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The House Stimulus Package: The Good and the Bad

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A bipartisan deal on a stimulus package has been reached between House Majority Leader Nancy Pelosi (D–CA) and House Minority Leader John Boehner (R–Ohio). The package reportedly includes tax rebates for wage earners and tax cuts for businesses.[1] Certain elements would boost the economy both in the short- and long-term, but other elements would do little and should not make the final cut in any stimulus package.

As the agreement is being reported by the media, its positive aspects are tax cuts to boost business investment and a rejection of new government spending. The negative aspects are refundable rebates that function more as handouts than stimulus, no new tax cuts that could be returned as a rebate, and an expanded government role in the housing market.

The Good. The best part of the agreement is tax cuts for businesses. "Bonus depreciation," which allows companies to rapidly deduct qualified investment from their tax liability, makes new investment opportunities more profitable and attractive. This provision would increase business investment, which would create jobs and strengthen the economy.

An even better approach would have been to extend the pro-growth elements of the 2003 tax cuts, which reduced taxation of capital gains and dividends. Those tax cuts and the bonus depreciation helped spark the economy in the latter part of 2003. Since investment is forward-looking, many businesses are in the process of making investment decisions for 2011 and beyond. Permanent reductions in the cost of capital would help the economy by eliminating the uncertainty that businesses face when making investment considerations.

Business investment was flat in the second quarter of 2003 but grew by 3 percent and 5.1 percent, respectively, in the third and fourth quarters after passage of the 2003 tax cuts. The increase in business investment reversed the trend of the earlier three quarters, when investment declined by 6.5 percent, 3.8 percent, and then grew at 0 percent, respectively. In the quarter immediately following the 2003 tax cuts, the economy began to add jobs, and job growth has continued every month since.

The stimulus package appears to have rejected some of the additional spending that many politicians wanted. A number of new spending proposals, from bridges to renewable energy, were described as stimulative. Because the government is running a deficit, funds for new spending must be borrowed from domestic savers (which reduces investment spending) or from foreigners (which reduces net exports). There is little reason to trust politicians to make the right public investments. It is better to reduce tax rates and let businesses, families, and markets decide on the most productive way to spend money.

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Also, the new stimulus package does not extend unemployment insurance (UI) benefits. Extending unemployment benefits does not stimulate the economy as some politicians assume. Instead, it reduces the incentive of workers to look for a new job. Studies are almost unanimous in concluding that extending UI leads to workers staying unemployed for longer periods of time. UI also encourages employers to wait longer to hire workers after temporary layoffs. Also, extending UI does not increase consumption as expected. When workers get additional benefits, they do not spend their personal savings, and spousal earnings fall. Only 50 cents of each dollar spent on UI funds new consumption. The UI system is designed to cushion the pain of losing a job, not to improve the economy. Studies find that it has, at best, a modest effect on economic growth.

Like most legislation, the stimulus bill is likely to become increasingly expensive as it makes its way through Congress. Lawmakers sensing a "Christmas tree" bill are likely to each demand their own spending ornaments in exchange for their votes. As sound economic policies take a backseat to political expediency, taxpayers will be left funding a massive increase in government (and future taxes) that does little to stimulate economic growth. To avoid that scenario, responsible lawmakers must draw a line in the sand and reject any new spending initiatives from being added on the House and Senate floors.

The Bad. One of the key components of the package is a targeted rebate that is refundable against payroll taxes. Proponents of rebates believe that people would quickly spend their rebates, thus providing a short-term boost to consumption and the economy. However, traditional economic theory holds that rebates have limited impact unless recipients believe their permanent income will increase. The rebate would also do little to change incentives to work or invest; thus, it would not be effective in boosting long-term economic growth. Tax rebates and similar cash transfers don't stimulate the economy. The federal government cannot just wish new purchasing power into existence. The government must borrow the funds for the rebates, which means either less money available for investment or an increase in the trade deficit.

