



Fiscal Policy Program: Issue Brief Paying for the Stimulus

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Summary

We are currently in the midst of two immense economic challenges: an immediate and severe financial crisis, which has already wiped out over \$20 trillion in global wealth; and a longer-term fiscal crisis, which existed before the financial crisis but will be made worse because of it.

To bring about an economic recovery, the federal government will spend trillions of dollars to help stabilize the financial sector and stimulate the economy.^[1] The United States entered this economic recession in a vulnerable fiscal position, and now policymakers will have walk a tight rope by stimulating the economy in the short term without permanently increasing what are already expected to be unsustainable levels of borrowing over the longer term.

Luckily, the choice between running deficits today and reducing debt tomorrow is a false one: economic stimulus can be both powerful and fiscally responsible. If government intervention is effective, it will protect against a deeper and more protracted recession and further fiscal deterioration. But such stimulus can be provided without further increasing our debt over the long-term. To do this, the spending must be offset over the long term and all the borrowing associated with the stimulus package repaid. In this paper, we offer a set of proposed offsets to finance the measures that appear likely to be included in the upcoming stimulus package. Included in our plan is the following:

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Stimulus Measure	Financing Mechanism	Cost
Individual Tax Cuts	Fix the CPI	\$200 billion
Food Stamps & Unemployment Expansion	Reduce Farm Subsidies	\$75 billion
Health Care Spending	Reform Medicare and Medicaid Payments	\$150 billion
Aid to States	Limit the State and Local Tax Deductions	\$150 billion
"Green" Investments	Increase the Gas Tax	\$100 billion
Infrastructure Investment	Increase User Fees and Reform Federal Contracting	\$100 billion
Corporate Tax Breaks	Cut Corporate Welfare	\$25 billion

Background

In the coming weeks, President Obama will likely sign the largest economic recovery package in the history of this country. This latest stimulus bill could cost as much as \$1 trillion. The plan is intended to mitigate the current economic downturn by boosting what economists call "aggregate demand," or the amount of goods and services purchased throughout the economy. Economic theory suggests that when the economy is performing far below capacity, the government can contribute to economic growth by increasing its own spending and/or inducing private actors to spend. This is especially true in the current situation where the financial sector remains essentially frozen and traditional monetary policy tools are nearing their limits. In theory, this new spending will increase and enhance the employment of capital and labor, and new rents and wages will be used for further spending, creating a virtuous cycle of recovery. This new government spending (or tax cuts) must be financed through borrowing, since any tax increase or spending cut will have a de-stimulating effect, canceling out most or all of the benefits from stimulus.

Although paying for stimulus up front (or too early) would be counterproductive, permanently increasing the national debt would also be damaging. Already, the debt held by the public has climbed to over \$6 trillion, and the total national debt is more than \$10 trillion. As the economy recovers, this large and growing debt could crowd out private investment, permanently slowing the country's long-term growth. Increased borrowing will also force future generations to pay for today's consumption, either through higher taxes or lower government spending.

Additionally, there is a the risk that our creditors and bondholders will be less inclined to continue the practice of extending us cheap credit if the United States does not show itself to be fiscally responsible.^[2] This would mean higher interest payments by taxpayers, less fiscal flexibility on the part of the government, and less stability in the financial markets.

How to Make the Stimulus Package Effective

A successful stimulus package must use dollars to maximize economic activity in the near-term. Accomplishing this goal will require measures with a high "fiscal multiplier" -- the ratio of dollars of economic activity created per dollar spent. For direct government purchases, this means focusing on initiatives that can be undertaken quickly and employ idle labor and capital. For government transfers and tax cuts, this means getting money into the hands of those most likely to spend it rather than save it, or inciting them to do so. It also means not directing resources to politically popular but economically dubious policies or the favorite programs of individual members of Congress.

It is also important for the stimulus to be temporary. The purpose of stimulus is to boost immediate demand to compensate for the decline in private spending and to stem job loss to help get the economy back on track. Although most economists believe these demand-side policies can work in the short run, the size of the economy over the long term is determined by its productive capacity (which determines the "supply" of goods and services), and cannot be indefinitely supported by fiscal stimulus. Continuing stimulus policies after the economy has recovered would unnecessarily drive up the national debt. Moreover, by trying to force demand above capacity, these policies could be highly inflationary and might fuel economic bubbles that would inevitably burst.

