IRET Congressional Advisory

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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FISCAL STIMULUS OR FISCAL FOLLY?

Fear of a possible recession is leading to calls for action to restore growth. But what to do? Unfortunately, the "fiscal stimulus" package negotiated between the Administration and the House leadership is not the answer.

The House tax plan would include a tax rebate (up to $600 for single filers, $1,200 for joint filers) and a child credit ($300 per child) to encourage consumption spending by individuals[1], and two expensing provisions to encourage investment by businesses. The revenue estimate is about $150 billion.

The history of tax rebates is not encouraging. They have not worked in practice (see the discussion of the Ford and Carter rebates, and the first year of the 2001 Bush tax cut, below). They should not work in theory, because they do nothing to reward additional production. They are merely handouts. The expensing incentive in the stimulus package could induce the manufacture of more capital goods in 2008. However, because it is temporary, it would not increase the desired capital stock over time, and would "borrow" investment spending from 2009.

What does "fiscal stimulus" mean?

Fiscal stimulus is a term from Keynesian economic theory for policies that are designed to increase spending by individuals, businesses or government. The object is to raise "aggregate demand" if it falls short of the potential output of the economy. Either the government spends more directly to boost aggregate demand, or it cuts taxes to let people keep more of their income to spend to boost aggregate demand. The magnitude of the stimulus is measured by how much it initially increases the budget deficit.

Problems with fiscal stimulus

Problem one: the government budget constraint.

Every tax cut or spending increase has to be paid for, either with other tax increases or by additional federal borrowing. The Treasury does not kite checks.

In the mid-1960's, monetarist economist Milton Friedman asked, "If the government is spending $500 billion, and cuts taxes to $450 billion, where does the $50 billion tax cut come from, the tooth fairy?" Friedman then explained that the government has to issue additional debt to cover the deficit. If it sells the bonds to the public, it is borrowing the tax cut right back, leaving the public with no additional money to spend, and, hence no boost to "disposable income" or aggregate demand. The process plays musical chairs with the money, and does nothing to boost economic activity. (The same analysis also debunks the idea of a stimulus from higher federal spending, which must be covered by raising taxes or borrowing.)

Alternatively, the Federal Reserve might step in to buy the added government debt, which it does by creating new money. That would add to aggregate demand, but the rise would be due to the change in the money supply, i.e., to monetary policy, not to the fiscal stimulus per se. The Fed can add to the money

supply without any fiscal action by the Congress, or it can stick to its desired rate of money creation regardless of the fiscal stimulus.

Put another way: Keynesian pump-priming is a charade. It does not work. Increasing the deficit by raising Federal spending or cutting taxes does not directly boost demand. There is no stimulus from fiscal policy in the Keynesian sense. In the absence of Federal Reserve action, there is no change in demand, no stimulus, and no boost to the economy.[2]

But what if we target the tax cut to people who will spend it? Suppose we cut taxes for lower income people who spend most of their income and save very little, and fund it by borrowing money from the rich, who tend to save their income? Would that boost spending?

No. Income that is saved goes into the financial markets. Banks and credit card companies lend the money either to consumers or to investors. Consumer-borrowers spend it on consumption goods and services. Investor-borrowers spend it on capital goods (that is, on inventory or equipment, on factories, or on office, commercial, or residential buildings.) The money is spent one way or the other. Taking money from savers and redistributing it to consumers may actually depress economic capacity by encouraging consumption and discouraging investment. (See "2001 rebate" below.)

Problem two: tax cuts boost output by changing price incentives, not incomes.

Economics 101: Income equals output. Tax changes can impact the economy if and only if they affect the decision to increase output by providing more capital and labor to the production process. We are paid to produce, and without production there is no real income, nothing to buy, use, or consume. If a tax cut is to boost income, it must first induce a rise in the supply of inputs and the production of output. This is also known as Say's Law.

A tax cut raises income and GDP only if it makes it more attractive to increase production of goods and services. That means making it more rewarding to work more hours and take less leisure, and less costly to hire additional workers. It means making it more rewarding to add to savings (instead of consumption) and less costly to purchase and operate additional plant and equipment. Output and income rise first, and demand rises second. In economic jargon, there are no "first order" income effects from a tax cut. If, and only if, there are first order "price effects," the tax cut will boost output, and then there will be "second order" income effects on demand.

The key words here are "more" and "additional." The tax cut has to affect the decision to increase activity, and that means the tax must be reduced on the next dollar of income that might be earned, "at the margin." Not on the first dollar earned, but on additional dollars that might be earned. Not on the first hour of work, or the first worker hired, but on the next hour that might be worked, and the next worker who might be hired. Not on the first machine employed, but the next one that could be bought.

