two-year state deficit, Governor Tim Pawlenty has proposed cutting state expenditures by \$2.9 billion. Deep cuts in a wide range of areas, from health care to public safety to services for seniors, are likely in communities across Minnesota. The effects on quality of life, safety, and the state's economic future will be profound. If the federal government were to redirect some of the proposed tax cuts to states instead, some of the proposed service cuts could be avoided. For instance, under a stimulus plan proposed by Senator Tom Daschle, Minnesota would receive an estimated \$664 million in federal fiscal relief.⁷ As part of a more modest stimulus proposal (see below), such state grants would be fiscally sound and well targeted to where needs are greatest.

4. A stimulus package should have fair effects.

The U.S. has experienced substantial increases in wealth and income inequality over the past three decades and currently maintains greater inequality than any other developed nation. The Bush

⁴ See, for instance, Paul Krugman, “A Fiscal Train Wreck,” *New York Times*, OpEd Pages, March 11, 2003. Although Dr. Mankiw will be defending the Bush Proposal as an economics advisor to the President, he has been highly critical of such proposals in the past. In a previous edition of his best-selling economics textbook, Dr. Mankiw listed the Reagan tax cuts, which are the model for the present Bush proposal, in a section titled “Cranks and Charlatans” because the tax cuts’ proponents claimed that the cuts would spur so much economic growth that they would pay for themselves in increased tax revenues. (N. Gregory Mankiw, *Principles of Economics* (1st Edition), Harcourt College Publishers, 1998.)

⁵ See Jonathan Weissman, “Chronic Budget Deficits Forecast,” *The Washington Post*, Saturday, March 8, 2003, p. A01, and The Committee for Economic Development at www.ced.org.

⁶ William Nordhaus, “The Economic Consequences of a War with Iraq,” *War with Iraq: Costs, Consequences and Alternatives*, American Academy of Arts & Sciences (2003).

⁷ Economic Policy Institute estimate.

Administration’s Stimulus Plan is tilted quite heavily toward the very wealthy, with 78% of the benefits going to the top 20% of the nation’s wealthiest households.

Government policy should attempt to secure the basic needs of society’s most vulnerable members before increasing the economic well-being of those whose basic needs and much more are already satisfied. Lower- and middle-income households generally experience the lowest levels of economic security — that is, they tend to be the “last hired, first fired” workers — and are saddled with higher debts and fewer assets to fall back on when unemployment hits. They also constitute the vast majority of the more than 40 million Americans who have no health insurance.

In order to enable more Americans to obtain their basic needs and improve their economic security, a stimulus plan should provide a substantial portion of its resources to lower- and middle-income groups primarily through well-targeted tax cuts and extended unemployment benefits. Since the concept of fairness is necessarily based on individuals’ values, there of course will be disagreements over how much a “fair” stimulus plan would devote toward lower- and middle-income households. While it is sometimes argued that the better off pay a larger share of total taxes and therefore should receive a larger share of tax cuts, the cuts in the Bush Stimulus Plan are out of proportion to each income groups’ share of total federal taxes paid. In 2001, the bottom 60% paid 14% of total federal taxes but would only receive 8% of the benefits from the Bush Stimulus Plan, while the top 20% paid 68% of total federal taxes but receive 78% of total benefits.⁸ This skewed distribution of benefits is difficult to reconcile with general notions of fairness.

	Bottom 60%	Top 20%
Share of federal taxes (2001)	14%	68%
Share of tax benefits in Bush Stimulus Plan (2003)	8%	78%

5. A stimulus package should target unmet needs.

If possible, a stimulus program should focus on areas of greatest priority, such as rebuilding and modernizing the faltering educational infrastructure, cleaning up environmental hazards, ensuring adequate medical care for the uninsured, and reducing homelessness and hunger. The Bush proposal does not address any of these unmet needs.