Given that this recession will be longer and deeper than the typical recession, there is an opportunity to enact policies that take longer to work their way into the economy than typical stimulus measures. The current recession has suppressed both private consumption and investment. Temporary investments that jump-start important changes -- without engendering permanent new spending programs -- will boost economic activity now and strengthen economic capacity over the long run. It is therefore potentially quite beneficial to devote some of the stimulus package to longer-term investment policies as long as those short-term investments are repaid over a reasonable amount of time and do not lead to permanent spending policies.

How to Make the Stimulus Package Fiscally Responsible

The stimulus package should be targeted, temporary, and focus on both short- and long-term growth. Passing a well-crafted high "bang for the buck" stimulus package that leads to higher economic output can speed up the economic recovery, increase government revenues, and decrease the cost of government spending on automatic stabilizers.

To guard against permanently damaging the nation's fiscal health, however, we should aim to repay all the borrowing that has been used to finance the stimulus package once the economy has recovered. There are many ways to do this. For instance, Congress could include an agreement to reduce the debt as a share of GDP by set increments once the recession is over. Or it could put in place a broad deficit reduction plan to be phased in once the recovery was sufficiently strong (with an escape clause for cyclical economic decline).

Another alternative is sketched out below: linking the various elements of a stimulus package to specific offsets that would be put in place now but take effect only when the economy was growing strongly again. It is necessary to make a decision on offsets now because to delay would increase the likelihood that they will not be found later. On the other hand, phasing offsets in too quickly could halt or hinder a recovery. Directly linking new spending or tax cuts to offsets would not only lock in a way to bring down the debt, but force lawmakers to think twice about larding up the stimulus bill with their own pet projects, regardless of cost.

Our proposed offsets, highlighted in the accompanying chart and discussed below, relate to the major provisions in the American Recovery and Reinvestment Act, which is currently working its way through Congress.^[3] (This reflects neither our support for nor opposition to this particular stimulus package, but simply an acknowledgment of the types of policies that appear likely to pass.) For political reasons, we advocate paying for stimulus provisions with measures logically connected to the provisions themselves. Thus, clean energy investments are financed with a

new gas tax, and health care spending is financed with Medicare and Medicaid payment reforms. Moreover, our proposed offsets are meant to reduce (or minimize the increase in) economic distortions, largely by targeting wasteful spending and base-narrowing "tax expenditures," and they are roughly proportional to the stimulus package itself in terms of tax versus spending measures.

Specific Offset Recommendations

Stimulus Measure	Financing Mechanism	Cost
Individual Tax Cuts	Fix the CPI	\$200 billion
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1. Pay for Individual Tax Cuts by Fixing the CPI (\$200 Billion)

Individual tax cuts, particularly those targeted at lower-income workers, can be fast and powerful stimulus measures. The stimulus package is likely to include roughly \$200 billion in individual tax cuts in the form of both broad rebates and targeted tax credits.

We recommend that the costs of these temporary tax cuts be offset by changing the way the government calculates inflation, which many economists believe is overstated. Supplanting the use of the standard Consumer Price Index (CPI) with the "superlative CPI" would slow the automatic indexing of a number of programs. This would gradually reduce the growth of Social Security and other government benefits, as well as the adjustments of income tax bracket levels. Switching to the superlative CPI would raise more than \$220 billion in 10 years -- around \$80 billion from tax revenue, over \$100 billion from Social Security, and the rest from other government programs.^[4]

2. Pay for Increased Food Stamps and Unemployment Benefits by Reducing Farm Subsidies (\$75 Billion)

Food stamps and unemployment benefits are "automatic stabilizers," with increases kicking in during hard economic times. They are an effective stimulus because they go to individuals who would otherwise see drastic reductions in their personal consumption. The current package includes proposals to increase the size of food stamp benefits, and to expand and extend the Unemployment Insurance Program.

