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Building a Better Stimulus Bill

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With the recession entering its second year, President Obama has called for a large stimulus package that contains a mixture of tax cuts, new public works projects, and increased government spending on existing programs. House Democrats have already increased the size of the stimulus plan from $775 billion to $825 billion while cutting the amount allocated to tax cuts from $300 billion to $275 billion. While the House leadership may have many reasons for reducing the tax component of the stimulus package, no doubt one reason is the ineffectiveness of the rebates of 2001 and 2008 enacted under President George W. Bush.

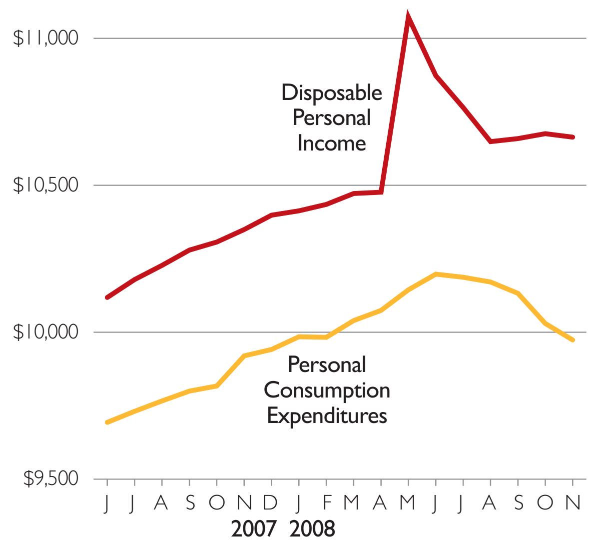
The one-time rebate issued in the spring of 2008 did not stem the recession because it did not cause people to spend more. As Chart 1 shows, there was a spike in disposable personal income in May 2008 due to the rebate. But personal consumption expenditure did not follow suit. According to a paper by Shapiro and Slemrod, "The official aggregate data on personal saving are broadly consistent with most of the rebate being saved."[1] They found that most of the rebate was used to repay debt.

But the rebate checks' lack of success is due to the fact that they did not increase the marginal incentive to work and because they did not create any permanent change to individuals' real wealth.

These two flaws remain in the centerpiece of President Obama's tax cuts—an individual tax cut that is refundable and given to low- and middle-class individuals, a credit equal to 6.2 percent of up to $8,100 of earnings for the next two years.[2] This

Rebates and Personal Consumption

In Billions of Dollars, Months Seasonally Adjusted at Annual Rates



Source: "Personal Income and Outlays," Bureau of Economic Analysis.

Chart 1 • WM 2247 heritage.org

This paper, in its entirety, can be found at: *www.heritage.org/Research/Economy/wm2247.cfm*

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means a credit of $500 per person, or $1,000 for couples per year, effectively giving individuals $10 more per paycheck every week. This refundable tax credit accounts for over half of the $275 billion tax cut allocation in Senate Finance Chairman Max Baucus's bill.

The individual tax cuts proposed by President Obama and the rebate checks of last year are essentially the same thing, the only difference being that instead of getting a check in the mail, the tax cut would be awarded through withholding less from a worker's paycheck. The idea of using a tax cut instead of a rebate is that it would allow people to receive the money faster than they would a rebate, which could take much longer to administer.[3]

Nevertheless, most people make more than $8,100 a year, so most of the tax relief will not produce an incentive to work more since once earnings exceed $8,100, the value of the credit no longer changes. However, a reduction in the marginal tax rate would increase incentives, especially for lower-income workers.

Supporters for a low-income tax rebate believe that boosting the income for low-income groups is more beneficial than marginal tax cuts because lower income groups have a higher marginal propensity to consume. But empirical studies on previous tax cuts produce a different conclusion. According to a Federal Reserve Board paper, "the percent of households that reported spending most of the proceeds of their tax cuts rises with income, stock ownership, education, and age.… [T]here is little support for the hypothesis that liquidity constraints boosted the MPC's [marginal propensity to consume] of low wealth households."[4] These results are also consistent with the findings of Shapiro and Slemrod.[5] Even Paul Krugman, a 2008 Nobel Prize winner, does not think there is any reason to believe that low-income people can stimulate the economy more than high-income people can.[6]

Temporary Tax Cuts Are Not Stimulus. Most people know that this tax cut will last only two years, just as they knew that last year's rebate check was a one-time event. They know that in future years, the deficit will have to be repaid via higher tax rates. This makes workers even less likely to spend the additional money, because individuals prefer to have a constant consumption path.[7] The permanent income and life cycle theories developed by Milton Friedman and Franco Modigliani respectively say that permanent increases in income increase consumption considerably more than a temporary increase does, because the decision to consume

