**IRET Congressional Advisory**

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## THE ECONOMY NEEDS MORE THIS YEAR THAN A TAX REBATE

The terrorist disaster makes it essential to strengthen the economy. With limited money for further tax relief, we must use it as effectively as possible. The current economic weakness is due to slumping investment. The best fix, by far, is faster write-off of outlays for equipment and structures. Faster write-offs are better at permanently raising investment in a non-distorting way than are an investment tax credit (ITC) or a cut in the capital gains or corporate tax rates.

The U.S. Treasury began sending out tax rebate checks in mid July and will have the bulk of them mailed by the end of September. The checks are up to $300 for a single filer, $500 for a head of household, and $600 for a couple. The checks will total $39 billion and will go to almost 92 million households.

Congress added the rebate to the Economic Growth and Tax Relief Act of 2001. In essence, the rebate is advance payment of the tax relief provided by the new 10% tax bracket that the President had first proposed, made retroactive to the start of the year. (Technically, it is much more complicated. Congress used a tax credit instead of the 10% bracket for 2001, and the rebate checks are advance payments of the tax credit. The Treasury is computing the rebate checks using 2000 tax returns because returns for 2001 are not yet available. Although taxpayers will be required to do a reconciliation when they file their 2001 tax returns, they will not be required to repay the government if they received too much but will be able to claim the difference if they are owed more.)

Congress hopes the rebate will help jump start a sluggish economy by prodding consumers to spend more. In the words of the Conference Report, "[T]he issuance of [rebate] checks ... will deliver economic stimulus to the economy more rapidly..." In reality, though, the rebate is a return to the type of Keynesian thinking that proved so disappointing in the 1970s; it will have little economic effect, notwithstanding its political appeal. First, the rebate checks will not generate much increased consumer spending. Second, a government-engineered burst of consumption is not the path to a stronger economy.

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Economic theory, public opinion surveys, and early economic data all suggest that people will not rush out and spend their rebate checks. In a Washington Post-ABC News poll taken in June, only about 20% of those polled said they planned to spend the rebates on extra consumption; roughly two-thirds said they would save the money or use it to pay down bills (a type of saving). In a USA Today-CNN-Gallup poll in July, just 17% said they planned to spend the money on consumption while 79% said they would save it or use it to pay down bills. The latest data from the government's Bureau of Economic Analysis indicate

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a saving surge. Personal saving rate jumped to 2.5% in July, when the first rebate checks were being mailed out. That is the highest level for the personal saving rate in two years; it was only 1.0% in June.

One reason the rebate might have little immediate impact on consumption is that people may base their consumption on expected long-term average income, not current income. This is Milton Friedman's permanent income hypothesis, and is partially responsible for his Nobel Prize in economics. In this view, people's perception of their permanent income takes time to change. People have not yet had the higher after-tax income long enough to have altered their spending habits.

A more fundamental objection, also based on the work of Milton Friedman, is that a key step in the Keynesian chain of events by which tax changes supposedly affect the economy does not occur. The Keynesian model postulates that a tax decrease gives people more money to spend, which boosts aggregate demand in the economy. Friedman's insight was that a tax change by itself does not alter the amount of money people have to spend outside the government sector. When the government sends a taxpayer $1 via a rebate check, the taxpayer does indeed have $1 more. However, the government then has $1 less for debt repayment (or needs to borrow $1 more if it is running a deficit.) That means bondholders, after lending to the government, have $1 less. Because the added dollars the rebate puts in the hands of taxpayers are exactly countered by fewer dollars in the hands of bondholders, the rebate generates no first-order income effect to increase consumer spending and aggregate demand.

Tax reductions can strengthen the economy, but the pathway is through supply, not demand, by changing incentives, not by altering money flows. The current tax system depresses after-tax work incentives and even more severely depresses after-tax rewards for saving and investment. It lowers the after-tax reward to an additional hour of work or dollar of saving. Tax changes that raise the rewards to added production will bolster the economy. The benefits will increase over time, but they will begin quickly and provide economic support even in the short term. To spur the economy, however, tax changes must apply at the margin: to the dollars people can earn (or forgo earning) by working, saving, and investing somewhat more (or less). If a tax cut is a lump sum, like the rebate, or only pertains to the first few dollars of income and does not reduce the tax bite at the margin, it will have no incentive and growth effects.

In all but a few cases, the rebate does not decrease the tax liability on the last dollars of income and, hence, does not reduce marginal tax rates. An IRET calculation using IRS data from 1997 indicates that the new 10% bracket will apply at the margin to taxpayers with only 2%-3% of total income. Thus, the rebate (which is in lieu of the 10% bracket in 2001) will provide little economic stimulus. In its failure to reduce marginal tax rates, this rebate is similar to the ineffective Ford Administration rebate of 1975.

The Tax Act of 2001 does have provisions that will lower marginal tax rates, but at the insistence of members of Congress, especially those in the Senate, they will take effect only slowly (and then vanish at the end of 2010 unless renewed). What can be done immediately to help the economy?

Senate Minority Leader Lott (R-LA) suggests cutting the maximum capital gains tax rate to 15% for two years. This would trim the tax bias against saving, but the two year limit, designed to get a positive revenue number from the static revenue estimators, would slash the long-term effectiveness. Also, because U.S. saving can flow overseas, some of the added investment from the lower capital gains tax rate might occur abroad, not here.

Following the terrorist attack, House Ways and Means Chairman William Thomas (R-CA) suggested reinforcing our "economic strength to wage this

war" by permanently cutting the capital gains tax rate to 15%, enacting a 10% investment tax credit (ITC), and increasing the amount small businesses may expense. This is an improvement, but not the best approach. The ITC, with its on-again off-again history, will not encourage businesses to undertake permanent enlargement of their capacity. The combination of the ITC and stretched-out depreciation schedules would still distort investment; it would sometimes undercompensate for investment costs and sometimes overcompensate, depending on the rate of inflation and the type of asset. Expensing (immediate deduction of investment outlays from taxable income), by contrast, is always an accurate measure of a business's capital outlays. Corporate tax rate reduction is another possibility, but it provides much of its relief short term to earnings of investments made in the past, and gives less incentive to new investment than would expensing or faster write-offs.

One of the best ideas now on the table is the High Productivity Investment Act (HPI). Introduced by Representatives Philip English (R-PA) and Richard Neal (D-MA), it would shorten capital cost recovery periods for equipment purchases. HPI would let businesses expense high-tech equipment purchases and permit investors to deduct all other equipment purchases with less tax-code-imposed delay. The faster write-offs would lower after-tax equipment costs and increase capital formation. The proposal would provide short- and long-run benefits by helping to reverse the sudden drop-off in investment that is responsible for the current slowdown. For tax neutrality, investors should be able to deduct all capital costs when they incur those costs. The English-Neal proposal does not go that far, but it would be an excellent start.

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*Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.*