

CRS Report for Congress

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Government Spending or Tax Reduction: Which Might Add More Stimulus to the Economy?

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Summary

Members have proposed several “stimulus” measures to help end the recession. A fundamental difference in competing stimulus packages is how much of the stimulus should be devoted to government spending and how much should be devoted to tax cuts. This report considers that issue in the context of conventional economic analysis. It first identifies any policy change that increases the budget deficit (or reduces a surplus) and is not entirely saved by the recipient as “stimulative” if the economy is operating below its full potential. It then separates the short-run effects of a budget deficit from the long-run effects. In this context, certain spending proposals may be more stimulative than certain tax reductions in the short run if they result in a bigger boost in aggregate spending. This advantage may come at the cost of forgone growth in the long run, however. This report will be updated as events warrant.

In March 2001, the U.S. economy entered a recession, and Members of Congress have since proposed several “stimulus packages” in response. On March 9, 2002 a stimulus package was signed into law (P.L.107-147) that included an acceleration in depreciation rates and an extension of unemployment benefits. In January 2003, the President introduced a proposal for “economic growth and job creation” that focused on tax cuts. Throughout this year’s and last year’s debate, there has been heated debate concerning how to get the most short-term “bang for the buck” out of any stimulus package, and one key element of that debate is whether spending proposals or tax reductions would be more effective in that regard. To answer that question, one must first understand why the economy has entered a recession. While the ultimate causes are complex and diverse, they can be boiled down to one proximate cause: spending (aggregate demand) in the economy is currently lower than what could be produced if the economy were at full employment (aggregate supply).

Given the cause of the recession, how should a stimulus proposal be judged? By whether it boosts economic growth might seem to be an obvious answer, but the answer is a little more complicated. Policy proposals have distinct short-run and long-run economic effects, and often a proposal beneficial in the short run may be detrimental in

the long run, and vice versa. In the short run, many proposals would affect the economy by boosting aggregate spending; in a recession, their effects on the productive capacity (“supply side”) of the economy are likely to be slight because spending is not adequate to support existing production. In the long run, proposals can affect economic growth by changing individuals’ work effort, productivity, and the national saving rate. By contrast, a proposal’s effect on aggregate spending can be ignored in the long run because aggregate spending can never be permanently altered; once prices, wages, and credit markets adjust, aggregate spending effects are dissipated. If one is to judge a proposal whose aim is to stimulate the economy during a recession, it seems logical to judge it on the basis of how much it boosts aggregate spending in the short run. This does not alter the fact that, for better or worse, it will also have long-run effects.

Evaluating the stimulative nature of different proposals does not answer the question of whether the fiscal stimulus already in place is sufficient to revive the economy. CBO estimates that the standardized (full employment) budget has moved from a surplus of 0.7% of GDP in 2001 to a deficit of 1.7% of GDP in 2002. This is the result of both changes in spending, such as the emergency appropriations worth \$40 billion (P.L.107-38) in the wake of September 11, and the major tax cuts passed in 2001 (P.L.107-16) and 2002 (P.L.107-147). And new provisions of EGTRRA (P.L.107-16) were phased-in on January 1, 2003. These phase-ins will result in an additional estimated stimulus of \$53 billion in 2003, beyond the stimulus provided in 2001 and 2002.

Nor does this evaluation constitute an endorsement of the need for a fiscal stimulus. Expansionary monetary policy (i.e., lower interest rates) by the Federal Reserve also stimulates the economy. The Fed reduced overnight interest rates by 3 percentage points in the first eight months of 2001 and a further 2.25 percentage points since September 11. These reductions brought nominal short-term interest rates to their lowest level in 40 years. In addition, prices, wages, and credit markets naturally adjust to bring aggregate spending back into line with aggregate production. A look at the historical record suggests that these two factors have proven highly capable of moving the economy out of recession in the absence of a fiscal stimulus.¹