Some examples of tax changes that raise incentives at the margin: cuts in marginal tax rates on personal income in all brackets, cuts in the corporate tax rate, expensing or faster write-off of investment outlays on a permanent basis, reduced tax rates on capital gains and dividends, higher contribution and income eligibility limits on retirement saving plans, a cut in the payroll tax for those below the income cap.

Rebates and other handouts are not "at the margin" and generate no incentives to produce or to add permanently to the capital stock. Whether a tax cut helps the economy is not determined by its size, as measured by its static effect on the deficit, but by its structure. Does it raise the after-tax reward to working longer or owning a bigger capital stock, or not?[3]

Rebate history

In 1975, the country was in the midst of rapid inflation and recession. Income tax rates had been driven up by inflation, and inflation was causing the deductions for plant and equipment to fall below the true cost of the assets, causing many firms to owe tax when they were really losing money. Capital and labor costs were soaring, and output was shrinking.

President Ford proposed the Tax Reduction Act of 1975 that included a rebate of between $100 and $200 on 1974 income (10% off the first $2,000 of 1974 tax liability, with a minimum of $100). It was phased out for taxpayers with between $20,000 and $30,000 of AGI. The bill also had a more permanent general tax credit, $35 per filer and dependent, going forward in time, that acted much like a rise in the personal exemptions (not a marginal rate cut). The rebate on 1974 income was clearly just a one-time hand-out. It had zero incentive effects, as it was clearly impossible for people to go back in time to earn additional money the previous year. The rebate was passed on March 29, 1975, and checks were mailed out in May and June. It had no measurable impact on the economy, which remained a mess. It was widely ridiculed as a gimmick and a flop.

In 1977, with inflation and unemployment still high, and tax rates still rising, President Carter proposed another rebate. It would be $50 per filer and dependent, to be paid out as soon as the bill was passed. The rebate passed the House. In the Senate, Finance Committee Chairman Russell Long (D-LA, one of the most knowledgeable and influential men ever to head the Committee) took a dim view of it. He described the rebate as throwing $50 bills from the top of the Washington Monument. He (and most of the Senate) recalled the Ford rebate fiasco, and took the attitude, "Fool me once, shame on you. Fool me twice, shame on me." Long led action that got the rebate removed from the Senate package with wide support, and some marginally better provisions were passed instead.

The 2001 "rebate"

The 2001 Bush tax cut contained a mixed bag of provisions. Some immediate tax reductions were income transfers with no economic incentive (such as the expanded child credit). There were marginal tax rate reductions, but they were implemented in stages, with two-thirds of the rate cuts postponed until 2004 and 2006. There were gradual increases in retirement saving contributions limits.

The one rate cut to be completed in 2001 was the creation of a new 10% bracket out of the bottom of the 15% bracket. Its implementation looked much like a rebate, in that people received lump sum checks from the government. The Treasury mailed out checks for $300 (single filer) or $600 (joint filer) in the summer of 2001, reflecting the reduced tax liabilities associated with the 10% bracket, so that people could get the money without adjusting their withholding. The provision was not technically a rebate, but rather a "pre-refund" of an ongoing reduction in a tax rate that was supposed to be in place for several years. However, it was not "at the margin" for the vast majority of taxpayers, whose incomes went higher up in the bracket structure. Indeed, the relatively low income people whose income stopped in the 10% bracket produced only about 2% of the national output and income. Consequently, the incentive effect of that rate cut and its impact on GDP were negligible.

Surveys suggest that much of the "rebate" was initially saved (over half), as theory expects of a windfall (because consumption is "sticky"). Over the next few months, however, more was spent on consumption. Nonetheless, Friedman's prediction that such a tax cut would not boost spending as a whole may have been correct. At the same time that consumption spending jumped in the fourth quarter of 2001, investment spending suddenly contracted, by about three-quarters as much. Apparently, the government borrowing to cover the rebate checks cut into lending to the private sector.

These early-acting provisions of the 2001 tax cut did not do enough to spur growth in 2001 and 2002, years which were mocked (with some exaggeration) as "the jobless recovery." There is a lot of irony in the current argument. Some of the people calling most loudly for a new round of rebates and praising their effectiveness in 2001 are the same people who were loudly criticizing the Bush tax cuts in 2001 and 2002 for failing to boost employment quickly. These same people are ruling out the more effective sort of tax cuts that were enacted in 2003 in response to the sluggish growth, and that did spur the economy and job creation.

Partial expensing of equipment – how would it fare today?

