What Is Economic Stimulus? The Key Question

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How much should the U.S. government spend on an economic stimulus program? If you have trouble answering the question, it is because it is the wrong question.

The United States (and the world) economy is (or at least has been for the last few months) in decline with rising unemployment rates. It is widely believed the government must "do something." The political and media classes, and even many economists, call for an "economic stimulus program." But what do they mean by "stimulus," and will it do any good?

The argument is made that many Americans are suffering from a decline in income, and thus the government should give them money so they can buy more and put others back to work. Sounds good - but where does the government get the money? It must either tax someone else now or borrow more money, which diverts productive saving to current consumption. Either way, it is less than a zero-sum game.

Every time direct government payments have been tried, they have failed. During the Great Depression, government spending soared as a percentage of gross domestic product, but full employment did not return until World War II. During the last eight years, U.S. government spending has greatly increased in both absolute terms and as a percentage of GDP, yet the economy now performs worse than it did a decade ago.

When one person is taxed more to pay another person, the incentive to work diminishes and so the total income enjoyed by both people declines. The recipient might be slightly better off for a few months, but the economy (that is, everyone else), and eventually even the original beneficiary will be worse off. The government can only divert savings (through additional government bond sales) for a limited period before everyone will be worse off. The evidence is that the first Bush tax cut back in 2001, which was actually a tax rebate, did little good. In fact, it is now known that people saved much of the money, so the government borrowed some people's savings to provide money for others (or even the same people - who didn't spend it, but saved it). The lesson was learned, and in 2003 the tax rates were cut, which increased incentives for work, saving and investment and hence did a lot of good.

The history of various economic experiments and sound theory (unlike much of the Keynesian claptrap) teaches us government handouts, or tax rebates, are unlikely to do any good and can often be counterproductive.

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Some advocate government spending on infrastructure as part of a stimulus package. In theory, government infrastructure spending (highways, bridges, dams, etc.) can help the economy: if the project meets a solid cost-benefit test; if it is well-managed; if there is little or no corruption; and if it can be done quickly to help the current downturn. Do you want to bet your tax dollars on all of those "ifs"?

If government handouts, tax rebates and infrastructure spending are unlikely to help, what can be done? First, recognize what caused the problem - misguided government monetary policy and financial regulation, which created the wrong incentives, and mismanagement of government-sponsored enterprises (i.e., Fannie Mae and Freddie Mac). Thus, Step One is for those at the Fed, Treasury, Congress, etc. to clean up the financial mess they created.

The government could also cut the payroll tax for both employees and employers for at least two years to allow the economy to get back to full employment. A payroll tax rate cut would have the advantage of immediately increasing home pay for workers, while giving them added work incentives, and giving employers an additional incentive to retain or hire more workers. Critics of the idea will complain it will raid the Social Security trust fund - but since Congress has already spent the trust fund money on other things, the additional liability would mean little.

A payroll tax cut will increase the deficit (and it is more costly than an across-the-board tax rate cut, but it has the political advantage for President-elect Obama that it would not be a further rate cut for the "rich"), but if it puts more people back to work and helps end the recession more quickly, the cost would be justified.
As to the additional hole in the trust fund, the government could shift title to some of the land it holds (roughly one-third of all the land in the United States) to the trust fund.

Politicians complain that companies have been shifting jobs to other countries. A major reason is that corporate income taxes in the United States are higher than other countries and regulations are more severe. So a good "stimulus" for job creation would be to cut the corporate tax rate to make U.S. companies competitive again.

The stock market has plunged, in part, over fear the capital-gains tax rate will be increased. If Mr. Obama would say he will not increase the capital-gains tax and index the basis for inflation, the markets would jump, which would strengthen the balance sheets of many companies. And finally, if the congressional leadership and the president-elect would say they will allow the full writeoff (or at least greatly increase the current $3,500 limit) of capital gains' losses for any new purchase of stock or other productive assets, including real estate, there would be a rush to buy. Current limitations are unfair and economically destructive (the government takes part of the gain, but you take the loss).

The above measures would be less costly and more effective than the various proposed versions of "dumping money out of airplanes," and would provide real "economic stimulus."

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