Short-Run Effects

As a first approximation, any proposal – whether it be a tax or spending proposal – that increases the size of the budget deficit (or decreases the size of a surplus) would be expected to boost aggregate spending by some degree, thereby stimulating an economy operating below its full potential.² The key is that current proposals would be financed with borrowed money, and credit markets would not fully adjust immediately in terms of higher interest rates, so that the spending is “new.” In that context, if the proposal is offset by spending cuts in other parts of the budget or other tax increases, it will largely lose its stimulative effect on aggregate demand. Proposals labeled as a “stimulus package” or, say, “higher military spending” would both stimulate aggregate spending; the most important determinant of a proposal’s effect is how much the budget deficit

¹ See CRS Report RL31237, *The Current Economic Recession: How Long, How Deep, and How Different from the Past?*, by Marc Labonte and Gail Makinen.

² For a more detailed analysis, see CRS Report RL31235, *The Economics of the Federal Budget Deficit*, by Brian Cashell.

increases as a percentage of gross domestic product (GDP). Because the policy brings unused resources back into production, the increase in aggregate spending will be greater than the budgetary cost of the proposal by some “multiplier.” To the extent that interest rates rise as a result of the decline in saving (increased budget deficit), the multiplier will be reduced because the proposal will tend to “crowd out” private investment and other interest-sensitive spending. Economic theory suggests it will also crowd out exports and import-competing goods because higher interest rates will tend to attract foreign capital that will cause the exchange value of the dollar to appreciate. Similarly, if the proposal causes inflation to rise, some of the spending will be crowded out as real income falls. More crowding out will occur as production moves closer to its full potential.

All measures that increase the size of the deficit will boost aggregate spending in a recession to some extent, but some measures are likely to boost it more than others. The government can increase the budget deficit (or reduce the surplus) in three ways: it can spend money directly by purchasing goods and services, it can make income transfers by giving cash or in-kind benefits to selected individuals, or it can cut taxes. (Note that while in budgetary terms government spending and government transfers are both defined as outlays, they have different economic meanings and effects.) Government spending is likely to boost aggregate spending more than tax cuts or a government transfer because some part of a tax cut or transfer would be saved. By definition, any resources that are saved cannot add to aggregate spending. Similarly, different tax cuts and transfers will have different short-run effects because they offer different incentives to save or spend and their recipients have different spending/saving patterns.

Who should a tax cut or government transfer target to get the most short-run “bang for the buck?” Empirically, there is evidence that lower income recipients are likely to spend more of a tax cut or transfer payment than higher income recipients. There is no strong theoretical rationale to explain this. One fairly well-accepted theoretical explanation holds that lower income recipients are more likely to be “liquidity-constrained” than higher income recipients, meaning that they are more likely to lack access to credit markets that allows them to alter their borrowing or saving at will. Thus, spending a tax cut or transfer payment may allow them to achieve a level of consumption that they would have undertaken if they had unrestrained access to credit markets.

If the economic effects of both transfer payments and tax cuts depend on the recipient’s behavioral response, is there any reason to generally expect one or the other to cause a greater boost in aggregate demand? To answer this question, two further points are worth considering. First, about 20% of low-income households accrue no federal income tax liability, although some do pay federal payroll and excise taxes. Thus, there are limited options for targeting lower income recipients through the individual income tax. Second, it would be difficult to target an individual tax cut in such a way that it could only be spent.³ The recipients of tax rebates, income tax cuts, or payroll tax holidays would be free to decide whether to save or spend their payment. A sales tax holiday is a notable exception, but raises problematic administrative and federalism issues since sales taxes are levied by state governments. By contrast, there are other types of tax cuts such

³ It is easier to target a business tax cut in such a way that it must be spent. For instance, a business could claim the proposed accelerated depreciation only if it purchased new capital. See CRS Report RL31134, *Using Business Tax Cuts to Stimulate the Economy*, by Jane Gravelle.

as the expansion of tax deferred savings accounts that are intended to stimulate more *saving*, and hence less spending. Certain types of transfer payments, such as food stamps or rental vouchers, are more easily targeted in such a way that they *cannot* be saved, and must be spent. Even these policies do not prevent individuals from shifting an offsetting amount of any other income into saving, however. Thus, government spending on goods and services remains the only way to prevent the short-term increase in aggregate spending from being partially offset by private saving.