For businesses, the current stimulus plan would revive the 50% "bonus expensing" provision of the 2003 tax cut. Businesses would be allowed an immediate deduction for half of the cost of equipment purchased and placed in service in 2008. (The rest of the cost would be subject to normal cost recovery over time - i.e., depreciation.) Small businesses would get an increase in the amount of investment they are permitted to expense under the small business expensing rules, from $125,000 to $250,000.

Expensing is the best tax treatment for capital investment. It most closely reflects the true cost of the investment to the business, most correctly measures the real income (revenue less cost of production) of the business for tax purposes, and yields the optimal economic outcome. Enactment of expensing, either complete or partial, on a permanent basis, would be a step toward a better tax system. It would cause a permanent rise in the amount of capital created and maintained. If this provision were to be a start on a permanent improvement in the tax treatment of capital, it would be effective in stimulating more investment.

The temporary expensing provision, by contrast, would only cause businesses to buy replacements for current capital assets a bit sooner than otherwise. It would "borrow" investment spending from the future, and raise GDP in 2008, but weaken it in 2009 or 2010. Another difficulty is that the provision requires that the assets be not only bought, but delivered and placed into service by the end of this year. That is a very tight time frame. Earlier versions of partial expensing required that equipment be ordered by a certain date, but allowed several additional months for it to be delivered and placed into service.

Furthermore, the 2003 expensing provision was working with other 2003 tax provisions (moving up the personal rate reductions and putting a 15% rate caps on dividends and capital gains) that made it worthwhile to acquire, operate, and maintain a larger capital stock. This time, an expensing provision would face some serious head winds, due to the looming expiration of the Bush 2003 tax cuts. The lower marginal tax rates that encouraged small businesses to expand their use of capital will expire at the end of 2010. The 15% rate cap on dividends and capital gains will expire then as well, depressing the creation and use of capital in the corporate sector.

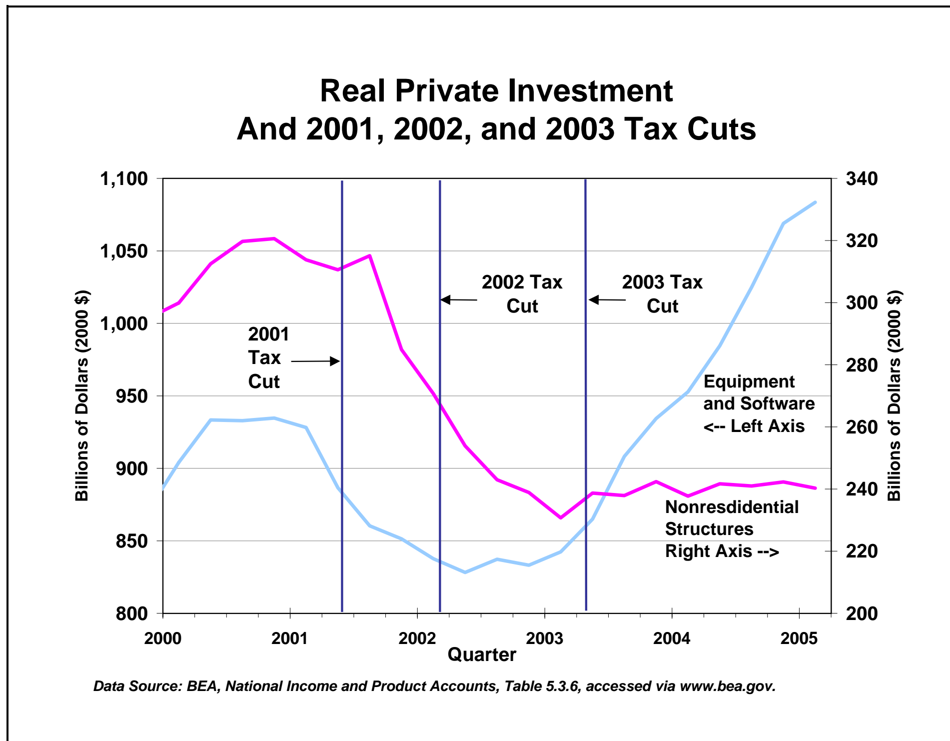
A new round of expensing would be more effective if it extends through the end of 2010, in line with the rest of the Bush tax cuts. Moreover, it should be presented as an integral part of the tax cut program that the Administration wants to see made permanent. Barring that, the incentive has to be in operation at least long enough for businesses to plan, order, receive, and put the new capital in place. For example, the incentive might be for any equipment ordered before December of 2008 and place in service by December 31, 2010.

Partial expensing and rate cuts in 2002 and 2003

The main cause of the 2001 recession was a sharp drop in investment spending on equipment and software, and in non-residential structures. The 2001 Bush tax cut did nothing specific for investment. It did provide for a gradual reduction in individual marginal tax rates, which would have encouraged some added investment by non-corporate businesses,

but the bulk of the reductions were scheduled to occur in 2004 and 2006.

