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WILL SENATOR DASCHLE'S STIMULUS PLAN WORK? IS CHAIRMAN GREENSPAN RIGHT THAT WE DON'T NEED ONE?

The Senate is considering a four part economic package urged by Senator Daschle. It contains 13 weeks of extended unemployment benefits for people whose ordinary benefits have been exhausted, a new round of $300 to $600 rebates for those who did not receive them in last year's tax cut, an increase in the federal match for state spending on Medicaid, and 30% "bonus" depreciation for investment in equipment for one year. Meanwhile, Federal Reserve Chairman Alan Greenspan says the economy is poised for recovery without any further stimulus, and suggests that we do not need another package.

Senator Daschle describes his plan as "non-controversial economic recovery provisions" and urges that the Congress "immediately pass what we agree on." Unfortunately, the package is not so much a common approach to growth as it is the lowest common denominator of the various items in various "stimulus" packages recommended over the last few weeks. Three of the four pieces would have no effect on growth, and the fourth would have so little as to be nearly worthless. If this is the best the Senate can do, it would be better to do nothing, save the money and the added future debt service, and wait for the chance to use the money for real, fundamental pro-growth tax reform.

How taxes and transfers do and don't work

Federal tax cuts or transfer programs do not work by "pumping up demand" or giving people "more money to spend". The same money would otherwise have been available to pay down more federal debt (or result in less federal borrowing), in which case the federal bondholders would have had the funds to spend themselves or to lend to others to spend. There is no "demand" effect unless the Federal Reserve buys the added debt, thereby increasing the money supply faster than otherwise.

Tax cuts only work to stimulate the economy if they increase, at the margin, the after-tax rewards to work, saving, or investing. Such tax cuts encourage more labor and capital to be supplied and employed to produce more output; the workers and capital owners are paid for their trouble, and they then buy their added product. Supply and demand rise together, or not at all. Transfer payments generally reduce incentives for those who receive them and for those who are taxed to pay them; they reduce output by attacking supply at both ends.

The provisions in the package

Extended unemployment benefits. The extended unemployment benefits in the Senate package would be a humanitarian gesture to those hurt by the downturn, but they would not stimulate employment or growth. Indeed, extended benefits would enable some workers to remain unemployed longer than they otherwise would. Such payments would not boost "demand" in the economy by giving them money to spend, as the outlays would come at the expense of other uses of the same money.

Rebate checks. Ditto for the rebate checks. The government will have to borrow more to cover these outlays, which takes as much money from

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private users as it gives to the rebate recipients. Some argue that the rebate recipients would be more inclined to spend the money than the people from whom it was taken (the savers who buy the added government debt), but that is nonsense. The private savers would have lent the money to businesses to buy plant or equipment, to homebuyers, or to people borrowing for consumption. That is what happens to saving; it is why credit markets exist.

Aid to the states for Medicaid. The additional assistance to the states would, according to Senator Daschle, keep them from having to raise taxes or cut spending in a recession. But again, the payments would just be substituting one form of spending for another.

A depreciation "bonus" for equipment spending. The proposal to allow firms an immediate write-off ("expensing") of 30% of their equipment spending for one year would reduce the cost of investment, but only for a short time. There would be some replacement of old capital equipment a few months ahead of schedule, but no reason to expand the capital stock on a permanent basis. Therefore, most of the investment stimulated by the provision would merely be "borrowed" from the next year, triggering an offsetting slump in investment at that time. Only a permanent improvement in the taxation of capital can lead to a permanent increase in the capital stock, productivity, employment, and wages. The only good thing about the provision is that it might be extended in conference. The House-passed tax cut would have the same provision for three years. However, an amendment in the Senate to extend the provision to three years was offered and voted down. The conference would not be likely to move all the way to the House version. Even if it did, the improved treatment of investment would not be permanent. The only hope is that, by the time it expired, the budget outlook will have improved by enough to allow the provision to be extended permanently.

Greenspan's comments

Federal Reserve Chairman Alan Greenspan told the Senate Budget Committee last Thursday that the economy is poised for recovery and did not need another round of "stimulus". His comments are reducing Congressional enthusiasm for the struggle to craft a bill. Is Greenspan right or wrong? Yes. Both. Greenspan's focus is on the short run business cycle, his lifetime field of research. He is correct that the economy will resume growth sometime fairly soon without another tax and spending bill.

Greenspan is wrong, however, in not thinking further ahead to the strength and length of the subsequent expansion, and to the policies that would promote a decade of growth. We ought not to think of any "stimulus" bill in counter-cyclical demand-management terms, or worry whether or not is it still needed for such purposes, because that is not how fiscal policy and the economy work anyway. Rather, good policy is about reforming the tax system to permit a long and vigorous expansion of the labor force and the capital stock, sustained growth of productivity and real wages, and expanding output of goods and services. The task of reforming the tax system, and restraining runaway government spending to help pay for it, is still before us. Let's get on with it.

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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.