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STIMULUS OPTIONS TO AVOID

The U.S. economy is being battered by rising energy costs, higher food prices, falling home values, a growing number of mortgage defaults and foreclosures, huge losses by some debt holders, and uncertainty about which lenders are most exposed to future losses. The now punctured housing bubble, which is tied to some of the problems, appears, in retrospect, to have had several facilitators: the Federal Reserve kept short-term interest rates too low for too long after pushing them down in 2001; new, unfamiliar debt securities proved much riskier than originally thought; and credit standards grew too lax.

These adversities are weakening the economy. Although the nation's real output expanded briskly through the third quarter of 2007, December's anemic job growth of 18,000 and its unemployment rate of 5.0% have stoked fears of a slowdown. The December unemployment rate is not high by historical standards (unemployment averaged 5.8% in the 1990s and 5.1% for 2000-2006), but its rise of 0.3 percentage point from the previous month is worrisome.[1] Goldman Sachs and at least one researcher at Merrill Lynch now predict a recession in 2008.[2] While most economists are unsure if the economy will slide into recession, the odds look greater today than they did a few months ago.

Understandably, the economy's problems are focusing attention on whether the government can take actions now that would help support economic activity. What is to be done?

Good fiscal policy according to the *New York Times*

The *New York Times*, in an editorial, recommends several tax and spending initiatives (Editorial, "Economic Policy For Tough Times," *New York Times*, January 6, 2008, accessed at http://www.nytimes.com/2008/01/06/opinion/06sun1.html?pagewanted=print). The *Times's* suggestions provide a handy guide to some of the policies that should ***not*** be pursued. If the newspaper's advice were adopted, it would weaken an already struggling economy and undercut prospects for future growth.

The *New York Times* sees spending by governments and individuals as an all-purpose economic elixir. "[S]pending means hope for the economy," enthuses the *Times's* editorial staff. The newspaper views the unemployment data from this perspective and sees it as most threatening because of its possible negative impact on spending. "A job means a paycheck, a paycheck means spending," and fewer jobs force some belt tightening. In other words, the *Times* fears that the uptick in the unemployment rate may throw the economy into recession because unemployed people spend less than those who are employed.

According to the *Times*, the "best hope" for rescuing the economy is for the government to intervene "with stimulus measures to increase spending" and the best stimuli are those that would juice spending the most. "To be effective, stimulus must be targeted at low- and middle-income Americans....[because] they will spend most, if not all, the assistance they receive, giving the economy an immediate lift." The options that would provide the most extra spending, the *Times* continues, "are enhanced unemployment benefits and direct aid to states..."

An ancillary benefit, in the *Times's* view, is that the stimuli it advocates would redistribute income and "lessen the impending economic harm to the most vulnerable families."

In contrast to its praise for government spending, the *Times* is scornful of tax cuts. It dismisses as "not new" and "wrongheaded" the President's call for extending the 2001-2003 tax reductions, which are scheduled to expire at the end of 2010. Although the expiration of the provisions would produce huge tax increases, the *Times* claims that extending the provisions would do nothing to strengthen the current economy because "[t]he promise of tax relief in 2011 would not increase spending in 2008." The *Times* further argues that "tax cuts for investment income" are an ineffective stimulus and should be avoided because they "are skewed to high-income Americans who tend to save rather than spend their extra dollars." The newspaper declares that the "toughest part" of enacting a good stimulus package "will be getting the White House to finally recognize that more tax cuts is [sic] not what the country needs and will not head off a recession."

The newspaper also insists that any stimulus should be "temporary"; it should be something the government turns on and off to fine-tune the economy. Permanent tax relief is, therefore, verboten. The *Times* adds that permanent tax relief "could actually hurt the economy by worsening the outlook for the budget deficit..."

The only tax cut the *Times* mentions approvingly is a "one-shot tax rebate ... targeted to people who will spend the largess" because it would be temporary and, in the *Times's* judgement, would boost spending.

The *Times* is wrong to suggest that its views represent an economic consensus. Many economists strongly dissent from the newspaper's analysis and proposals. However, a number of other economists, including Martin Feldstein and Lawrence Summers, agree with at least some of the newspaper's recommendations. So do several of the candidates in the presidential primaries. Federal Reserve Chairman Ben Bernanke has said he could support a temporary stimulus package, although he has avoided specifics. Even the Bush Administration is calling for a large one-shot tax rebate, although it would couple it with another initiative that would spur investment.

Nostrums from the Keynesian medicine cabinet

The *New York Times's* suggestions would be familiar to someone studying economics in the 1960s. They are the standard Keynesian prescriptions from that era regarding how to treat a weak economy.

