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.

January 26, 2009 **Advisory No. 249**

STIMULUS OR BUST?

President Obama and Congressional Democratic leaders are proposing a two-year, $825 billion economic stimulus. That is on top of the vast sums already being spent in the financial bail-out packages. This is an immense program. It is not just refilling the federal trough, it is building new ones. It would not restore the economy to health, because it does not push any of the buttons that would trigger an economic recovery. It would not boost private sector investment and employment. It would over-spend on programs of dubious value, and would saddle future budgets with a greatly increased interest burden. It would preclude the sort of tax reductions necessary to generate real economic benefits. There are far better tax cuts that should be adopted instead.

Stimulus Mirage.

We hear that all economists agree that stimulus is needed, even conservative economists who worked for President Reagan. The correct distinction is not liberal versus conservative, but Keynesian versus non-Keynesian. Richard Nixon said, "We are all Keynesians now." But monetarist and supply-side neoclassical economists do not agree, because we do not think that fiscal policy works the way the Keynesians assume.

The idea behind the stimulus plan is to jump-start "demand". Demand stimulus is a Keynesian view that peaked in the Nixon, Ford, and Carter years — not the economy's finest hours. In fact, as Milton Friedman taught us, government spending and tax hand-outs do not stimulate "demand" because every dollar doled out by government must be first taken in by other taxes, borrowing, or other spending cuts. The net effect on "demand" is zero, and there are no subsequent "multiplier effects". The stimulus evaporates before it gets started.

What if we sell the added federal bonds to the Federal Reserve, instead of borrowing the money from the public? Wouldn't that boost demand? Only if the Federal Reserve allowed the bond purchases to increase bank reserves and the money supply, with no offsets. But that would be due to the change in monetary policy, not the deficit per se. The Federal Reserve does not have to wait for a deficit to create new money, and it does not have to create new money when there is a deficit.

What if we sell the bonds to foreigners? If this merely displaces lending they were going to extend to other U.S. borrowers, there would be no effect. If the foreign lending is an additional capital inflow, its demand effect would be offset by a rise in imports and a drop in exports (a rise in the current account deficit) because it would bid up the dollar against other currencies. Again, no help.

Not All Tax Cuts Are Created Equal.

Republicans are pleased that $275 billion, or a third of the package, is tax cuts, mostly temporary, some permanent. Beware. Temporary rebates do nothing (witness the 2008 rebates and the Ford rebates), but even a permanent trashy tax cut is as ineffective at boosting demand and output as a temporary one. To boost output and income, a tax cut must be the right type, one that cuts taxes "at the margin" on the additional income associated with additional output (supply), and it should be permanent if the gains are to last. The current package does not pass that test.

Refundable credits.

The biggest piece of the tax cut would be a refundable "make work pay" credit of $500 for a single worker and up to $1,000 for two-worker families, offsetting payroll taxes on the first $8,100 of earnings. It would be phased out — an effective tax rate hike — over a range of household income from all sources, not just wages, starting at $75,000 for single filers, $150,000 for couples. The credit would encourage work at the margin only for people who produce and earn less than $8,100, but would discourage work, saving, and investment for more productive filers with income in the phase-out range. The effect on GDP would be negative. Ditto for proposed expansions of the income-capped refundable Earned Income Tax Credit and the refundable portion of the Child Credit. Note that the refundable parts of these credits are spending, not tax reductions.

Carry back losses.

Except for firms getting TARP money, businesses could carry back losses for 5 years, instead of only 2 years, against past profits to get a refund. Carrying losses forward with interest would be better, rather than giving money to businesses that are failing the test of the market and might never again produce a desirable, profitable product. Cutting the corporate tax would be better still. The carry-back by itself would give businesses cash, but unless some other provision cuts taxes on future earnings, it would not encourage more investment and hiring. (A very slim case can be made for the provision to get losses off books so firms can be eligible to use other incentives. It could also help liquidity-constrained firms with good investment prospects that are having trouble getting credit — although this fear is exaggerated. If firms do not want to issue new shares in a depressed stock market, then carry-back could lead to more investment, but cutting the capital gains and corporate tax rates would boost the stock market and make that concern moot.)

