IRET Congressional Advisory

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

IRET is a non-profit 501(c)(3) economic policy research and educational organization devoted to informing the public about policies that will promote growth and efficient operation of the market economy.

December 23, 2008 **Advisory No. 248**

FISCAL STIMULUS: WHY WE DON'T NEED FORD AND CARTER ECONOMICS

President Elect Obama is developing an economic stimulus plan that is rumored to be about $850 billion dollars. The plan would increase government spending and lending at all levels. It would include federal building programs, support for "green" industries, support for state and local infrastructure spending, loans to the auto industry, and more. Many others are lining up for federal help, including property developers and state governments. Other governments around the world are pursuing similar Keynesian pump-priming steps.

The United States adopted a more modest stimulus plan last winter, the biggest portion of which was a tax rebate handed out in the spring and summer. The rebate notably failed to spur consumption and jump-start the private sector of the economy.

Will the new spending stimulus plan work any better? Almost certainly not. Economic theory has grown up a lot since the 1930s, 1950s, and 1970s. People who have been paying attention to the historical evidence now know that government spending and tax cuts do not work by boosting "aggregate demand", and do not "jump start" the economy by handing people money to spend.

Tax reductions can boost the economy if they improve private sector incentives to produce additional output by working harder, longer, and more efficiently, and by encouraging additional capital formation. Only those tax changes that are designed to increase the reward to labor and capital have any beneficial impact on output, income, and employment. Government spending displaces private economic activity. It seldom adds to GDP, and can do so only insofar as it adds more value than the private activities it displaces.

The government should focus on removing tax and regulatory barriers to economic output, and on cutting spending to reduce the tax burden on the private sector. It should not try to resolve the current crisis by expanding its share of the economy and its control over production and resources.

The charts and text on the following pages are based on a presentation given on Capitol Hill in December 2008 that provided an economic analysis of these issues.*

Stephen J. Entin
President and Executive Director

* Stephen J. Entin, Presentation, at CATO Institute, Capitol Hill Policy Briefing, "Do Government Spending and Tax Rebates Stimulate Growth?" December 18, 2008.

