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Essential Conditions for a Pro-Growth Stimulus Package

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Congress is considering some form of tax relief to help the nation's sputtering economy, but not all tax cuts are created equal. Some proposals, such as temporary tax cuts, tax rebates, and "tax holidays," will do little or nothing to restore economic growth. It also is a bad idea to increase federal spending. Though such spending may result in increased economic activity in one sector, it shifts resources from more productive uses in the private sector. To boost the growth of national income, tax relief should permanently reduce marginal tax rates on work, savings, investment, risk-taking, and entrepreneurship.

A stimulus bill that fails to include a significant reduction in all tax rates might be worse than doing nothing. A package comprised of new spending and gimmicks like rebates and temporary tax cuts will not enhance long-term economic growth. Indeed, such proposals will increase the risk of continued recession and high unemployment. Adding insult to injury, lawmakers who block supply-side tax cuts this year might point to the economy's poor performance next year and argue that this is "proof" that pro-growth tax cuts do not work. Such misguided claims, if taken seriously, would jeopardize important tax rate reductions that are scheduled to take effect in 2004 and 2006.

Taxes and Growth. Some policymakers do not understand the relationship between fiscal policy and economic growth. Advocates of tax rebates and tax holidays argue that quickly putting more money in people's pockets will trigger more consumer spending and jump-start the economy. This is also the rationale of those who believe that increased federal spending will boost growth by putting more money in the economy.

While superficially plausible, this approach has a dismal track record, as is evident in the failed policies that many Western nations adopted during the 1960s and 1970s. During that time, many countries, especially in Europe, relied on government spending and targeted tax breaks to increase "aggregate demand." But instead of boosting growth, those Keynesian policies resulted in stagnating economies. In more recent times, Japan's economy has been mired in a ten-year stagnation in spite of—perhaps because of—repeated doses of additional government spending.

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The Keynesian view is fundamentally flawed because it fails to consider both sides of the equation. More specifically, it does not recognize that government cannot give a consumer a dollar—either in the form of new spending or as a tax rebate—without first taking that dollar from someone else. Every dollar used for tax rebates and tax holidays means that one less dollar can be used to pay down debt, so Keynesian policies merely take money that would have wound up in the pockets of bondholders and instead put that money in the pockets of selected taxpayers. There is no increase in total spending power.

In any event, the Keynesian preoccupation with consumer spending makes no sense. Economic growth occurs when there is an increase in national income. Efforts that simply alter the use of income by encouraging people to spend instead of save do nothing to increase the economy's overall output. Moreover, because less saving translates into decreased investment spending, the Keynesian approach is flawed from both a theoretical and a practical perspective.

The only way to increase national income is to encourage more work, saving, investment, risk-taking, and entrepreneurship. This is why incentive-driven supply-side economics has a successful track record. When tax rates are reduced, people have more motivation to be productive and create wealth. And when they earn more income, they are able to spend more and save more.

An Effective Stimulus. Advocates of faster economic growth should insist on a stimulus package that satisfies the following three criteria:

- **All personal income tax rates should be reduced permanently, and those lower tax rates should take effect immediately.** Across-the-board tax rate reductions are one of the strongest tonics for an ailing economy. It is particularly important to reduce the top tax rate, since it is this levy that imposes the greatest disincentive on investors, entrepreneurs, and small-business owners.
- **There should be firm limits on the growth of domestic spending since a bigger government is likely to harm economic performance.** In times of war, it is both necessary and desirable to increase spending on programs that help defend the nation, but lawmakers should not delude themselves by believing that such new spending, by itself, will help the economy. Government spending—even for legitimate purposes—diverts resources from the productive sectors of the economy. And under no circumstances should special interests be allowed to hijack a national emergency to increase domestic spending.
- **Temporary tax cuts and "tax holidays" have no effect on growth and should be kept out of a stimulus bill.** Such proposals would temporarily suspend a tax (the Social Security payroll tax and state sales taxes are the two most frequently mentioned options) in an effort to boost consumer spending. As discussed above, this is a counterproductive approach. Lawmakers should devise policies that increase national income. Proposals that merely seek to alter how income is used, by contrast, will do nothing to improve the economy's overall performance.

Conclusion. To be worth implementing, a stimulus bill should stimulate the economy, not curry political favor with high-profile "tax holidays" or spending projects. The Administration's proposal—including reductions in all tax rates, elimination of the corporate alternative minimum tax, and depreciation reform—would improve incentives to work, save, and invest. Yet some Members of Congress would blunt the pro-growth nature of this package by gutting key provisions.

Proponents of economic recovery in the Administration and on Capitol Hill should insist that the stimulus package meet the conditions described above and reject any proposal that does not. Most important, the legislation must fully reduce all personal income tax rates to the levels in the tax package approved in June. The President should not sign a bill that does not include this provision.

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