Expensing.

In the only good thing going for it, the plan extends the temporary expensing provisions of the 2008 stimulus package. These were partial expensing for equipment for businesses of all sizes (50% of equipment spending could be written off immediately instead of being depreciated over time), and a temporary increase in section 179 small business expensing limits from $175,000 to $250,000. The 50% bonus expensing is for equipment with asset lives of 20 years or less; it would be extended through 2009 for most assets, through 2010 for long lived and transportation property. The higher small business expensing limit would extend through 2009. Enhanced expensing would more fully reflect the real cost of equipment than depreciation, and would raise after-tax returns on investment. (Depreciation delays the reporting of business expenses for tax purposes, which devalues the tax deduction due to the time value of money and inflation, understates costs, and overstates and overtaxes profit.) Expensing would boost capacity and employment, but would work much better if it were permanent.

Energy Tax Incentives.

President Obama and Congressional leaders talk of creating several million green jobs by promoting energy efficiency and alternative energy sources. This initiative will not work as a stimulus package or a jobs generator. It is an excuse for adopting a questionable, uneconomic energy policy.

The stimulus package extends for two or three years the existing tax credits for investment in, and production from, various facilities for generating electricity from renewable energy sources. It would also increase for two years the credit for installing alternative fuel vehicle refueling property. It would expand the quantity of "clean renewable energy bonds" and "qualified energy conservation bonds" that governments and non-profit producers of "greener" electricity may issue that give the bondholders federal tax credits that supplement the interest. The bonds may be used to fund production facilities, retrofit government buildings to save energy, conduct research into alternative fuels and carbon sequestration, provide mass transit facilities, and educate consumers on energy conservation. The package would triple and extend for a year the existing credit for "residential energy efficient property" improvements to existing homes (energy efficient windows, furnaces, biomass stoves, air conditioners, water heaters, roofing, and insulation). It would create a new 20% energy research credit for businesses for 2009-2010.

These green projects would cost jobs, not increase them. If they were economical, we would be doing them now. Those that are promising are already being researched with private money. To date, alternative fuels and green vehicles require more resources to deliver less energy and transportation at greater cost, if they are possible at all. These projects divert resources from higher-value-added uses. Employment, output, and income are lower as a result.

State aid and infrastructure spending.

Some $550 billion would go for federal spending and shoring up state budgets for medicaid, infrastructure, schools, and unemployment programs. Most federal and state spending programs would merely displace private activity by taking money and resources off the market. Worse, each dollar government spends eventually costs the public $2.75 (= $1 of tax plus about $1.75 in collateral economic damage due to tax-generated disincentives and distortions). (This estimate of the cost of a dollar of marginal revenue was calculated by William Niskanen. See his new book, "Reflections of a Political Economist", page 95. Under some methods, his estimate was as high as $4.50.) Our modelling at IRET finds even larger numbers for some types of taxes. Government spending must be worth much more than its apparent budget cost to be good for the country. Most of it is not.

Some infrastructure projects might pass that cost-benefit test (perhaps electric grid modernization, or unclogging strategic rail bottlenecks). Some might keep worthwhile construction going on projects that the states might otherwise cancel. Most other projects would take months or even years to get started, and be of no immediate help to the economy. Unfortunately, many projects on the governors' and mayors' wish lists (like the organized crime museum proposed for Las Vegas) are a waste of taxpayer money and serve no national purpose. The less money thrown at such make-work ideas, the better.

Like a tick on a deer, government depends on the private sector for nourishment. Restoring the private economy would help the states and the unemployed more than a federal handout. The National Income and Product Accounts show state and local government spending rising 83.6% over the last ten years, versus 64% for GDP. States and local governments should roll back some of the increases in their spending, not turn to Washington for help.

