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How to Successfully Stimulate the Economy

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When the economy is struggling, Congress has a tendency to invoke the same tried and failed policies of the past. Typically, these policies promise hundreds of billions of dollars in government spending while doing little to actually revitalize economic activity. The first round of stimulus checks, like those rebates issued in the 1970s and 2001, were a bust, with only a small portion (perhaps less than 30 cents on every rebate dollar) used for consumption. Furthermore, prior government spending on infrastructure such as highways merely transferred—rather than created—wealth.

During the current period of slow economic growth, Congress should do what it does best: set broad economic policy. Specifically, Congress should concentrate on signaling to investors and workers alike that its principal focus will be on improving pro-growth economic policy, mainly in the areas of tax, energy, and spending policies. The test for distinguishing good stimulus ideas from bad ones should be this: Is the proposal likely to raise the economy to a sustained, higher level of growth?

Tax Policy. What can increase risk for investors and businesses? Many factors, of course, but public policy commonly looms largest. For example, tax increases, especially on capital, increase the cost of capital and lower investment returns. When investors are uncertain about whether taxes will increase or stay the same, they can still act as though taxes have risen if they judge the risk of an increase to be nearly equal to an actual increase. And rising uncertainty can have the effect of driving down investments in riskier undertakings. Congress can take the following actions on tax policy:

- *Make the Tax Reductions of 2001 and 2003 Permanent.* Among the first actions Congress can take to address the current economic slowdown is to make a definitive statement regarding the tax increases scheduled for 2009 and 2011. There are projects, new businesses, and expansions of existing businesses that would be undertaken today if Congress signaled that taxes would be lower in three years. Since nearly all major capital undertakings last beyond this three-year period, it is likely that making all or most of the Bush tax reductions permanent would stimulate economic activity today as well as in 2011. If Congress increases taxes, then investors will find more favorable economies to support and business owners will, as much as they can, locate their expanded activities in other countries with more favorable tax regimes.
- *Accelerate Tax Depreciation.* Past economic slumps have proven that accelerating the tax depreciation of capital equipment and buildings or the one-year expensing of business purchases that would otherwise be depreciated over a

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longer period of time for tax purposes can help during periods of slow growth.[1]

- *Lower the Corporate Profits Tax.* In one area of tax policy, there is now nearly universal agreement: Our federal business taxes are far too high. The U.S. tax rate on corporate profits is the second highest in the world. Why is it not the firm policy of this country's government to ensure that the corporate profits tax is always below the average corporate income tax of other industrialized countries? Such a policy would enhance our competitive standing worldwide and significantly reduce the incentive for U.S. firms to relocate to lower tax countries.

By making the 2001 and 2003 tax reductions permanent and reducing the corporate profits tax by 1,000 basis points, an annual average of 2.1 million more jobs would be created. Indeed, 3.4 million jobs above a current law baseline would be created in 2018 by newly energetic businesses. These tax changes dramatically increase the level of national output, and household income rises as the result of a healthier economy and lower taxes. In fact, the average household would have $5,138 more to spend or save after paying their taxes, and by 2018 this amount would jump to $9,750.[2]

Energy Policy. Rapidly increasing prices for gasoline and petroleum-based energy slowed the economy and helped bring about our current recession. Additionally, the effects of such increased energy prices continue to impede job and income growth. If Congress acts to expand energy supplies, forward-looking prices will fall and economic activity will shed off the drag stemming from this sector.

The Heritage Foundation's Center for Data Analysis analyzed the economic effects if domestically sourced petroleum increased by 2 million barrels per day, and it found that such an increase would expand the nation's output—as measured by the Gross Domestic Product—by $164 billion and increase employment by 270,000 jobs annually.

If Congress were to announce greater access to proven reserves, mining activity would immediately begin, capital and talent would leave other parts of the world and travel to the U.S., forward-pricing markets would feel the downward pressure on prices as the result of impending supply increases, and ordinary Americans' concerns over their economic future would lessen.

Spending Policy. While the attention of most policymakers will be on immediate responses to the current slowdown, the seeming unwillingness of Congress to seriously address the enormous financial challenges from entitlement spending should not go unnoticed. Many investors and organizations that play key roles in the future of the U.S. economy are worried about long-term growth given the fiscal challenges posed by Social Security's and Medicare's unfunded liabilities.

At a time when the economy is slowing and the voice of Congress, as well as its actions, can affect economic activity, policymakers should take concrete steps that will announce their intention to address unfunded liabilities in these important programs. While reforms in these programs may be beyond what this Congress can accomplish, it is possible to signal change by reforming the budget rules.

Currently, the federal budget functions on a pay-as-you-go system, with a very limited forecast of obligations and supporting revenues. It is impossible for the official budget to predict what may happen over the next 30 years; the five- and 10-year budget windows do not permit Members of Congress or the general public to sense the obligations that are coming beyond that 10-year horizon. However, Congress can take two important steps in addressing the long-term entitlement obligations of the U.S.:

1. *Show These Obligations in the Annual Budget.* This could be done by amending the budget process rules to include a present-value measure of long-term entitlements. Such a measure would express in the annual budget the current dollar

1. Matthew Knittel, "Corporate Response to Accelerated Tax Depreciation: Bonus Depreciation for Tax Years 2002–2004," U.S. Department of the Treasury, Office of Tax Analysis, Working Paper No. 98, May 2007.
2. After subtracting inflation.

amount needed today to fund future obligations. Such a measure has been endorsed by a number of accounting professionals, as well as the Federal Accounting Standards Advisory Board.

2. ***Convert Retirement Entitlements into 30-year Budgeted Discretionary Programs.*** Such a move recognizes that mandatory retirement funding programs for millionaires that crowd out discretionary spending programs for homeless war veterans do not make any sense at all. If we are to contain entitlement spending and reform the programs driving those outlays, then a paradigm shift will likely be required. Recognizing Social Security and Medicare as discretionary programs helps to force attention on changes that will assure their survival well into the 21st century.[3]

Greater Predictability, Greater Productivity. Serious work by the Congress on tax, energy, and spending policy will create greater predictability for investors and business owners and assure workers that they will have a better chance of improving their wages through increased productivity. Efforts to enhance this nation's long-term economic health may very well have immediate, short-run benefits as economic decision makers reduce the risk premium they place on starting new businesses or expanding existing enterprises.

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3. See Stuart M. Butler, "Solutions to Our Long-Term Fiscal Challenges," testimony before the Committee on the Budget, U.S. Senate, January 31, 2007, at *http://www.heritage.org/Research/Budget/tst013107a.cfm.*