Chart 1 Keynesian Demand Management

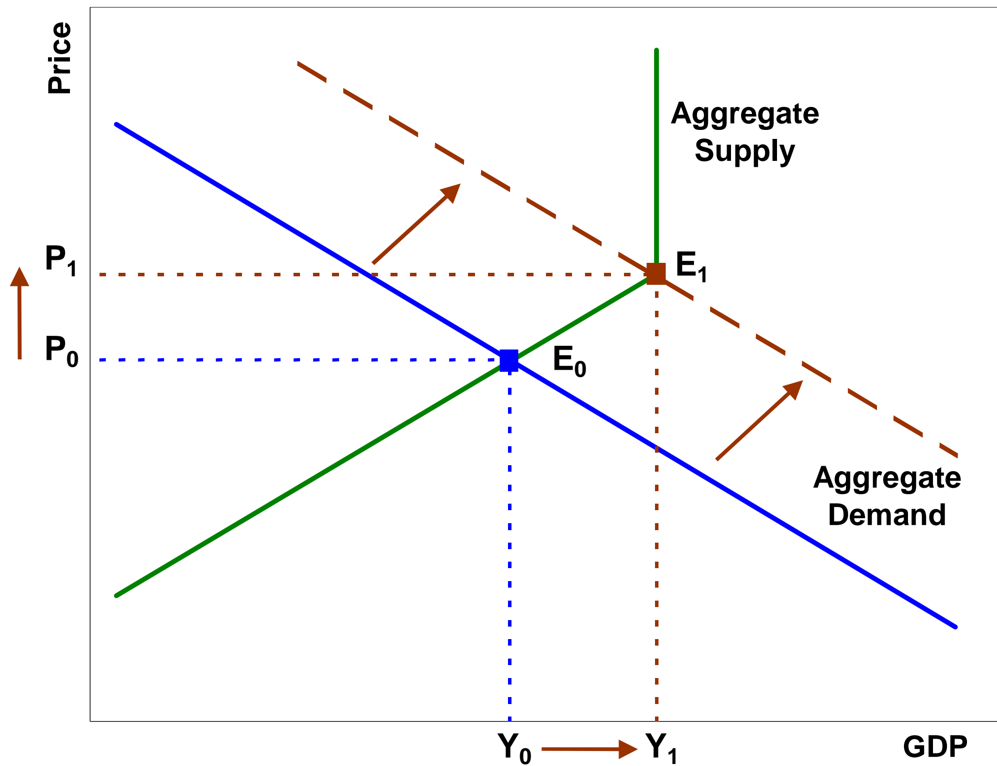
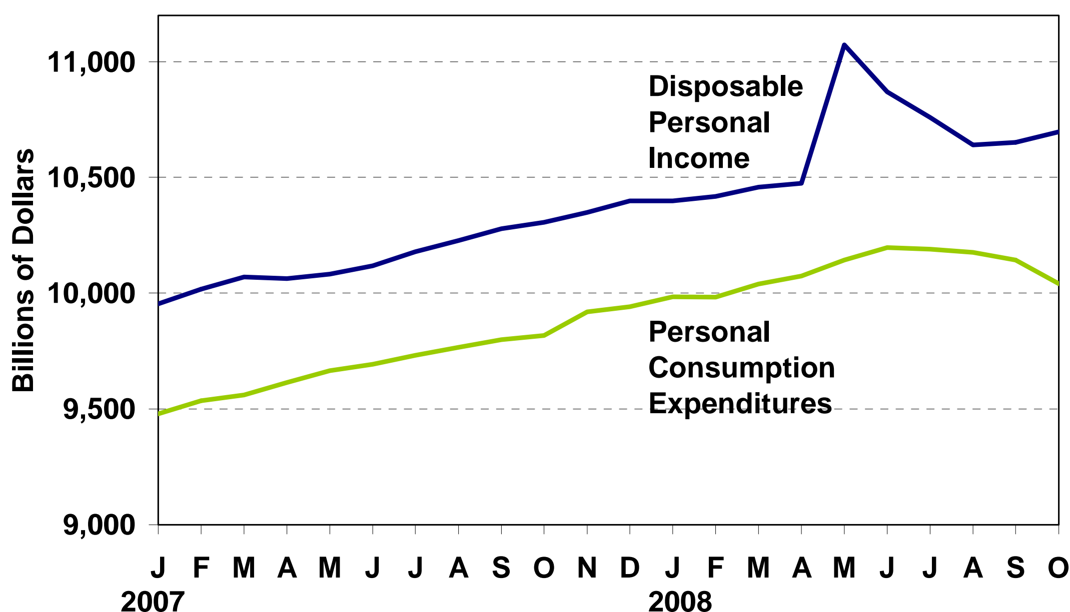


Chart 1.

Keynesians assume tax cuts, spending increases, or easier money can raise demand to get the economy to full employment (move from Y_0 to Y_1). In fact, tax cuts and spending increases cannot stimulate demand, because they must be paid for by some offsetting federal budget action: cut other spending, increase another tax, or increase federal borrowing from the public to fund the deficit. Milton Friedman once made this point by asking, "If the government is spending $500 billion, and cuts taxes to $450 billion, where does the $50 come from, the tooth fairy?" (Beyond Y_1, which is the level of full capacity utilization, more demand would only raise prices.)

Chart 2   Rebates Did Not Boost Consumption



Data Source: U.S. Bureau of Economic Analysis <http://www.bea.gov>. Based on John B. Taylor, "Why Permanent Tax Cuts Are the Best Stimulus,' Wall Street Journal, Nov. 25, 2008.

Chart 2.

President Ford's 1975 tax rebate did not boost the economy. A rebate proposed by President Carter was killed by the Senate. The first year rebate of the 2001 Bush tax cut had no effect, and we had the "jobless recovery". The rebate portion of the 2008 stimulus package had no effect on consumption. The added "disposable income" was saved to buy the added federal debt.

The chart was inspired by one in a recent article by John Taylor in the Wall Street Journal. He attributed the stickiness of consumption to Friedman's *permanent income hypothesis*, which states that people consume according to how they view their permanent earnings prospects, not according to temporary swings in income. He implied that the tax cut would have done more to boost consumption if it had been permanent. I disagree. Even a permanent tax cut is not "stimulative" if it is the wrong kind, one that does not reward increased output at the margin. Professor Robert Barro has a *rational expectations theory*, which holds that people will save a tax cut because they know that there will be a future tax increase to pay off or service the added federal debt. This may be how economists think, but is hardly likely to be how the public thinks. Friedman's other observation, that the Treasury has to pay for spending as it occurs, and that someone does, in fact, buy the Treasury debt when it is issued, is a more straightforward reason for the failure of the rebate policy.