To pay for the expansion of these programs, we recommend a large reduction in agricultural subsidies. The farm sector benefits considerably from food stamp increases, making this a logical source for offsets.^[5] Moreover, there is broad agreement that current farm subsidies are economically distorting, go mostly to large agribusinesses, and hamper international trade. This is the perfect time to dramatically reduce an unfair and outdated slice of the budget pie. By doing so, we could easily generate tens of billion in savings.

3. Pay for Increased Health Care Spending through Reforms to Medicare and Medicaid Payments (\$150 Billion)

The stimulus package is likely to include considerable funding for health care, including increased matching rates to the states for Medicaid, new spending to increase health insurance coverage for unemployed workers, and investment incentives for health information technology.

Funding for health care within the stimulus bill should be offset by reducing the federal government's future health care spending. Although a stimulus package is not the appropriate vehicle for making the wholesale changes needed to bring health care costs under control, small reforms can be undertaken-especially as information technology permeates the industry. Information obtained from analysis of electronic medical records can be used to reduce payments for over-treatment and preventable medical errors, and additional savings can come from payment penalties on providers who fail to update their information systems. Other savings might be achieved by reducing reimbursement rates for high-cost providers, streamlining Medicaid matching rates, reforming the Medicare Advantage system, or reducing Medicare payments for some elective procedures.^[6]

4. Pay for Aid to the States by Limiting the State and Local Tax Deduction (\$150 Billion)

Almost all states are required to balance their budgets on an annual basis. Thus, economic downturns typically force state governments to cut spending or increase taxes -- not desirable policies during a recession. The forthcoming stimulus package is likely to send considerable amounts of money to state and local governments, either directly or indirectly, in the form of education funding, law enforcement funding, tax subsidies for state and local bonds, and general grants to state governments.

To pay for this aid to the states, we propose capping the state and local tax deduction. This tax preference allows individuals to deduct the cost of most state and local taxes from their federal taxable income. In addition to being regressive, this deduction serves as a backdoor subsidy to state and local governments -- especially those with high income and property tax rates. Capping or otherwise limiting this deduction could raise considerable revenue for the federal government. Replacing it with a 15 percent credit, for instance, would easily raise over \$150 billion in ten years.^[7]

5. Pay for "Green" Investment by Increasing the Gas Tax (\$100 Billion)

A large portion of the stimulus package relates to "green" investments, which many argue will have the triple benefit of creating jobs in the short run (especially in the foundering construction sector), reducing nationwide energy costs in the medium run through less (and more efficient) energy use, and addressing the threat of global climate change over the long run by reducing carbon emissions. The stimulus bill is likely to include funds for retrofitting public buildings to make them more energy efficient, modernizing the nation's energy grids, expanding mass transit, and providing a number of clean energy tax credits.

To finance these investments, we recommend increasing the tax on gasoline and diesel fuel. A gas tax is a logical, almost necessary, component of a comprehensive environmental and energy policy. The transportation sector alone consumes over a quarter of all domestic energy and creates nearly a third of the country's carbon emissions.^[8] Increasing the gas and diesel tax by a mere five cents per gallon would raise \$10 billion a year.^[9]

6. Pay for Infrastructure Investments with User Fees and Contracting Reforms (\$100 Billion)

In addition to energy investment, the stimulus package is likely to include considerable amounts of traditional infrastructure investment, which policymakers have argued would create jobs and stimulate economic activity in the short run while increasing economic growth over the long run. Current proposals include funding for bridges, roads, schools, water treatment facilities, urban renewal, disaster protection, and broadband technology, as well as several tax changes designed to encourage infrastructure investment.