In response to the continued decline in investment in 2001 and 2002, the 2002 Tax Act created a partial expensing provision (30% of the cost of equipment could be written off at once, with the rest subject to regular depreciation rules). It applied only to equipment. Spending on equipment quickly leveled off in mid-2002, while spending on structures continued to fall. (See Chart.)



Another tax bill, in 2003, boosted partial expensing to a 50% immediate write-off, extending through the end of 2004. Also in 2003, the remaining marginal tax rate reductions being phased in under the 2001 tax cut were brought forward, increasing the incentive for non-corporate businesses to invest. Third, the maximum tax rates on long term capital gains and dividends were reduced to 15%, which greatly reduced the double taxation of corporate income.

The expensing provisions were explicitly described as a temporary stimulus. The rate marginal tax rate reductions and the 15% caps, which have been extended through 2010, were described as more fundamental reforms that the Administration wanted to make permanent.

The 2003 tax changes were followed by a surge in spending on equipment, and a modest hike in spending on structures. For both corporations and non-corporate businesses, over two-thirds of the improvement in the tax treatment of investment in 2003 came from the rate caps and rate reductions. The tax rate reductions and caps made it profitable to employ more capital, and businesses began to raise the stock of capital by increasing investment.

The 2003 expensing provision was labeled as temporary, did not cut the cost of using capital permanently, and did not add to the long run desired capital stock, as it would have done if it had been just as permanent as the other tax provisions. However, it did encourage businesses to acquire the additional capital made possible by the lower tax rates more quickly than otherwise. In other words, it caused businesses to move some investment forward from 2004 and 2005 into 2003 and 2004, but did not raise the permanent level of capital. It changed the timing of the additional investment, but not the total amount of investment over time. As the capital made possible by the more permanent provisions of the Bush tax cuts has now largely been put in place, investment spending has been growing at a slower rate in recent quarters. It is time for a renewed cut in the tax on capital.[4]

Conclusion

There is no such thing as a quick, temporary fiscal stimulus for the economy that does not lead to offsetting damage down the road. The only worthwhile tax changes that are beneficial in the short run are those that are also beneficial in the long run, ones that lead to a tax system with fewer obstacles to production.

Expensing is a good idea, but it should be be permanent. At a minimum, the proposal must include sufficient time for the equipment that is ordered to be produced and installed.

Rebates do not boost the economy. There is no good reason to think they should work, and when they have been tried, they have failed. This is not a case of being fine in theory and not working in practice. Rebates don't work in any sensible theory either.

The Keynesian theory that is spawning the rebate idea was never valid. It was killed and buried over thirty years ago. That it has been exhumed and brought back from the dead in the 21st century is disturbing. This walking-dead rationale for rebates is moldy, rotting, and mindless. It is "zombie economics." One hopes that the Senate will adopt a different package entirely, one involving permanent tax relief of a truly pro-growth nature.

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Endnotes

1. For individuals, the plan would create tax rebates and credits based on 2007 incomes (reported on April 15th of this year). It would send a check of 10% of the first $6,000 of taxable income for single filers (up to $600) and $12,000 for joint filers (up to $1,200). The payment would be limited to tax liability (be non-refundable). However, there would be a minimum payout of $300 (single) and $600 (joint), if the taxpayer had at least $3,000 of "earned income" (wages and salaries and small business income). The minimum portion of the payment would be allowed to exceed the tax owed (be refundable). There would be an additional refundable credit of $300 per child for families receiving at least $1 of the rebate. The payments would be phased out at the rate of 5% of AGI in excess of $75,000 (single filer) or $150,000 (joint filer). People subject to the AMT would receive the same benefits.

2. For more on the monetarist-Keynesian conflict, see Stephen J. Entin, "The Economics of Taxation and the Issue of Tax Reform," October 25-28, 2007, available at http://iret.org/pub/New_Orleans_(2007).pdf.

3. For more on the economic effects of taxation, see Entin, "The Economics of Taxation and the Issue of Tax Reform," *op. cit.*; and Norman B. Ture, "Supply Side Analysis and Public Policy," in David G. Raboy, ed., *Essays in Supply Side Economics* (Washington, DC: Institute for Research on the Economics of Taxation, 1982), available at http://iret.org/pub/SupplySideBook.pdf.

4. For more on expensing, see Stephen J. Entin, "Extending The Fifteen Percent Tax Rate On Dividends And Capital Gains," *IRET Congressional Advisory*, No. 190, June 30, 2005, available at http://iret.org/pub/ADVS-190.PDF.

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.