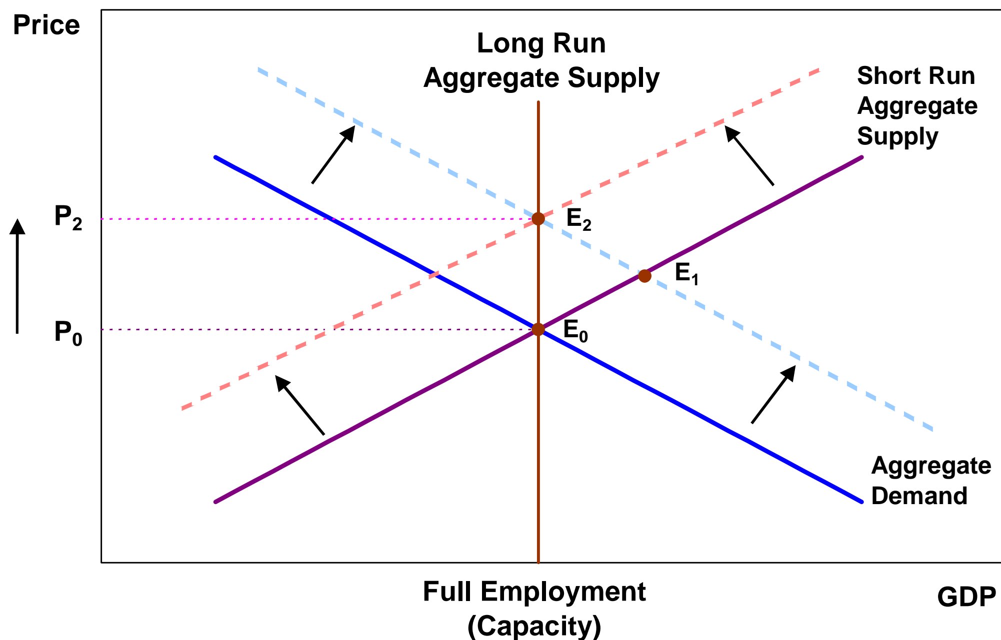


Chart 3.

If the government borrows from the public to pay for a tax cut or spending increase, the deficit cannot stimulate demand. However, if the Federal Reserve buys the added debt, it can stimulate demand by increasing money and credit. But as Friedman pointed out, that demand comes from the change in monetary policy, not the fiscal shift per se. Worse, it generally gives us higher prices, or, if repeated, higher inflation. There is no gain in real output, because suppliers demand higher wages and profits to cover the higher prices. We get less output, in fact, because higher inflation raises taxes on investment and depresses output (mainly because depreciation allowances are not indexed for inflation – and neither is the AMT.)

Can't the Federal Reserve spur growth with lower interest rates? No. Rates of return on real capital (plant, equipment, and structures) drive investment. They are affected by taxes, innovation, and risk. Long term interest rates are not subject to Fed control, and they follow the return on investment, they do not drive it. The current very low interest rates are not a good thing; they are a sign that investment is not profitable. When the Fed drives short rates too low, it spurs speculation in commodities and real estate, not real investment in productive capacity.

Low rates of return devastate retirees. Their stocks fall, and they suffer losses when they sell to get money to live on. Earnings on risk free Treasury bills and insured bank deposits have fallen from 3.5% to 0.035% or even lower. Where $100,000 in savings used to earn $3,500 a year, retirees are lucky now to get $35 a year. Even the ten year Treasury bond is paying under 2.5%. At 3% inflation, clothing, canned goods, paper towels, and toilet paper are better investments than U.S Treasury debt.

(Some ask, "Can't we sell the bonds to foreigners." Yes, but that either acts as a substitute for other dollar investments they were going to make, or it raises the value of the dollar and retards U.S. exports or encourages imports. There is no boost to domestic demand.)