In order to cover the costs of major new infrastructure investments, we recommend that policymakers look first at self-financing mechanisms -- particularly tolls and user fees. Since we do not expect these sources of revenue to be sufficient, we also propose reforming the bloated and inefficient government contracting process. Revisiting practices like awarding "no-bid contracts" and paying certain contractors above the market wage would be a good start, but cuts in the overall number of contractors will also be needed. If federal spending on contractors were reduced by 2 percent -- only a fifth of what President Obama has recommended -- it would save around \$80 billion over 10 years.^[10]

7. Corporate Tax Breaks Financed by Reducing Corporate Welfare (\$25 Billion)

In order to encourage private investment, the stimulus package is likely to include tax incentives for businesses. In particular, it will likely offer "bonus depreciation" along with special expensing and carry-back rules to reward investment in productive capital (e.g., machines and other equipment). Since firms that take advantage of these breaks are largely shifting their tax liability through time, rather than eliminating it, much of the immediate cost of these breaks -- which would total roughly \$100 billion -- would be recovered within a decade.

To finance the remaining costs, we recommend future reductions in federal subsidies to private businesses. Corporate welfare easily costs the government tens of billion of dollars a year, with much of the spending moving through the Advanced Technology Program, the Economic Development Administration, the Export-Import Bank, the Private Investment Corporation, and the Overseas Private Investment Corporation.^[11]

In addition, the tax code includes a number of "rifle-shot" corporate breaks, including those for insurance companies, credit unions, oil companies, exporters, and other entities. Once the economy recovers, these subsidies should be reduced significantly to pay for the corporate tax cuts.

A Stimulus Package for Long-Term Economic Health

We have offered one possible strategy to make the stimulus package more fiscally responsible. It is an attempt to reconcile the nation's short-term economic needs with its long-term fiscal situation. Our proposed approach would not only make stimulus revenue neutral over the long run, but force politicians to think carefully about which measures are worth enacting, and which are not.

Two warnings: Shifting attention from spending wisely to repaying too early would derail the recovery and create the need for another round of stimulus. Thus, the fiscal responsibility piece of the plan should not kick in until the economy is growing strongly again.

At the same time, paying for the stimulus package in no way absolves policymakers of the necessity of dealing with the nation's existing fiscal challenges, namely the long-term fiscal imbalances resulting from projected entitlement growth. Policymakers must address the unsustainable growth in Social Security and Medicare, and enact fundamental tax reform, if they are to deal with the daunting long-term fiscal gap.

If Congress is serious about fixing the economy, it is critical we take steps in this plan to address our burgeoning debt. Our proposal would be a good start.

Notes

^[1] The U.S. government has already provided trillions of dollars in loans, equity purchase, guarantees, and other measures in order to stabilize the financial sector, and has spent almost \$200 billion on direct fiscal stimulus. Further information is available at <http://www.usbudgetwatch.org/stimulus>.

^[2] The current instability in the financial markets has led to record demand for U.S. Treasury Bonds -- even at interest rates nearing zero -- but investors will want to diversify out of these bonds as the market recovers, especially if they begin seeing them as riskier assets.

^[3] A Congressional Budget Office analysis of the House version of the bill is available at <http://www.cbo.gov/ftpdocs/99xx/doc9976/hr1aspassed.pdf>.

^[4] Congressional Budget Office, <http://www.cbo.gov/ftpdocs/78xx/doc7821/650.htm>.

^[5] United States Department of Agriculture, <http://www.ers.usda.gov/publications/fanrr26/fanrr26-6/fanrr26-6.pdf>.

^[6] A full menu of Medicare and Medicaid spending options is available from the Congressional Budget Office at <http://www.cbo.gov/doc.cfm?index=9925>.

^[7] Congressional Budget Office, <http://www.cbo.gov/ftpdocs/88xx/doc8843/MainText.4.1.shtml>.

^[8] Bureau of Transportation Statistics, http://www.bts.gov/publications/transportation_statistics_annual_report/2005/html/chapter_02/transportation_sector_energy_use.html.

^[9] National Surface Transportation Policy and Revenue Study Commission, http://transportationfortomorrow.org/final_report/pdf/volume_2_chapter_5.pdf.

^[10] Authors' calculations based on figures from the Obama-Biden Presidential campaign, http://obama.3cdn.net/0080cc578614b42284_2a0mvyxpz.pdf.

^[11] Obama-Biden Presidential campaign, http://obama.3cdn.net/0080cc578614b42284_2a0mvyxpz.pdf

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