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Economic Recovery: How Best to End the Recession

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The economy has been in recession for over a year, contracted rapidly toward the end of 2008, and is likely to continue to contract through the first half of 2009 and possibly beyond. The new Administration and new Congress are developing a stimulus program to soften the recession and accelerate the recovery.

Given the high level of economic pain, policymakers need to pursue stimulus policies that work. The centerpiece of an effective stimulus policy should involve two elements:

1. Extend the 2001 and 2003 tax reductions for as long as possible—certainly through at least 2013 to prevent a tax increase. Better yet, make the tax reductions permanent; and
2. Reduce tax rates on individuals, small businesses, and corporations through 2013 by lowering the top rate by 10 percentage points and reducing rates by similar amounts for lower income level taxpayers.

According to analysis using The Heritage Foundation's mainstream model of the U.S. economy, relative to current law, these policies would:

- Soften the recession in 2009 and speed the economic recovery through 2010 and beyond;
- Increase employment by a half million jobs in 2009 and by 1.3 million jobs in 2010 and create 4.8 million jobs from 2009 through 2012; and
- Reduce federal tax receipts during the critical fiscal years of 2009 and 2011 by $636 billion.

The aggressive tax policy changes of Heritage's plan, plus the intensive activities of the Federal Reserve, are the best combination of federal policies to end or shorten recessions.[1] Further, whereas the Heritage tax plan would strengthen the economy, the types of tax proposals mentioned as part of the Obama stimulus would have almost no effect on the economy, the proposed increase in spending would have no effect on the overall economy whatsoever, and the resulting deficits would be of such unprecedented magnitudes as likely to trigger a recovery-stifling rise in interest rates. Thus, rather than increasing spending, Congress should reduce spending now and over the long-term through entitlement reform to reduce the upward pressure on interest rates.[2]

Focusing on What Works. The current recession is likely to be deep and may be more severe than any economic downturn since the Great Depression of the 1930s—call today's economic mess the "Great Recession." Fortunately, the economy and financial markets are working through their difficulties and will, eventually, stabilize and strengthen on their own. The economy will recover even absent an effective federal fiscal policy

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response. However, an effective tax policy response can meaningfully soften the recession and speed the recovery, which is no small feat to an individual looking for work.

Much of official Washington is focused on a big stimulus plan based predominantly on increased spending, possibly including an expanded infrastructure program plus aid to the states and to low-income families. Whatever the merits of these programs on other policy grounds might be, they would not stimulate—and indeed are likely to weaken—the economy in the near term.

The American economy does not rise and fall with the level of aggregate demand or deficit spending. Further, government cannot simply pump up total demand through deficit spending. The deficit for 2009 is already projected to exceed $1 trillion, so if deficit spending were effective, the economy should already be poised to take off.

Yet the economy is contracting despite these unprecedented deficits because government spending in excess of tax revenues will be financed by borrowing from the private sector, which deprives the private sector of a like amount of purchasing power. In short, deficit-financed government spending goes up and private spending goes down, changing the composition of demand but not the total.

Focusing on demand in this way is like focusing on the sound of one hand clapping. The other hand is supply, and that is where the economic action really is. There are normal processes that launch a recovery and drive an economy. These processes involve individuals and businesses responding to opportunities and incentives. When they respond, these individuals and businesses produce more goods and services valued in the marketplace, simultaneously increasing production, demand, and income. An effective stimulus policy recognizes these economic processes and seeks to accelerate them. Lower marginal tax rates stimulate the economy because they improve the incentives facing individuals and businesses to work, invest, take risks, and seize opportunities.

Step One: Extend the 2001 and 2003 Tax Cuts at Least through 2013. The economy faces a massive tax hike in 2011 when the tax relief enacted in 2001 and 2003 expires. President Obama has suggested he would prevent most of this tax hike but not the increase in top marginal tax rates, the increase in the dividend and capital gains tax rates, and the return of the death tax. That policy view is highly unfortunate: It is difficult for the economy to gain its footing when facing the threat of a punitive tax hike. There will be time enough to debate the progressivity of tax policy when the economy recovers fully. The focus now must be on speeding the recovery itself, and extending current policy in its entirety is the first step. It is, however, a policy of avoiding harm, and so it is only a necessary first step.

Step Two: Reduce Marginal Tax Rates for Individuals and Businesses. Reduce the top tax rates on individuals, small businesses, and corporations by 10 percentage points through 2013, and reduce the individual income tax rates to three levels: 10, 15, and 25 percent. In addition, as part of this second step:

- The Alternative Minimum Tax should be repealed; and
- The death tax rate reduced to 15 percent with a $5 million individual exclusion.

President Obama and Congress may want to consider additional tax elements to build on this foundation, such as expanding bonus depreciation for small businesses, but these additional elements cannot match rate reductions as sound and effective tax policy.

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1. Christina Romer and David Romer, "What Ends Recessions?" NBER *Working Paper* No. 4765, June 1994.
2. For related discussions on effective stimulus policies, see Nicola Moore, "Economic Stimulus: Dos and Don'ts," Heritage Foundation *WebMemo* No. 2187, January 6, 2009, at *http://www.heritage.org/Research/Economy/wm2187.cfm*; Ronald D. Utt, "Learning from Japan: Infrastructure Spending Won't Boost the Economy," Heritage Foundation *Backgrounder* No. 2222, December 16, 2008, at *http://www.heritage.org/Research/Economy/bg2222.cfm*; Brian Riedl, "Why Government Spending Doesn't Stimulate Economic Growth," Heritage Foundation *Backgrounder* No. 2208, November 8, 2008, at *http://www.heritage.org/Research/Budget/bg2208.cfm.*

According to analysis performed at the Center for Data Analysis at The Heritage Foundation using the widely respected Global Insight U.S. Macroeconomic Model,[3] these policy changes would strengthen the economy significantly this year. Compared to the economy's trajectory absent a stimulus policy, adopting the Heritage tax proposal would mean that 493,000 more Americans have jobs by the end of 2009, and, by the end of 2010, employment would increase by 1.3 million jobs. Over this same two-year period, these tax policy changes would add an additional $187 billion in GDP and increase the economy's otherwise sluggish growth rate by six-tenths of a percentage point.

This two-step tax policy would reduce tax receipts relative to current policy by about $640 billion over three years. This figure results from the fact that new growth in jobs and output would expand the tax base for personal income taxes by an average of $204 billion and corporate income taxes by an average of $51 billion per year over this critical three-year period, thereby significantly reducing the net tax loss to the Treasury.

Economic recovery does not come from Washington, but Washington can help. Economic recovery is achieved by the economy itself, and Washington's effective help moves that process along at a swifter pace. By far the most effective means of helping the economy recover is to improve the incentives that drive economic activity, and that means reducing tax rates on work, saving, investment, risk taking, and entrepreneurial activity.

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3. For information about the details and operation of the Global Insight U.S. Macroeconomic Model, see "Description of the Global Insight Short-Term US Macroeconomic Model," at *http://www.heritage.org/cda/upload/globalinsightmodel.pdf*.