The central Keynesian "insight", which is mirrored in the *Time's* editorial, is that spending ("aggregate demand" in Keynesian nomenclature) is key to the economy's health. Until the economy reaches the point at which it is humming along on all cylinders, Keynesians see production as passively following the lead of spending. That is to say, if goods and services are demanded, they will come. Keynesians worry that spending is very unstable, and think that the instability of demand tends to produce enormous short-run fluctuations in economic activity. They call on wise government officials to ride to the rescue by regulating total demand within the economy.

In line with the supposedly decisive role of spending, the standard Keynesian recommendations for a weak economy are to temporarily increase government outlays and temporarily lower taxes in order to pump up government and personal spending. Because productive capacity is regarded as comparatively unimportant, at least within the relevant time frame, Keynesian policies are usually crafted without paying much attention to how the policies change work and investment incentives. If most incentive effects do not matter much

(Keynesians allow one exception: the effect of the interest rate on investment), why worry about them?

The *Times* actually goes a bit beyond standard 1960s Keynesian economics because it seems not merely indifferent to investment but hostile, in its call for letting tax rates on investment income jump back to their pre-Bush level, which would sharply reduce after-tax rewards for saving and investing. Even during the Kennedy Administration of the 1960s, when Keynesian thinking was in the ascendancy, it was recognized that investment is desirable as both a component of demand and, going outside the Keynesian analysis, a spur to productivity. The concern about investment was one of the motivations for the Kennedy tax cuts, which began with an investment tax credit (ITC) in 1962, before moving on to across-the-board marginal tax rate cuts and a four percentage point drop in the corporate tax rate, which Kennedy proposed in 1963 and which Congress and the Johnson Administration approved in 1964.

In the Keynesian model, a stimulus directed to the poor and lower-middle class is thought to provide somewhat more bang for the buck than a stimulus going to the wealthy or the general population because the poor and lower-middle class have somewhat higher marginal propensities to consume. However, a stimulus to any part of the population is regarded as expansionary because people at all income levels are thought to consume more when their incomes rise (except perhaps for a few super-wealthy individuals and a small number of misers.) When the *Times* asserts that the only effective fiscal stimuli are those that go to the poor and lower-middle class, it is either misunderstanding the Keynesian model or deliberately misusing Keynesian analysis in an effort to push for more income redistribution.

The *Times* is in the Keynesian mold in its focus on the short run, its call for temporary stimuli, and its lack of interest in whether the policies it recommends will have any long-term effects on the economy for good or ill. The editorial's one departure from short-run analysis is to blast permanent tax cuts (by which the *Times* means the tax rates of recent years) because of their impact on the federal budget "for years to come."

Reality tests

Keynesian economics's fall from grace was the result of two forces. First, Keynesian theory has serious flaws and inconsistencies because it is poorly grounded in what we know of people's behavior as individuals (microeconomics), ignoring how prices and other incentives affect our choices of what to produce and buy. The second problem, a result of the first and likely more influential, is that Keynesian predictions do not match real-world experience.

If the Keynesian model is correct, the economy could soar into hyperinflation or crash into depression – and remain stuck there – with no internal mechanism to bring output back into line with productive capacity or return the unemployed to jobs. In fact, business cycles have occurred throughout U.S. history and they continue (although they seem to have become milder as services have become a larger part of the economy relative to durable goods), but production rarely deviates far or for long from the nation's gradually rising level of productive capacity. The tendency of production and employment to return to a trend based on the nation's productive capacity strongly suggests that market forces, which reflect the decisions of millions of individuals acting as households and producers, are powerful internal stabilizers. This is exactly contrary to the Keynesian vision of wild and persistent instability.

The largest short-run downturn by far was the Great Depression. At the time and for many years afterward, it was portrayed as a failure of the market system. However, in their magisterial *A Monetary History of the United States, 1867-1960*, Milton Friedman and Anna J. Schwartz provided evidence that the length and severity of the Depression were primarily the fault of misguided government policies.[3] Particularly damaging, in the opinion of Friedman and Schwartz, were government policies that allowed the nation's money supply to plunge by one-third between 1929 and 1933. (The government had created the relatively new Federal Reserve to prevent banking crises, but in its first major test, the central bank made matters worse.) The government further harmed production with other ill-advised actions, such as the Smoot-Hawley Tariff Act of 1930, which ignited an international trade war that saw exports and imports drop by over 50 percent, and sharp increases in marginal tax rates during the Hoover and Roosevelt Administrations, which eroded incentives for private-sector production. Instead of attesting to the inherent instability of a market economy, the Great Depression demonstrated how much economic damage a government can inadvertently cause through misguided policies.[4]

