

WHY PERMANENT TAX CUTS ARE THE BEST STIMULUS.....John B. Taylor

The incoming Obama administration and congressional Democrats are now considering a second fiscal stimulus package, estimated at more than \$500 billion, to follow the Economic Stimulus Act of 2008. As they do, much can be learned by examining the first.

The major part of the first stimulus package was the \$115 billion, temporary rebate payment program targeted to individuals and families that phased out as incomes rose. Most of the rebate checks were mailed or directly deposited during May, June and July.

The argument in favor of these temporary rebate payments was that they would increase consumption, stimulate aggregate demand, and thereby get the economy growing again. What were the results? The chart nearby reveals the answer.

The upper line shows disposable personal income through September. Disposable personal income is what households have left after paying taxes and receiving transfers from the government. The big blip is due to the rebate payments in May through July.

The lower line shows personal consumption expenditures by households. Observe that consumption shows no noticeable increase at the time of the rebate. Hence, by this simple measure, the rebate did little or nothing to stimulate consumption, overall aggregate demand, or the economy.

These results may seem surprising, but they are not. They correspond very closely to what basic economic theory tells us. According to the permanent-income theory of Milton Friedman, or the life-cycle theory of Franco Modigliani, temporary increases in income will not lead to significant increases in consumption. However, if increases are longer-term, as in the case of permanent tax cut, then consumption is increased, and by a significant amount.

After years of study and debate, theories based on the permanent-income model led many economists to conclude that discretionary fiscal policy actions, such as temporary rebates, are not a good policy tool. Rather, fiscal policy should focus on the "automatic stabilizers" (the tendency for tax revenues to decline in a recession and transfer payments such as unemployment compensation to increase in a recession), which are built into the tax-and-transfer system, and on more permanent fiscal changes that will positively affect the long-term growth of the economy.

Why did that consensus seem to break down during the public debates about the fiscal stimulus early this year? One reason may have been the apparent success of the rebate payments in 2001. However, those rebate payments were the first installment of more permanent, multiyear tax cuts passed that same year. Hence, they were not temporary.

What are the implications for a second stimulus early next year? The mantra often heard during debates about the first stimulus was that it should be temporary, targeted and timely. Clearly, that mantra must be replaced. In testimony before the Senate Budget Committee on Nov. 19, I recommended alternative principles: permanent, pervasive and predictable.

- Permanent. The most obvious lesson learned from the first stimulus is that temporary is not a principle to follow if you want to get the economy moving again. Rather than one- or two-year packages, we should be looking for permanent fiscal changes that turn the economy around in a lasting way.

- Pervasive. One argument in favor of "targeting" the first stimulus package was that, by focusing on people who might consume more, the impact would be larger. But the stimulus was ineffective with such targeting. Moreover, targeting implied that increased tax rates, as currently scheduled, will not be a drag on the economy as long as increased payments to the targeted groups are larger than the higher taxes paid by others. But increasing tax rates on businesses or on investments in the current weak economy would increase unemployment and further weaken the economy. Better to seek an across-the-board approach where both employers and employees benefit.

- Predictable. While timeliness is an admirable attribute, it is only one property of good fiscal policy. More important is that policy should be clear and understandable -- that is, predictable -- so that individuals and firms know what to expect.

Many complain that government interventions in the current crisis have been too erratic. Economic policy -- from monetary policy to regulatory policy, international policy and fiscal policy -- works best if it is as predictable as possible.

Many good fiscal packages are consistent with these principles. But what can Congress and the incoming Obama administration do to give the economy a real boost on Jan. 20? Here are a few fairly bipartisan measures worth considering:

First, make a commitment, passed into law, to keep all income-tax rates were they are now, effectively making current tax rates permanent. This would be a significant stimulus to the economy, because tax-rate increases are now expected on a majority of small business income, capital gains income, and dividend income.

Second, enact a worker's tax credit equal to 6.2% of wages up to \$8,000 as Mr. Obama proposed during the campaign -- but make it permanent rather than a one-time check.

Third, recognize explicitly that the "automatic stabilizers" are likely to be as large as 2.5% of GDP this fiscal year, that they will help stabilize the economy, and that they should be viewed as part of the overall fiscal package even if they do not require legislation.

Fourth, construct a government spending plan that meets long-term objectives, puts the economy on a path to budget balance, and is expedited to the degree possible without causing waste and inefficiency.

Some who promoted the first stimulus package have reacted to its failure by saying that we must now switch to large increases in government spending to stimulate demand. But government spending does not address the causes of the weak economy, which has been pulled down by a housing slump, a financial crisis and a bout of high energy prices, and where expectations of future income and employment growth are low.

The theory that a short-run government spending stimulus will jump-start the economy is based on old-fashioned, largely static Keynesian theories. These approaches do not adequately account for the complex dynamics of a modern international economy, or for expectations of the future that are now built into decisions in virtually every market.

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