In the fall of 2001, the government attempted a rebate in the form of an advance payment of the 2001 tax cut. A survey of rebate recipients found that less than a quarter of households planned to spend their rebate.[2] Most respondents said they would use the rebate to pay down their debt. A different study of the rebate found that spending over the next year did increase by approximately one-half to three-fourths of the rebate.[3] But it is possible that this relatively high amount of consumption occurred because the rebate was a pre-payment of a larger tax cut that some taxpayers might have considered permanent.[4] Unlike 2001, the rebate in the new stimulus agreement is not attached to a larger, long-lasting tax cut that could alter incentives to work or save more. Individuals would likely see the rebate as a temporary addition to income, in which case they would be more likely to save it or pay down debt.

Supporters of rebates believe that low-income households are more likely to spend their rebate. However, two recent studies of the 2001 rebate and the 2003 rebate challenge that notion. A Joint Tax Committee report states that the 2001 study "found no evidence that low income individuals were more likely to spend their rebate."[5] More surprisingly, a

[1] Andrew Taylor, "Tax Rebates Deal Announced," Associated Press, January 24, 2008, at *http://news.yahoo.com/s/ap/20080124/ap_on_go_co/economy_stimulus;_ylt=AiZy737sR1oVn6od2Za.lXqs0NUE.*

[2] Matthew Shapiro and Joel Slemrod, "Consumer Responses to Tax Rebates," *American Economic Review*, 2003, Vol. 93, No. 1, pp. 274–283.

[3] David S. Johnson, Jonathan A. Parker, and Nicholas S. Souleles, "Household Expenditure and the Income Tax Rebates of 2001," *American Economic Review*, Vol. 96 No. 1 (December 2006), , pp. 1589–1610.

[4] Joint Tax Committee, "Overview of Past Tax Legislation Providing Fiscal Stimulus and Issues in Designing and Delivering a Cash Rebate to Individuals," January 21, 2008.

[5] *Ibid*, citing Shapiro and Slemrod.

Federal Reserve Board study found that households with an income of more than $100,000 were more likely than households with less than $30,000 to spend the 2003 child tax credit rebate or to spend more of the reduced tax withholdings in a paycheck.[6] In reality, the rebate appears to be little more than a targeted government handout for low-income Americans, dressed up as a stimulus.

A more disturbing aspect of the package is a provision that will allow the federal government to get even deeper into the residential finance market by being able to acquire more mortgages. Fannie Mae and Freddie Mac—companies that are given extensive, special privileges by the federal government—would be allowed to purchase more expensive home mortgages valued at up to $725,000, which is well above the median home price. The government should be reducing its role in the mortgage market instead of expanding it and crowding out private companies.

Conclusion. The stimulus package has one element that would contribute to both short-term stimulus and long-term economic growth: the business tax cuts. Also, Representatives Pelosi and Boehner deserve praise for resisting, thus far, the urge to load up the agreement with all sorts of new spending programs. Such spending would increase the deficit and would have little impact on economic growth. However, the provision that allows government-sponsored mortgage companies to buy more expensive houses is misguided.

A stimulus bill is not the place to expand government interference in the economy, bail out banks that make bad loans, or pile on unrelated new spending. Congressional leadership should resist any attempts to do so. Instead, they should focus on pro-growth policies. The bonus depreciation proposal is the strongest part of the agreement and should be strengthened by extending current tax rates on dividends and capital gains and indexing capital gains. While a tax rebate may be inevitable at this point, the public should recognize that this rebate is poorly targeted and would not have a significant effect on the economy.

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[6] Julia L. Coronado, Joseph P. Lupton, and Louise M. Sheiner, "The Household Spending Response to the 2003 Tax Cut: Evidence from Survey Data," 2005–32, July 25, 2005, at *http://www.federalreserve.gov/pubs/feds/2005/200532/200532pap.pdf* (January 24, 2008).