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FISCAL STIMULUS 101: LOWER TAXES AND SENSIBLE SPENDING

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Fiscal Stimulus 101: Lower Taxes and Sensible Spending

President Barack Obama wants to use tax credits and deductions, along with hundreds of billions of dollars of government spending, to stimulate our flagging economy. This is the wrong approach. Instead of spending our way into a bigger mess, we should cut taxes, because this approach has the best record for increasing employment and investment.

In 2005, the nonpartisan Joint Committee on Taxation (JCT) issued a study showing that, although both reducing tax rates and increasing credits/deductions would result in increased demand for good and services, only tax rate reductions increase incentives to work more. According to the committee report:

“Reductions in marginal individual income tax rates (tax rates on incremental amounts of income earned) create an incentive to work more because taxpayers get to keep more of each dollar earned, making each additional hour of work more valuable.”¹

Furthermore, if refundable tax credits are subject to an income restriction (i.e. the benefits of the credit are phased out over some range of income), tax rates actually go up and decrease individual incentives to work. This is true for the “making-work-pay” tax cut supported by the Obama administration, which offers a \$500 tax credit that is phased out for middle-income taxpayers — creating a diminished incentive to work by reducing the amount earned when working additional hours.

The JCT study concludes that tax rate cuts increase employment, investment and gross domestic product (GDP) more than increasing tax credits or deductions. Thus, if we really want to stimulate economic activity, we should cut tax rates, rather than expanding tax credits and deductions.

Another issue is whether or not to provide economic stimulus through increased spending. It is often argued that we should use government spending instead of taxes to stimulate the economy

¹ Joint Committee on Taxation, “Macroeconomic Analysis of Various Proposals to Provide \$500 Billion in Tax Relief,” (JCX-4-05), March 1, 2005.

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because government spending has a larger multiplier effect. A multiplier effect of size “m” implies that for every \$1 in government spending or tax cuts, GDP increases by “\$m.”

The problem is that no one knows what the actual multiplier effect would be, and experts are split. It has been reported that the Obama administration has assumed a multiplier of around 1.5 for government spending. However, Harvard economics professor Robert Barro argues that the multiplier effect for government spending is only 0.8.² In 2009, the Congressional Budget Office (CBO) published a range of multiplier effects ranging from 0.7 to 2.5 for government spending and from 0.5 to 1.7 for well-targeted tax cuts. In my view, the size of the spending multiplier is likely to be modest, which implies that massive increases in government spending are not likely to solve the current crisis.

Additionally, it is very difficult, if not impossible, to enact large amounts of new spending in an efficient, timely and noncorrupt manner. A 2009 CBO report implies that only 8 percent of the stimulus spending would occur in fiscal year 2009, and only 41 percent in the first two years of the Obama administration.³ This should raise concerns that the increased spending will be poorly timed, and thus ineffective and wasteful. Also, the financial crisis is not the only crisis we face. We have a looming fiscal crisis that we are handing down to future generations. To me, this implies that the massive spending increases should be significantly reined in, as “spending for spending’s sake” is not likely to be a panacea for our current economic struggles, which stem from a massive financial crisis.

We need to focus on reasonable spending increases that add social value and abandon the “free lunch” mentality based on a contentious economic concept such as the government spending multiplier. On the tax side, we need to reduce tax rates to increase the incentives for individuals and businesses to work and invest.

² Barro, Robert, J. “Macroeconomics: a Modern Approach,” Mason, Ohio : Thomson South-Western, 2008.

³ Congressional Budget Office. “H.R. 1 American Recovery and Reinvestment Act of 2009,” <http://www.cbo.gov/ftpdocs/99xx/doc9968/hr1.pdf>, January 2009.