WebMemo

Published by The Heritage Foundation

No. 2152
December 3, 2008

Permanent Tax Relief—Not Tax "Holidays"—Stimulates Economic Growth

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It has grown fashionable in the media and in Washington to assume that what the economy needs right now is a quick stimulus, or "jolt," by putting cash in the hands of ordinary Americans—or government agencies—that they go out and spend. The theory is that people will take this money, go out and buy things, and this spending spree will reignite economic growth. Economists often refer to this as a "Keynesian" fiscal stimulus, named after the late British economist John Maynard Keynes.

A tax version of this idea has been embraced by some Republicans as well as Democrats. Their proposal: Americans would receive temporary tax rebate, or a "tax holiday" for a few months during which they would pay no federal taxes.

To be sure, letting Americans keep their money rather than sending it to Washington means it is more likely to be used wisely. But if the additional goal is to spur economic growth, this tax "jolt" will have little impact. Fiscal policy in the form of short-term tax holidays, or temporary spending jolts, will not rekindle economic growth; only long-term reductions in marginal tax rates on capital and work will accomplish that goal.

Long-term tax rate reductions—as opposed to short-term jolts—are needed because the important economic decisions that will trigger a real recovery depend on more investment in new factories and new equipment. Americans are more likely to make these investments when they believe that there will be a long-term improvement in the after-tax returns to investing, working, and taking economic risks. Such improvement requires long-term marginal rate reductions, not a temporary shot-in-the-arm.

Keynesian Fiscal Strategies: A Dismal Track Record. Keynesian fiscal strategies do not work. Trying to stimulate economic recovery and growth with new government spending has a long and dismal record in Europe as well as the United States.[1] The simple fact is that every dollar used for such spending comes from the private economy, meaning resources that would be spent or invested in one place are spent somewhere else. Potential economic activity in one place is shifted to another, typically with less efficiency. Moreover, the simplistic assumption that putting dollars in people's hands means they will rush to the store, purchase goods, and consequently create jobs just does not hold up.

Temporary tax holidays—rather than sustained reductions in tax rates—have similarly disappointing results. Why is this?

There are several factors behind the failure of temporary tax holidays to stimulate economic recovery. One reason is that even if the key to future growth was to increase household spending, a tax holiday will not prompt the necessary splurge. That

This paper, in its entirety, can be found at:
www.heritage.org/Research/Taxes/wm2152.cfm

Produced by the Domestic Policy Studies Department

Published by The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002–4999
(202) 546-4400 • heritage.org

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is because Americans adjust their spending according to what economists call the "wealth effect." When the value of their stocks or housing is going up, as it did for many years, Americans tend to save less and spend more. But when their housing values and stock portfolios have plummeted, as in recent months, the first thing Americans tend to do with unexpected cash is to try to replenish their wealth by increasing savings or paying down their credit card debt.

This behavior explains why the short-term tax rebates elements of the early Bush tax cuts, as well as the tax rebate element of the 2008 economic "stimulus," had almost no impact on household spending[2]: The rebates were not related to permanent tax rate reduction.

Another reason tax holidays fail to prompt economic renewal—and this reason is related to the wealth effect—is that a family considering a significant increase in spending, or an investor contemplating a new business venture or expansion, thinks about the long term, not the next few months. Consequently, such individuals are motivated by the likely future patterns of *after-tax* family income and the *after-tax* return on an investment when compared with the risk of that investment. That is why American families will not go out and buy a new car just because they get a short-term tax rebate or tax holiday and why Americans with large-scale resources to invest will not break ground on a new factory if they are merely relieved of taxes for a couple of months.

The only way fiscal policy can change this spending or investing inertia is to improve the prospects for *future* after-tax income from earnings or from capital investment. The kinds of tax reductions that do that are not short-term rebates or holidays but long-term tax rate reductions that are, as former Treasury official John Taylor recently wrote, "permanent, pervasive and predictable."[3] Taylor notes that the only tax rebates that actually speed up the economy are those that advance a long-term tax reduction. The one recent rebate that would fall into this category was the 2001 tax rebate, because it was actually the first installment of a long-term tax reduction already enacted.

Thus, rather than put forward a tax version of Keynesianism, which would "waste" tax relief intended to stimulate growth, those lawmakers who sensibly want to propose a tax reduction alternative to a spending "stimulus" should focus on long-term tax rate reductions. A short-term tax holiday would have little or no stimulative effect on the economy. Permanent, predictable, and pervasive reductions in marginal rates, by contrast, would change the future picture and, because of this, would have immediate effects on family and investor decisions.

Specific Steps for a Stimulative Tax Strategy. If lawmakers decide to adopt this truly stimulative tax strategy, they could include a number of specific steps. Among them:

1. Further extend or make permanent the tax rate reductions of 2001 and 2003, which are set to expire in 2010, including a repeal of the death tax.
2. Reduce the corporate tax rate to 25 percent or lower for at least 10 years, and preferably permanently. Not only would this reduction improve the after-tax return on investment, but it would also make American exporters more competitive with foreign firms, which generally enjoy lower corporate rates than U.S. firms.
3. Further reduce marginal income tax rates for at least five years, which would improve anticipated future after-tax family income.
4. Extend so-called "bonus appreciation" for at least two more years. This allows a business to deduct 50 percent of the cost of equipment in the year of purchase and so reduces the effective cost of the equipment. Currently this policy is set to expire this year.

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1. See Brian Riedl, "Why Government Spending Does Not Stimulate Economic Growth," Heritage Foundation *Backgrounder* No. 2208, November 12, 2008, at *http://www.heritage.org/Research/Budget/bg2208.cfm*.
2. John B. Taylor, "Why Permanent Tax Cuts Are the Best Stimulus," *The Wall Street Journal*, November 25, 2008, at *http://online.wsj.com/article/SB122757149157954723.html* (December 3, 2008).
3. *Ibid.*

Letting Americans keep their own money is a good instinct for lawmakers. Whether they save or spend that money, Americans are more likely to use their money wisely than if Congress decides where and how to spend it. But if the goal is also to encourage Americans to use their money in ways that will encourage faster growth, it is far better to provide any particular amount of tax relief as long-term reductions in tax rates rather than as a merely temporary respite from the IRS.

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