In determining a proposal's short-run efficacy, another issue to consider is the lag in policy implementation (a separate issue from the lag caused by the legislative process). It may take a considerable amount of time to set up an administrative infrastructure before certain government spending or transfer proposals can be implemented. Alternatively, other proposals expand existing programs and, in some cases, can be implemented quite quickly. For example, revenue sharing between federal and state governments (sending fiscal aid to states) could presumably be spent quickly by the states since it would most likely be used to finance existing state programs whose budgets would otherwise be cut. Tax cuts typically take effect in the following fiscal year, but exceptions can be made, as was the case with the 2001 tax "rebate." The rebate still entailed a lag: P.L.107-16 was signed into law June 7, 2001, the first rebate checks were issued the week of July 23, and the last rebate checks were issued the week of September 24.⁴

Long-Run Effects

Proposals that are good for the economy in the short run, in terms of boosting aggregate spending, are often bad for the economy in the long run due to the spending-saving dichotomy. Long-run growth depends on investment, work effort, and productivity gains. Investment, in turn, depends on saving. Since a budget deficit lowers national saving (while a surplus increases national saving), virtually any policy that increases the budget deficit would lower national saving. *Thus, measures that boost aggregate spending in the short run will lower saving, and therefore growth, in the long run.* The extent that national saving is reduced, in turn, depends on how much private saving offsets the reduction in public saving (the increase in the deficit).

The fact that some part of a tax cut is likely to be saved gives tax cuts an advantage over most government spending in the long run. In turn, a tax cut can be crafted to generate more saving by targeting higher income individuals (who have higher saving rates) or targeting saving directly (e.g., expanding tax-deferred saving accounts). Whether tax cuts actually induce private saving depends on whether individuals react to the higher after-tax rate of return by saving more because it is more rewarding (the substitution effect) or by saving less because less saving is now needed to reach their goal (the income effect). Similarly, tax cuts can be crafted to increase the rewards for working. Whether or not this generates more work effort depends on whether people work more in response to higher after-tax pay (substitution effect), or work less because less work is now needed to achieve a given standard of living (income effect). If a tax cut generates more work

⁴ For more information, see CRS Report RS20926, *Tax Rebate for 2001: Frequently Asked Questions*, by Louis Talley; and CRS Report RS20939, *The Rate Reduction Tax Credit ("Tax Rebate") in P.L.107-16*, by Gregg Esenwein and Steven Maguire.

effort, this could also help offset the negative effects on economic growth of raising the deficit.⁵

By contrast, most government spending and transfers do not increase the incentives for individuals to work or save. The negative effects on long-run growth caused by the larger budget deficit, therefore, would not be offset. There are exceptions such as government spending on public investment. Instead of diverting resources from private investment to public consumption, as most government spending does, it diverts resources from private investment to public investment. Whether this adds or detracts from long-run growth depends on whether public or private investment, respectively, has a higher rate of return. Productivity in government may grow more slowly than it does in the private sector over time, also detracting from long-run growth.

Although transfer payments may have significant social value, they can also reduce the incentives to work and save if they are means-tested for income level. A reduction in transfer payments when income rises is equivalent to a marginal income tax, and some individuals may reduce their work effort or saving to avoid this *de facto* marginal tax. Likewise, unemployment benefits can lower the incentive to find work. On the other hand, there are examples of transfer payments that increase the incentive to work, such as transfer payments for which only employed individuals are eligible.

⁵ For more information, see CRS Report RL30839, *Tax Cuts, the Business Cycle, and Economic Growth*, by Marc Labonte and Gail Makinen.