Redeploying resources and improving production.

The stimulus program as currently evolving will not fix the economy. We have over-built in the housing sector, and misallocated resources in other areas due to wild swings in energy and commodity prices. Labor and capital must shift from declining industries and areas to expanding ones. Government does not know which are which. Intercepting people as they make these shifts and parking them in government projects for a year does not speed the adjustment, it delays it. The debt and future taxes raised in the process become permanent burdens that shrink private output and income forever after.

We need permanent improvement in the production climate in United States. What would help? Cut the corporate tax rate. Permanently extend the 2008 expensing provisions, the 2003 dividend and capital gains relief, and the top marginal rate cuts. End the estate tax. Reduce burdensome regulations, such as auto fuel economy standards and alternative fuel requirements. Eliminate restrictions on oil drilling on federal land and offshore. These steps would encourage additions to capacity and employment across the board, letting businesses compete to determine and create what consumers value most.

Taxes on capital and burdensome regulations raise the bar that investment must clear to be profitable after-tax. They fall especially hard on capital intensive industries such as manufacturing and resource extraction. The United States has the second highest corporate tax rate in the developed world after Japan (national and state/local rates combined), according to the OECD (U.S., 39.25%; OECD Average, 26.6%). A lower corporate tax rate would make the United States a more attractive location for business. (Lowering this distorting "double tax" is especially crucial if tax rates on dividends and capital gains are pushed back up.) The excess of the U.S. corporate tax rate over the foreign rate is imposed on repatriated earnings. The added tax traps U.S. foreign-source earnings abroad at a time when domestic credit is hard to get. Perhaps another partial tax holiday on repatriated earnings is in order, as in 2004, when Congress wanted to spur some domestic investment and hiring while generating some added revenue.

Too Much Reliance on Monetary Expansion.

Congress has done nothing good for growth since 2003. The benefits of that tax cut for investment and growth have run their course and need reinforcement. Instead of building on them, we threaten repeal of the capital gains and dividend relief, and an increase in the top tax rates. Investment and jobs will suffer.

Meanwhile, Congress has been relying on the Federal Reserve to keep the economy moving. Big mistake! When the Federal Reserve drove short term interest rates too low after the previous recession, it spurred speculation in commodities and real estate, not real investment in productive capacity. It trashed the dollar and threatens higher inflation. Inflation raises taxes on investment and reduces growth. The Federal Reserve does its best for economic growth and employment when it concentrates on price stability, not on short run GDP.

The Federal Reserve does not drive investment by manipulating interest rates. Long term interest rates are not subject to Fed control; they only mirror the after-tax rate of return on capital investment in plant, equipment, and structures. The current very low long term interest rates are a bad sign that real investment is not profitable.

Low profits and low interest rates have devastated the stock market and crippled retirees' incomes from saving. Earnings on Treasury bills have fallen from 3.5% in 2001 to 0.035% or even lower today. Where $100,000 in T-bills once earned $3,500 a year, retirees now get $35 a year. The ten year Treasury bond barely pays 2%. At 2% core inflation, clothing, canned goods, and toilet paper are better investments than most U.S Treasury debt.

Tax cuts on investment and output would increase returns to capital, raise interest rates beneficially to normal levels, and restore growth. Meanwhile, government should spend less, not more. Adding $5 trillion to the debt over the next few years looks cheap now at a T-bill rate of 0.035% ($1.75 billion a year in added interest), but watch out when rates return to 3.5% ($175 billion a year).

Conclusion.

The economy is not a stalled motorcycle that just needs a kick-start, after which it will run on its own motor. It is a long distance racehorse that has been saddled with more and more penalty weights, slowing him to a crawl. 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.

In every crisis — war, recession, whatever — government gets bigger. Worse, it is usually government errors that cause the crisis in the first place. The expansion of government only makes matters worse. We must break this cycle.

Stephen J. Entin
President and 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.