Chart 4a Imposition Of A Tax

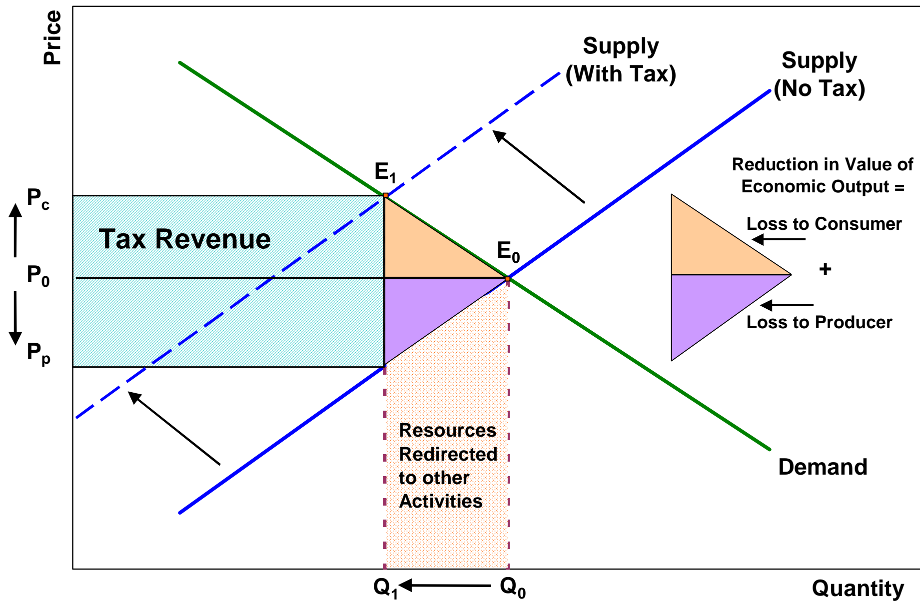
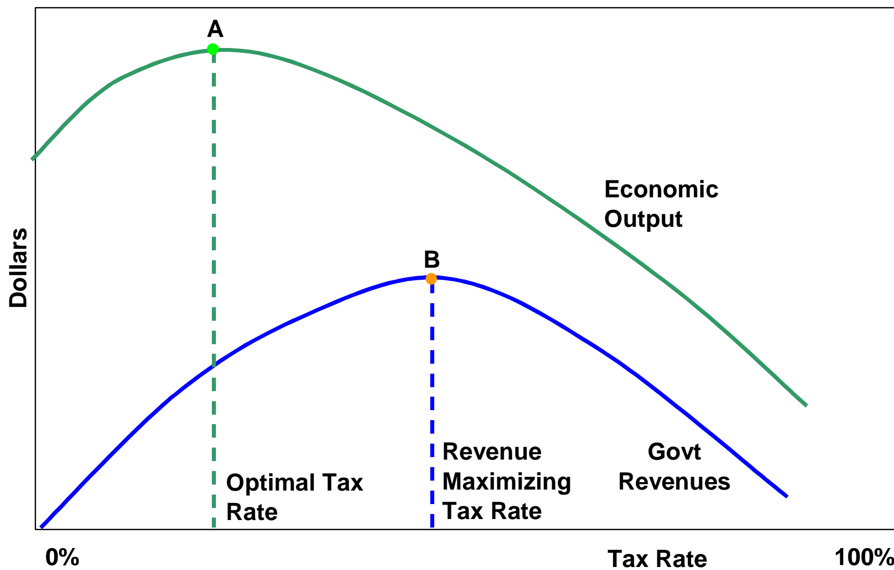


Chart 4b Tax Increases Reduce Economic Activity Long Before They Reduce Tax Revenues



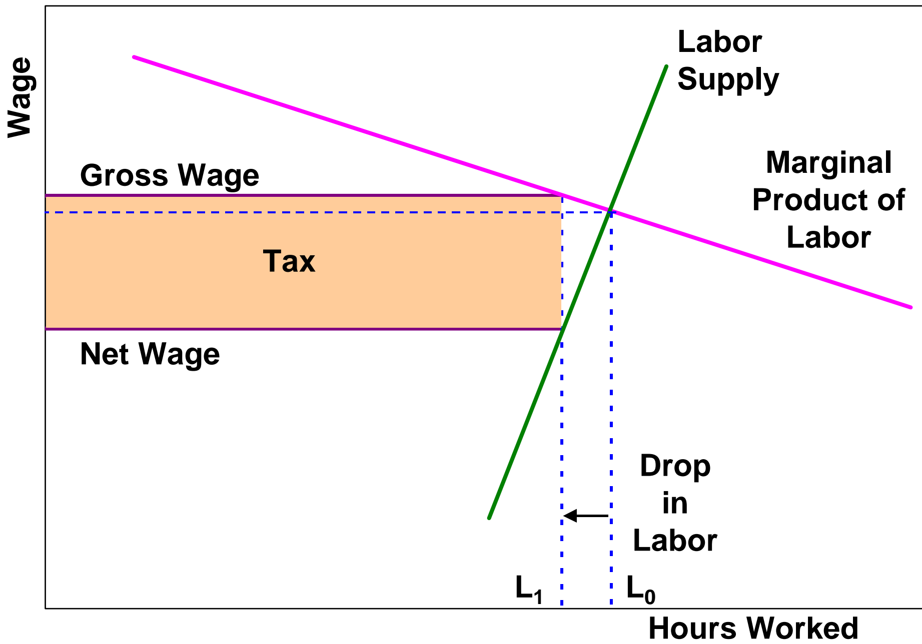
Charts 4a, 4b.

