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STIMULUS OR SILLINESS?

The stimulus package is rapidly becoming cosmetic rather than substantive. New and nearly useless provisions are being suggested based on theories that were discredited in the 1960s and 1970s, and useful provisions are being scaled back to pay for them. The best that can be said for the bill at this point is that the economy may have recovered before the bill is passed.

> ***The best tax proposals on the table are 30 percent expensing and repeal of the corporate AMT, followed by acceleration of all the pending marginal rate cuts (not just the bottom rates).***

The best tax proposals on the table are 30 percent expensing and prospective repeal of the corporate AMT, followed by acceleration of ***all*** the pending marginal rate cuts (not just the bottom rates). The investment incentives would work by making it easier, after taxes, for a prospective investment to earn enough to cover its own costs, thus enabling businesses to create and employ more plant, equipment, and buildings. The personal tax rate cuts would encourage additional work, hiring, saving and investment by raising after-tax returns to workers and entrepreneurs.

These constructive features are being short-changed and watered down in favor of provisions that would "give consumers money to spend" to "pump up demand". Two new ideas are a brief state and local sales tax holiday (reimbursed by federal revenues) and a one month payroll tax holiday. Both are advertised as ways to put money into consumers' pockets fast, and are offered in lieu of giving $300 to $600 dollar rebates to people who did not pay income tax and were not eligible for the first round of rebates last summer.

That analysis is flawed. The sales tax holiday would do no measurable good. The payroll tax holiday would do a bit of good, but not by expanding consumption. These plans, and the rebate scheme they would replace, and indeed any kind of tax cut, would not give people more money to spend. (They don't work by giving businesses money to spend either. It is not necessary to refund old AMT credits immediately; just allow them to be claimed over time.) The federal revenue used for these schemes might otherwise be used to repay more federal debt, which means it would go back to the bondholders, who would spend it themselves or lend it to others to spend. Alternatively, it might be used for more federal spending, or a larger tax cut of a more pro-growth kind. This "federal budget constraint" dictates that there be the same initial "demand" either way. (The only way federal policy can boost spending without first encouraging production is by increasing the money supply, but that is monetary policy, and is independent of federal tax and spending changes.)

> ***Tax provisions that are purported to work by "giving individuals or businesses money to spend" would do nothing of the sort.***

Institute for Research on the Economics of Taxation

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1730 K Street, N.W., Suite 910, Washington, D.C. 20006
Voice 202-463-1400 • Fax 202-463-6199 • Internet www.iret.org

Tax changes succeed in boosting the economy only if they make it more rewarding to do extra work (or to hire an extra worker) or if they raise the after-tax earnings on additional capital. A payroll tax holiday might stave off some lay-offs by reducing the cost of carrying workers for an additional month, but unless the economy turns up quickly, their respite would be short-lived. Being temporary, the payroll tax holiday would not encourage a permanent increase in work or hiring. It would certainly not work by boosting consumption.

If "pump-priming" provisions take over the package, it would be better to do nothing at all.

A temporary sales tax holiday would mainly move money around, not raise incentives to work or hire. Yes, the (briefly) lower cost of consumption would make earning income more rewarding, but only a bit. The sales tax holiday would only apply to a small portion of consumption. Rent, health care, tuition, and in some states, food, are not subject to sales tax. The holiday would affect consumer durables (buying a car in the tax window rather than a month later) or things that could be stored (a year's worth of clothes, canned soup or toilet paper). But one could not buy a year's worth of haircuts in ten days. Nor would one want to stock up on too much storable stuff, or one would lose more interest on depleted savings than one would save in sales tax. Meanwhile, drawing down savings to cram consumption into a short time frame would necessitate spending less in later months to restore the lost savings; it would shift spending around, not add to the total. There would be no net direct increase in spendable income, because the state tax cut would be reimbursed by the federal government, which would then either pay down less debt, or have less room for other federal tax relief or for government spending.

The best tax cuts are those that are permanent and that trim marginal tax rates, accelerate depreciation, and otherwise reduce the tax bias against saving and investment. Tax provisions that are purported to work by "giving individuals or businesses money to spend" would do nothing of the sort. They may be needed to muffle the demagoguery and grease the political skids for passage of a bill, but they are not effective as economic "stimulus", and must not be allowed to displace or water down those provisions that would actually work. If "pump-priming" provisions take over the package, it would be better to do nothing at all.

Stephen J. Entin
President & Executive Director

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.