An Alternative Plan

Dr. Mishel offers an alternative stimulus plan that satisfies all of the five criteria listed above. The plan calls for:

1. Temporary Spending Increases

Under this plan, \$110 billion in one-time spending would be divided as follows:

- \$50 billion in state grants to offset state deficits and preserve vital social services, such as health care, police and fire departments, and education.
- \$25 billion for school renovations and repairs.
- \$25 billion to extend unemployment benefits for long-term unemployed workers and expand eligibility to include those who previously were disqualified from receiving unemployment benefits because they did not earn enough or work enough hours prior to losing their jobs.
- \$10 billion in other temporary spending measures, such as hiring or training more teachers and cleaning up environmental Superfund sites.

2. Temporary Wage Rebates

⁸ Institute on Taxation and Economic Policy Tax Model.

This plan includes \$65 billion in one-time wage bonuses for 149 million workers equal to 3.5% of the first \$15,000 of their wages. The maximum rebate would be \$525 per person or \$1,050 per couple.

Dr. Mishel estimates that this stimulus plan would increase economic growth by an additional 2% of GDP in 2003 and create 1.5 million new jobs. By injecting spending directly through government expenditures and immediate wage rebates, the stimulus could be felt immediately. Since lower- and middle-income Americans would see larger tax rebates under this plan than under the Bush Plan — and since these groups spend more of their additional income than wealthier Americans — there would be a stronger direct effect on spending and overall demand in the economy.

Also, by avoiding the elimination of the tax on dividend income, this alternative plan would preserve a key source of state revenue. Since most states tie their income tax systems directly to the federal government's system, the elimination of the dividend tax could shrink state revenues by over \$4 billion per year just when the states are in their worst fiscal crises since World War II. If it conformed to this proposed change in federal law, Minnesota would lose \$110 million in FY 2004 alone.⁹

Preserving the states' dividend tax revenue, combined with tens of billions of dollars in state grants from the federal government, would allow many states to remain solvent without raising taxes drastically or slashing essential social services like police, education, and health care. Deep budget cuts or higher state taxes, as are necessary for states to balance their budgets under current conditions, would exacerbate the problem of weak demand and increase the likelihood of falling incomes and rising unemployment. Forecasters at Economy.com already estimate that there is a 30% chance of another national recession starting within the next six months (a 17% chance for a recession in Minnesota). State budget cuts could raise those odds dramatically. Instead of states cutting weeks from their school year (as Oregon is contemplating) or reducing social services as most states, including Minnesota, have proposed, federal fiscal relief could prevent the worst of the proposed cuts.

When budgets are extremely tight, and likely are to get even tighter as the U.S. finances the costs of war with Iraq, it is necessary to focus on the most urgent priorities. By earmarking funds for educational upgrades, homeland security, health care, and other essential programs, we can be sure that the most pressing needs do not go unmet due to lack of funds.

In sharp contrast to the Bush Administration's stimulus program, this alternative plan shares tax cuts much more equally and distributes benefits in a manner that guarantees that the most basic needs are met before limited resources are employed elsewhere.

And finally, since this alternative plan is based on temporary, and more modest and targeted, tax rebates and spending, it does not place the long-term federal budget in dire straits, as the Bush Plan does. This alternative plan would stimulate the economy when it most needs it for a one-time cost of \$110 billion this year. This is in comparison to the Bush Plan, which is likely to raise the national debt by about \$2.7 trillion over the next decade while providing the vast majority of its stimulus too late to jump-start the economy out of this current soft patch. By keeping long-term costs reasonable, this alternative plan does not risk increasing the debt burden on future generations. The federal government already spends \$200 billion a year in interest alone on the national debt (almost twice the cost of this alternative stimulus plan). With a ballooning debt,

⁹ Center on Budget and Policy Priorities, *Bush "Growth Plan" Would Worsen State Budget Crises*, www.cbpp.org/1-8-03sfp.htm.

larger and larger amounts of government resources will have to be diverted from real needs to pay for debt upkeep, less money will be available for private investment, interest rates will likely rise over time and investment, incomes, productivity, and overall standards of living will suffer.

Policymakers in Washington should consider what makes a stimulus package effective. If they are truly concerned about returning millions of Americans to work quickly, then they will pass on the Bush Administration's current proposal and enact a short-term, focused, and fair plan like the one described above.