In the 1960s, Keynesians were generally pleased with the economy but puzzled that inflation was accelerating. According to the Keynesian model, the government should be able to manage aggregate demand so as to stabilize the economy at full employment without triggering inflation. Keynesians decided that their model was almost right, except that modest inflation kicked in before full employment was reached. Nevertheless, they claimed the Keynesian tools of tax and spending leakages and injections could still precisely stabilize the economy at full employment, provided a little inflation was accepted. However, inflation continued climbing, and in the 1970s, inflation and unemployment worsened simultaneously. That combination, known as stagflation, is impossible in a Keynesian world, and the Keynesian model gave no insights on how to deal with it. It was the very un-Keynesian economic policies of the 1980s (which various Keynesians at the time decried as risky, ignorant, unsustainable, inflationary, and recessionary) that broke inflation and ushered in a generation of rapid growth.

Throughout history and around the world, many governments have furnished additional real-world tests of Keynesian theory. Government officials often like to spend their citizenry's money; many are very good at that. Therefore, it is common to have the combination of an economy operating below capacity and a government that decides to go on a spending spree. According to Keynesian theory, the demand stimulus provided by the spending is just what the economy needs to perk up and should lead to prosperity. The reality is that unless the government spending has more value than the private-sector consumption and investment it displaces, the typical results are economic problems, such as lower total output, more inflation, greater poverty, and slower growth. Often, the spending spree will temporarily generate hope and the illusion of a bustling economy, but reality soon sets in.

A look at the *Times's* specific proposals

Experience in the real world has clearly and repeatedly shown that Keynesian tax and spending stimulus policies do not work. An analysis of the *New York Times's* recommendations explains some of the reasons why Keynesian policies are either ineffectual or counterproductive.

Tax Rebates. Presidents and members of Congress have proposed one-shot tax rebates on a number of occasions. When rebates have become law, though, the results have always been disappointing. In 1975, President Ford and Congress enacted the Tax Reduction Act of 1975, which gave taxpayers a retroactive tax rebate of 10% of 1974 tax liabilities, with minimum and maximum bounds of $100 and $200, paid in May and June of 1975. To Washington's disappointment, the economy remained weak. When President Carter called for a $50 quick-fix rebate in 1977, fresh memories of the ineffectual rebates and credits during the Ford Administration roused Senator Russell Long (D-LA), chairman of the Senate Finance Committee, to block the proposal, comparing it to "throwing bushels of $50 bills off the top of the Washington Monument in a high wind."[5] In 2001, the Bush Administration pushed through a $300 "advance refund" on income taxes ($600 for joint filers) as part of the Economic Growth and Tax Refund Reconciliation Act of 2001. That did little to pull the economy out of the "jobless recovery".

The rebates were slow to show up in added spending. Milton Friedman had explained why in earlier theoretical work. When the government sends a rebate check to one person, it has to finance the check by borrowing or taxing away an equal amount from another person. (This assumes the government does not finance the rebate by printing money.) Hence, when the two sides are netted against each other, a tax rebate does not increase the funds available for spending, contrary to the appearance given when considering only rebate recipients.

It might seem that a tax rebate would increase spending as long as it comes from lenders' savings (i.e., funds lenders would not currently use for consumption). However, financial markets are extraordinarily efficient at channeling saving into investments. Whereas the Keynesian model implicitly assumes saving goes into mattresses or holes in the ground, it actually goes into investment spending or is borrowed by consumers to fund consumption (as with auto loans and credit card debt). Thus, although tax rebates twist the mix of spending – more consumption spending and less investment spending – they do not change total spending.

Moreover, rebates do not increase the after-tax rewards for working and investing, and, therefore, do not motivate people to supply more labor and capital inputs in the production process. Consequently, rebates can deliver no lasting improvement in output, income, employment, and living standards because they do not expand the supply of goods and services, which depend on production inputs. Indeed, rebates tend to lower future output because they shift some spending from investment, which expands productive capacity, to immediate consumption.

Enhanced unemployment benefits. The thinking is that the unemployed will quickly spend any additional benefits they receive and that their spending will give the economy a lift. As mentioned above, one flaw in this scenario is that if the government finances the unemployment benefits through borrowing or taxing, lenders or taxpayers have fewer funds to spend currently. Consequently, the fiscal policy will shuffle the identity of who does the spending, but will not increase total demand. Also, if beneficiaries have a higher marginal propensity to consume than lenders and taxpayers, the enhanced unemployment benefits will raise consumption spending and lower investment spending, which is not good policy because it will have a negative impact on the nation's future productive capacity.