Let's see how tax changes **really** work to help or hurt the economy. A tax on economic activity (= P_c - P_p) depresses production, raising the price to the buyer and lowering the price for the producer. In addition to the revenue transferred to the government (rectangle), there is a dead-weight loss to the private sector (triangle). When government taxes and spends, each dollar spent costs the public the dollar of tax plus the loss of output — a total of about $2 to $3 depending on the tax used. Spending needs to be worth more than the apparent budget cost to be good for the country.

As tax rates rise from low levels, revenues rise; as rates get higher, the base (Q) shrinks faster, and revenues fall. When one adds the economic damage to the tax take, one sees that the optimal levels of taxing and spending are well below the revenue maximizing tax rate.

Charts 5 and 6.

Taxes on labor and capital depress employment and capital formation. Lower levels of inputs mean less output, even if the government spends the tax money. Capital is harder hit than labor, because capital formation is more sensitive to tax than are hours worked.



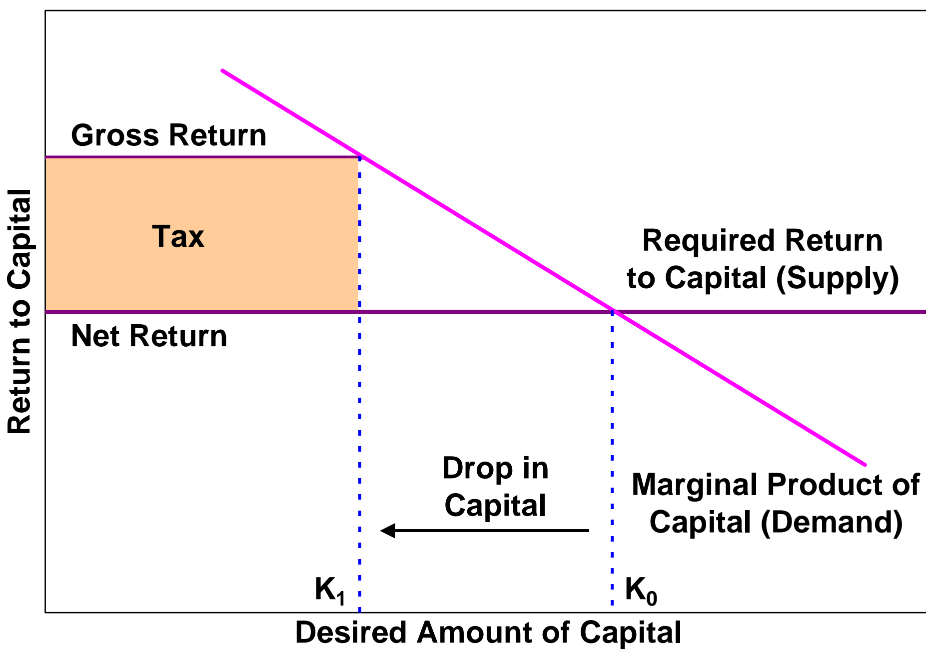


Chart 7 A Smaller Stock Of Capital Reduces Wages

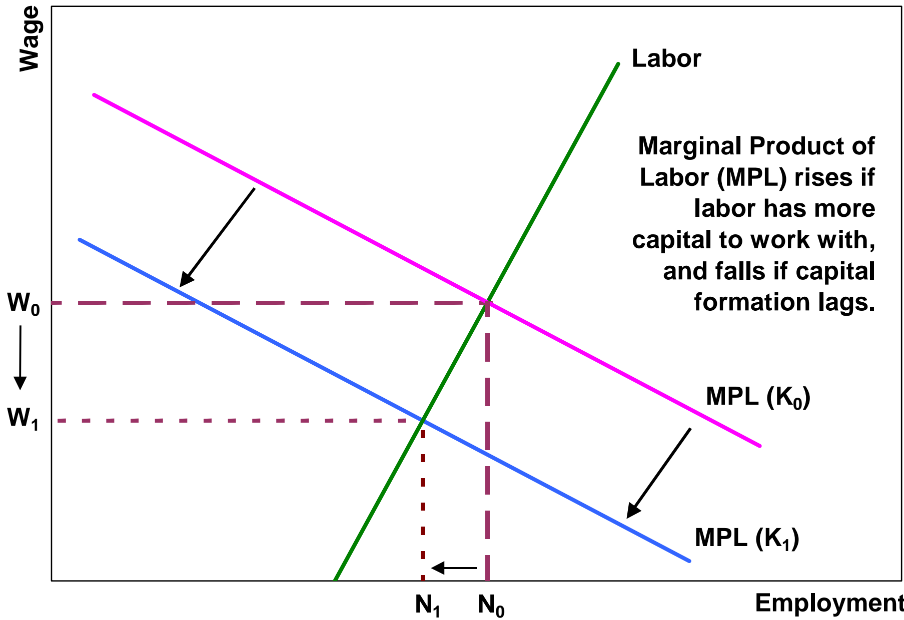
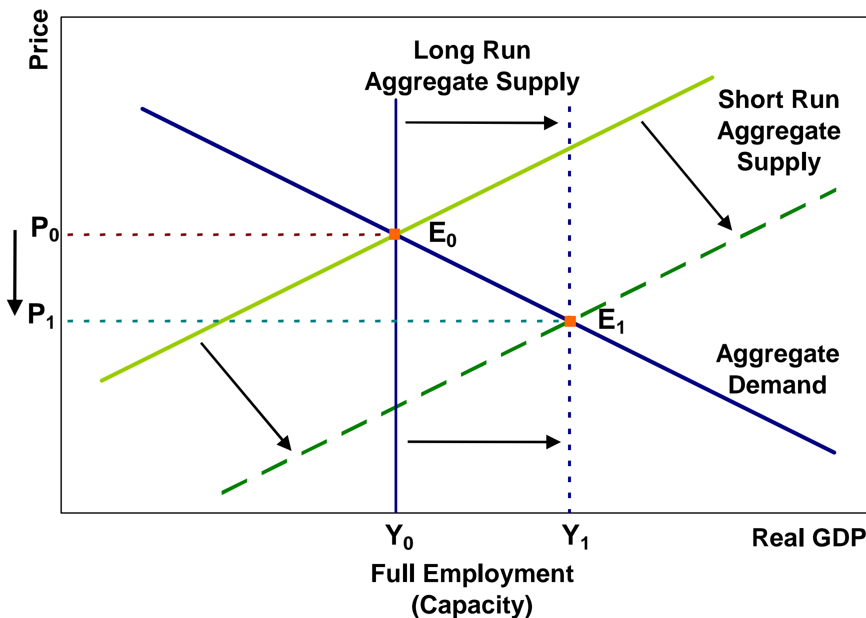


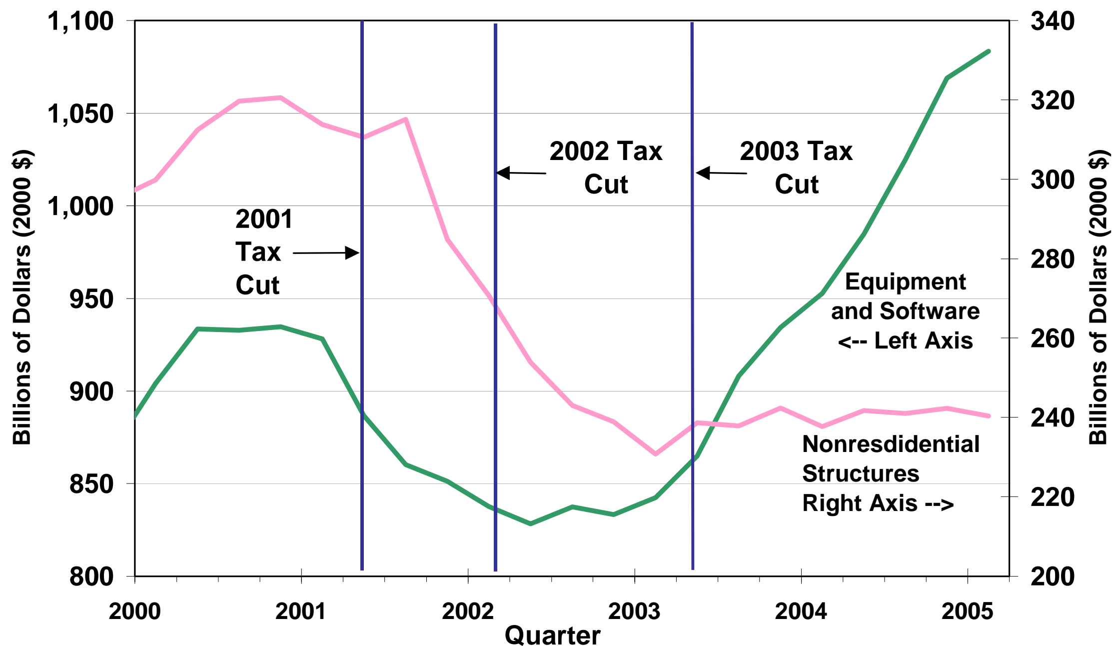
Chart 8 Expanding Capacity By Reducing Taxes At The Margin (Constant Money Supply)