1. Matthew D. Shapiro and Joel Slemrod, "Did the 2008 Tax Rebates Stimulate Spending?" University of Michigan and NBER, December 27, 2008, at *http://www.aeaweb.org/annual_mtg_papers/2009/retrieve.php?pdfid=294* (January 26, 2009).
2. Roberton Williams, "President-Elect Obama's Tax and Stimulus Plans," Tax Policy Center, January 8, 2009, at *http://www.taxpolicycenter.org/publications/url.cfm?ID=411816* (January 26, 2009).
3. Jeannine Aversa, "Obama Stimulus to Include $300 Billion Tax Cut," Associated Press, January 5, 2009.
4. Julia Lynn Coronado, Joseph Lupton, and Louise Sheiner, "The Household Spending Response to the 2003 Tax Credit: Evidence from Survey Data," Federal Reserve Board, July 25, 2005, at *http://www.federalreserve.gov/pubs/feds/2005/200532/200532pap.pdf* (January 26, 2009).
5. Matthew D. Shapiro and Joel Slemrod, "Consumer Response to Tax Rebates," American Economic Review, Vol. 93, No. 1 (2003), pp. 381–396.
6. "There's no obvious reason why consumer demand can't be sustained by the spending of the upper class—$200 dinners and luxury hotels create jobs, the same way that fast food dinners and Motel 6s do. In fact, the prosperity of New York City in the last decade—largely supported off of super-salaried Wall Street types—is a demonstration that you can have an economy sustained by the big spending of the few rather than the modest spending of large numbers of people." Paul Krugman, "Do We Need The Middle Class?" *The New York Times*, December 17, 2008, at *http://krugman.blogs.nytimes.com/2008/12/17/do-we-need-the-middle-class* (January 26, 2009).
7. According to Charles Steindel of the Federal Reserve Bank of New York, "if the tax cut is regarded as transitory, the saving rate should rise at the time of the cut, because after-tax income will increase but spending will be little changed.… [D]iffering consumer responses to the 1968, 1975, and 1982 income tax changes indicate that households do indeed distinguish permanent changes in taxes from temporary ones." Charles Steindel, "The Effect of Tax Changes on Consumer Spending," *Current Issues in Economics and Finance*, Vol. 7, No. 11, pp. 2, 4.

depends on an individual's real wealth, not current real disposable income.

The evidence supports this theory. Economic data from individuals' and families' consumption patterns over many years suggests that the marginal propensity to consume from a temporary tax cut is less than one-third of that from a permanent tax cut.[8] The forward-looking model, which takes into account how individuals expect their income to behave in the future, predicts the MPC from a temporary tax cut being only 5–10 percent of that from a permanent tax cut.[9]

A Better Way. It is commendable that President Obama wants a sizable portion of the stimulus package to contain tax cuts. However, the package should have tax cuts that are the most likely to boost the economy. A better tax proposal would be to reduce corporate taxes by 10 percent.

Too many of the tax cuts in the current stimulus bill would do little to boost economic growth. For example, one provision that would extend the net operating loss carryback to five years from the current law of two years would compensate failing companies while not providing any new incentive for investment. The same is true of some of the other proposals that rely on the same failed reasoning of the Making Work Pay tax credit.

A reduction of 10 percent in the statutory corporate tax rate for income and capital gains would achieve superior economic growth. The Joint Tax Committee (JTC) reports that this type of tax cut would increase investment, which "results in more goods and services and higher total output. It also results in higher labor productivity, leading to increased wages and employment."[10] A more aggressive stimulus bill would be a 20 percent reduction in corporate rates, which would amount to almost $275 billion in tax cuts in the first five years.

A Bad Strategy. The tax cuts that are currently part of the stimulus bills and supported by President Obama are a bad deal. They rely on increased consumer spending instead of boosting investment and saving. Similar proposals that rely on the same thinking failed to boost the economy, and it is unlikely that history will change course this time.

Instead, policymakers should look at enacting tax cuts that will provide the largest boost to the economy. For $275 billion, Congress could reduce the corporate tax rate, and that would increase economic growth for both the short and long run.

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8. *Ibid.*; Blinder (1981) and Poterba (1988), for example, find an initial MPC of 0.16 to 0.24 as a result of the one-time tax rebate in the 1975 Tax Reduction Act. On the other hand, Souleles (2002) found an MPC of 0.6 to 0.9 resulting from the Economic Recovery Tax Act of 1981. For this summarized data, see Coronado, Lupton, and Sheiner, "The Household Spending Response to the 2003 Tax Credit."

9. Coronado, Lupton, and Sheiner, "The Household Spending Response to the 2003 Tax Credit." The standard reason for the difference between empirical data and what is predicted by the forward-looking model is liquidity constraints (see Steindel, "The Effect of Tax Changes on Consumer Spending," p. 5).

10. Joint Tax Committee, "MacroEconomic Analysis of Various Proposals to Provide $500 Billion in Tax Relief," March 1, 2005, at *http://www.house.gov/jct/x-4-05.pdf* (January 23, 2009.)