Another problem is that enhanced unemployment benefits have an anti-work effect. When unemployment benefits rise, people who lose their jobs take longer, on average, to find new jobs. They tend not to look as hard for new jobs and to be more selective in what they are willing to accept. This outcome is not surprising; it reflects basic human nature and people's responsiveness to incentives. When the relative cost of unemployment falls due to government benefits, people naturally respond, on average, by working less. Obviously, this has a negative impact on the economy's production. Fewer goods and services will be produced when the supply of labor inputs in the production process declines. Ironically, although enhanced unemployment benefits are often touted as a powerful anti-recession tool, they tend to lengthen recessions and slow down recoveries.

The Keynesian model overlooks the anti-work effect because it ignores incentives. The *New York Times* has fallen into the same error. If one wishes to defend unemployment benefits, it should be on the basis that they can lessen the pain for people who lose their jobs. However, one should recognize that higher unemployment benefits have costs in terms of lower employment, production, and a nation's total income.

Direct aid to states. Fueled by rapidly growing income and property taxes and increased federal aid, state and local government spending has expanded quickly in recent years. From 2000 to 2006, state and local spending jumped by 40%, and federal grants-in-aid to states and localities rose by 45% during the same period, to approximately $360 billion in 2006.[6] With the puncturing of the housing bubble and the slowing of the economy, many states and localities are now finding that revenues no longer support their higher spending, and they face budget shortfalls.

States and localities would quickly spend additional direct federal aid to help maintain their spending and avoid some politically stressful budget choices. The Keynesian model assumes this means the aid would increase aggregate demand in the economy. As has been discussed earlier, however, total spending would not increase if the added federal largess is financed through more federal borrowing or higher federal taxes. Instead, states and localities would spend more, but that would be offset by lenders or taxpayers who would reduce their current consumption and investment spending. Thus, the supposed demand-side stimulus would be lacking.

The real questions, though, are whether states and localities would put the funds to better use than the private sector and whether the direct federal aid would increase the size of the economic pie (i.e., the nation's total output and income) by improving incentives to supply labor and capital in the production process. In both these areas, increased federal aid to the states is likely to be damaging.

When state and local governments are handed money without having the responsibility of raising it themselves and told to spend it rapidly, they will regard the funds as almost costless, face little accountability in their spending choices, and be less motivated than private-sector households and businesses to use the funds carefully and wisely. To the extent that states and localities apply the extra federal aid to their own investment projects, their investments will, on average, add less to the nation's productive capacity than the private-sector investments they displace. Moreover, because states and localities will use some of the money for transfer payments and many state and local transfer programs have perverse work and saving incentives, the supplies of labor and capital will tend to decline. The Keynesian model brushes aside negative incentive effects, but people in the real world respond strongly to rewards and penalties.

Higher taxes in the future, especially for upper-income individuals and savers. The *Times's* editorial does not propose tax increases immediately. However, the editorial suggests that the 2001 and 2003 tax acts should be allowed to expire at the end of 2010, which would be a massive tax hike compared to today's tax rules. The Times regards this as an welcome opportunity to redistribute more income and finance more government spending.

In a Keynesian world, the *Times* would be right that taxes three years hence do not matter. Within the Keynesian framework, people do not respond to positive and negative tax incentives, do not base their decisions today on their expectations about the future, and do not strengthen the economy when they save.

In fact, people care very much about taxes, do plan ahead, and adjust their actions today based on their expectations of future tax treatment. This is especially true of investment spending: because most investments undertaken now will deliver many of their returns in the future, investors often need to factor in their expectations about future tax conditions in deciding whether potential investments are worth doing. A concern that investment returns will be taxed more heavily starting in three years will reduce investment spending today. To be clear, investment is important not because it is a type of spending but because it adds to the nation's productive capacity, which enables the economy to produce more output and leads to better jobs, higher incomes, greater availability of goods and services, and higher living standards. In terms of incentives, the most important tax features to extend are those with the greatest impact on marginal tax rates: the current rate brackets, the current top rates on capital gains and dividends, and the promised elimination of the Death Tax.