Charts 7 and 8.

Taxes on capital hurt labor. Less capital depresses productivity, wages, and employment. But tax cuts that raise the return at the margin to investment and labor expand supply, employment, and output. (Among the tax cuts that improve incentives are marginal rate cuts, accelerated depreciation, corporate rate cuts, and dividend and capital gains relief.) Then, as people are paid for the added output, they spend more, so the amount demanded rises too, but only if supply goes up first. (Says Law: supply creates its own demand.)

Chart 9 Real Private Investment And 2001, 2002, and 2003 Tax Cuts



Data Source: BEA, National Income and Product Accounts, Table 5.3.6, accessed via www.bea.gov.

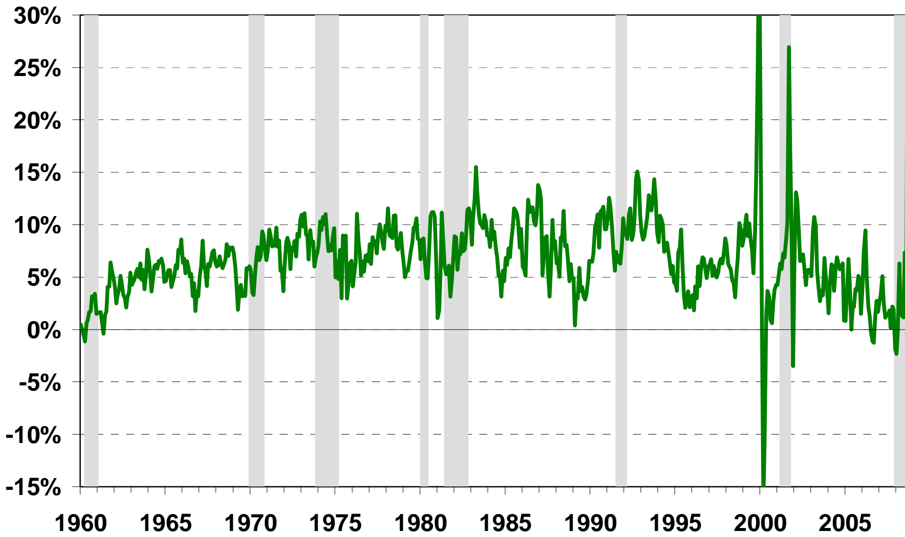
Chart 9.

The Bush 2001 tax cuts started with a rebate, which did not slow the slump in investment. The 2002 bonus expensing stopped the drop in equipment spending. The 2003 tax cuts (advancing the rest of the 2001 rate cuts, expanding expensing, cutting tax rates on dividends and capital gains) got investment and the recovery moving.

What would work today?

Extend the 2008 bonus expensing, the dividend and capital gains relief, the top marginal rate cuts to aid small business, end the estate tax, and cut the corporate tax rate. Also reduce burdensome regulations, especially in the auto industry. Eliminate restrictions on drilling on federal land and offshore.

We need a permanent improvement in the production climate in U.S., not a temporary boost. We need a permanently larger ***stock of capital*, not just a gimmick that shifts some investment spending** from next year to this year.



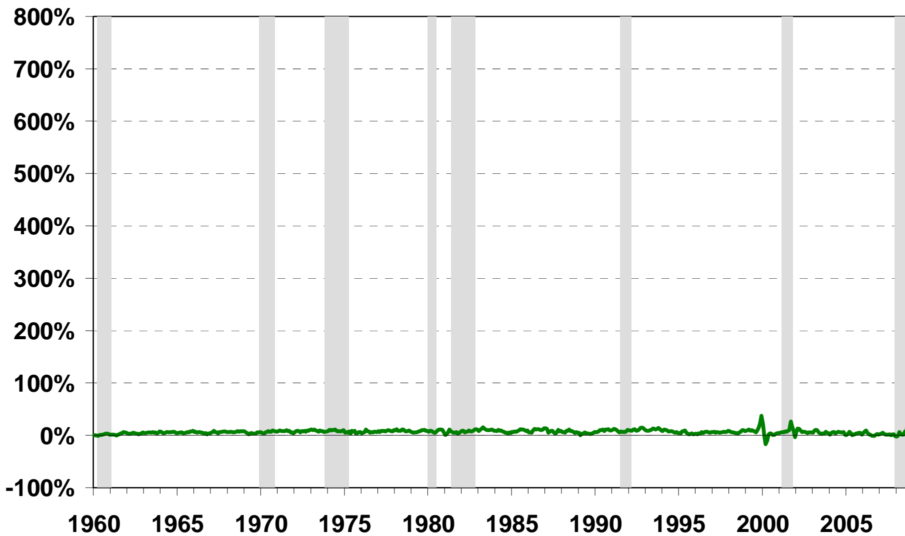
Charts 10a, 10b.

We cannot rely on the Federal Reserve to fix things. It is part of the problem.

The Fed gradually slowed money growth and inflation from the early 1980s to the mid 1990s (good for growth).

Fed policies became unstable (go-stop-go-stop) during the late-90s Asian currency crisis, the Long Term Capital hedge fund collapse, and Y2K fears. It contributed to the 2000-2001 recession, then poured reserves in to counter it. Investment did not respond because there were no investment incentives early enough in the 2001 tax cut. The Fed easing only boosted commodity and housing speculation.

Had the 2003 tax cut come two years earlier, we might have had the right kind of investment, higher returns and interest rates, less credit creation by the Fed, and less of a bubble in housing and oil prices. Erratic Fed policies always end badly. Today's Fed actions are literally off the chart.



Key points

! Tax cuts must not only be permanent; tax cuts must also be of the right kind. They need to alter incentives, at the margin, by lowering tax rates, by providing deductions that more fully reflect costs of production, or by eliminating double tax situations. Otherwise they do not affect labor and capital inputs, output, or income.

! Tax cuts that boost production incentives do far more to increase economic output than does higher government spending. The Keynesians got that backwards.

! Government spending is not the answer. For example, infrastructure spending can help only if the project is worthwhile on a cost-benefit basis (that is, if it should be done anyway). Its value must be above its construction costs, because the taxes raised to pay for it will hurt GDP.

! Japan tried spending its way out of its long economic slump, with several enormous spending packages in the 1990s. It failed. Few people know this, but a big tax hike on capital was the initial cause of the Japanese collapse. Tax hikes on saving and land collapsed the stock market and land values, which destroyed assets and collateral, and led to the Japanese banking system's becoming insolvent. They viewed it as a banking problem, but the damage was begun by bad tax policies that they have never fixed.

! The economy needs more than a jump start. It is not like a child who has fallen off a bicycle and scraped his knee. Mommy can't just kiss the boo-boo and prop the child back up on his bike and give him a shove and send him on his way. One shove won't help.

! Think instead of a long distance racehorse that has been saddled with more and more penalty weights, making it harder for him to go fast. Eventually the weights cause him to stop in exhaustion. He will never achieve top speed as long as the weights are in place. For "weights" read taxes and regulations. Congress must PERMANENTLY give up some revenue and some control over the economy if the productive sector of the economy is to be bigger on a PERMANENT basis.

Picture the economy as Milton Bradley's game of Chutes and Ladders. Where we start on the board depends on the size of the labor force and the level of the capital stock, which together generate output and income. We spin the dial and plod up the rows on the game board at a basic average underlying rate set by population growth, technological advances, and capital formation that just equips the new work force with the usual amount of tools.

We can get a surge in growth and jump ahead a few levels (climb a ladder) if something boosts labor and capital inputs. A permanent cut at the margin in taxes on labor boosts the willingness to get an education, enter or remain in the work force, and work longer hours. A cut

at the margin in taxes on capital raises the capital stock *per worker*, raises wages, and boosts output.

If we have a tax hike or impose a new regulatory hurdle, people leave the work force and let the capital stock wear down to a lower level (we fall down a chute). Output, employment, and income drop down to a lower level.

After each ladder or chute, we resume our upward plodding from the new level. The ladders and chutes are only triggered by permanent tax and regulation changes that affect additional output at the margin of current activity. Temporary changes, or changes that are not at the margin, do not alter the level of economic output and income.

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.