Conclusion

When thoughts in Washington turn to stimulus packages, the time-frame commonly discussed is at odds with that used by most prudent people. The Washington-based time-frame is ultra short run, the next few months, with little regard paid to the next few years and beyond. It is analogous to selecting a 30-year, 12% mortgage because it has a 1-year teaser rate of 2% while rejecting a fixed-rate mortgage of 6%. A more sensible perspective is to opt for policies that deliver sustained, long-term benefits. Many of them will start helping the economy fairly quickly. These smarter, more mature stimulus policies are in many ways the opposite of those recommended by the *New York Times*.

Extending the marginal tax rate cuts of the 2001 and 2003 tax acts, so that marginal tax rates do not rocket upward from current levels, and permanently eliminating the federal Death Tax were mentioned above as policy choices that would strengthen the economy in the long-run and begin helping in the short run. The 2002 and 2003 tax acts contained a very effective stimulus in the form of partial expensing (allowing the immediate write-off of 30% and then 50% of the cost of new investments).[7] The expensing provisions in those acts were temporary, and another temporary expensing provision would be a worthwhile stimulus. To the Administration's credit, part of its stimulus proposal will reportedly be a temporary renewal of the partial expensing provision, along with a temporary increase in the amount of new investment spending that small businesses may expense. But note that expensing reduces the tax system's anti-investment bias, and is appropriate tax treatment. Therefore, it would be even better to make it permanent. A temporary expensing provision will, in part, borrow some investment spending from investment spending that would otherwise occur in future years; it will raise GDP for a few years, but it will not permanently increase the stock of capital and GDP.

A more ambitious but more powerful initiative would be fundamental tax reform to simplify the tax system, lower marginal rates, and establish a tax base that does not possess the current system's bias against saving and investment.

Although most stimulus packages proposed in Washington seek temporary increases in federal spending, empirical research indicates that while modest spending on core government functions spurs growth and prosperity, higher levels of government spending slow growth, probably because they divert resources from more productive private-sector uses and create perverse work and saving incentives.[8] The United States is well past the growth maximizing level of government spending (and most other nations are even worse.) Hence, an excellent stimulus to permanently assist the economy would be to prune back the size of government. Empirical studies have also found that high-tax economies tend to be slow-growth economies, again presumably because of taxes' negative incentive effects.[9] Thus, another sensible stimulus, which would yield some benefits quickly and very large gains within a generation, would be to reduce taxes permanently.

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Endnotes

1. For data on gross domestic product (GDP), see U.S. Bureau of Economic Analysis, accessed at http://www.bea.gov. For data on employment growth and the unemployment rate, see U.S. Bureau of Labor Statistics, accessed on Jan. 8, 2008, via http://www.bls.gov/cps/home.htm.

2. See Reuters, "Goldman Sachs Sees Recession In 2008," January 9, 2008, accessed at http://biz.yahoo.com/rb/080109/usa_economy_goldman.html.

3. Milton Friedman and Anna J. Schwartz, *A Monetary History of the United States, 1867-1960* (Princeton: Princeton University Press, 1963).

4. For an enlightening discussion of how government actions transformed a business downturn into what became, sadly, the Great Depression, see Lawrence W. Reed, "Great Myths Of The Great Depression," revised September 2005, accessed at http://www.mackinac.org/archives/1998/sp1998-01.pdf.

5. "Carter's First Big Test," *Time*, Apr. 25, 1977, accessed at http://www.time.com/time/printout/0,8816,918854,00.html.

6. See U.S. Bureau of Economic Analysis, National Income and Product Accounts, Table 3.3, State and local government current receipts and expenditures, accessed at http://www.bea.gov/national/nipaweb/TableView.asp?SelectedTable=86&FirstYear=2005&LastYear=2007&Freq=Qtr, data as of December 20, 2007.

7. For a fuller discussion of bonus depreciation, see Stephen J. Entin, "Renew Bonus Expensing To Keep Recovery Strong," *IRET Congressional Advisory*, No. 173, May 6, 2004, available at http://iret.org/pub/ ADVS-173.PDF.

8. See, for example, Richard K. Vedder and Lowell E. Gallaway, "Government Size And Economic Growth," Prepared for the U.S. Congress, Joint Economic Committee, December 1998, accessed at http://www.house.gov/jec/growth/govtsize/govtsize.pdf. Vedder and Gallaway examined the federal government, state and local governments, and several foreign countries.

9. See, for example, Gerald W. Scully, "Taxes and Economic Growth," National Center for Policy Analysis, *NCPA Study*, No. 292, November 21, 2006, accessed at http://www.ncpa.org/pub/st/st292. Because of data limitations, Scully looked at average tax rates, not marginal tax rates. One would expect even stronger results looking at marginal tax rates because they determine how taxes alter our after-tax incentives.