WebMemo
Published by The Heritage Foundation

No. 2187
January 6, 2009

Economic Stimulus: Dos and Don'ts

Edited by Nicola Moore

The first order of business for the President-elect and the new Congress is to get the American economy back on track. To that end, Democratic and Republican leaders are busily crafting an economic stimulus bill that will likely spend anywhere between $700 billion and $1 trillion. But this unprecedented action—which would be equivalent to one-fourth to one-third of last year's entire federal budget—could do more harm than good if it is not well crafted.

The ultimate test for distinguishing a good stimulus idea from a bad one is this: Is the proposal likely to raise the economy to a sustained, higher level of growth, or will it slow or stall the economy? This guide outlines several dos and don'ts to help separate good stimulative ideas from the bad.

DOs: How to Stimulate the Economy the Right Way

Make the tax cuts permanent. The 2001 and 2003 tax cuts were designed to increase market incentives to work, save, and invest, thus creating jobs and increasing economic growth—and they worked. In the six quarters after the 2003 cuts were enacted, the economy grew 2.4 percent more than it had in the previous six quarters, the S&P 500 increased by 32 percent, and over the next 13 quarters 5.3 million jobs were created.[1] If the cuts were extended, projects, new businesses, and expansions of existing businesses would be undertaken that would stimulate economic activity today and in the future.[2]

Lower corporate tax rates and accelerate tax depreciation. The U.S. tax rate on corporate profits is the second highest in the world. Cutting corporate rates to a level below the average of other industrialized countries would enhance our competitive standing and significantly reduce the incentives for U.S. firms to relocate to lower-tax countries. Accelerating the tax depreciation of capital equipment and buildings or the one-year expensing of business purchases (which would otherwise be depreciated over a longer period of time for tax purposes) can also help during periods of slow growth.[3]

Expand domestic energy supplies. Rapidly increasing prices for gasoline and petroleum-based energy slowed the economy and helped bring about our current recession, but expanding domestic energy supplies could help reverse that trend. The Heritage Foundation's Center for Data Analysis found that an increase of 2 million barrels of domestically produced petroleum per day would expand the nation's output—as measured by the gross domestic product—by $164 billion and increase employment by 270,000 jobs annually.[4]

Reform long-term entitlement spending. Our short-term fiscal strength is threatened by enormous long-term financial challenges caused by entitlement programs. Many investors and organizations

This paper, in its entirety, can be found at:
www.heritage.org/Research/Economy/wm2187.cfm

Produced by the Thomas A. Roe Institute for Economic Policy Studies

Published by The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002–4999
(202) 546-4400 • heritage.org

Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

that play key roles in the future of the U.S. economy are worried about long-term growth given the fiscal challenges posed by Social Security and Medicare, yet Congress seems unwilling to act. To begin to address these challenges, Congress should amend the budget process to include a rule requiring that the long-term obligations of these programs are shown in the annual budget, and it should convert retirement entitlements into 30-year budgeted discretionary programs to contain long-term spending.[5]

DON'Ts: Stimulus Ideas That Would Make the Economy Worse

Spend public money in hopes of driving growth. Economic growth—the act of producing more goods and services—can be accomplished only by making American workers more productive. Productivity is driven by individuals and entrepreneurs operating in free markets, not by Washington spending and regulations. The U.S. economy has soared highest when the federal government was shrinking, and it has stagnated at times of government expansion. This experience has been paralleled in Europe, where government expansions have been followed by economic decline. A strong private sector provides the nation with strong economic growth and benefits for all Americans.[6]

Use rebates to "inject" money into the economy in an effort to increase demand. Supporters of rebates argue that they "inject" new money into the economy, increasing demand and therefore production. But every dollar that government rebates "inject" into the economy must first be taxed or borrowed out of the economy. No new spending power is created.[7] For instance, in 2001 Washington borrowed billions from the capital markets and then mailed it to Americans in the form of $600 checks. Rather than encourage income creation, Congress merely transferred existing income from investors to consumers. Predictably, the following quarter saw consumer spending growth surge by almost 6 percent, but it then dropped by nearly 23 percent. The overall economy grew at a meager 1.6 percent that quarter and remained stagnant through 2001 and much of 2002.[8]An effective fiscal stimulus means cutting tax rates—not because of the resulting higher deficits but because tax rate cuts improve the incentives for workers, investors, and producers to do more, thus stimulating the economy.[9]

Try to create jobs with frivolous transportation spending. Studies by the Congressional Research Service, the Government Accountability Office, and the Congressional Budget Office have concluded that the impact of transportation spending on jobs would be much less than anticipated—in fact, highway construction could even have a negative impact on the economy. Lost in the job-creation debate is the fact that the federal transportation program is supposed to be about transportation, mobility, congestion mitigation, and safety—not job creation. To the extent that these goals are sacrificed to some illusive job-creation process, the program becomes less effective, if not irrelevant, and ought to be scrapped.[10]

1. Brian M. Riedl, "Why Tax Rate Reductions Are More Stimulative Than Rebates: Lessons from 2001 and 2003," Heritage Foundation *WebMemo* No. 1776, January 18, 2008, at *http://www.heritage.org/Research/Economy/wm1776.cfm.*
2. William W. Beach, "How to Successfully Stimulate the Economy," Heritage Foundation *WebMemo* No. 2113, October 24, 2008, at *http://www.heritage.org/Research/Economy/wm2113.cfm.*
3. *Ibid.*
4. *Ibid.*
5. *Ibid.*
6. Brian M. Riedl, "Why Government Spending Does Not Stimulate Economic Growth," Heritage Foundation *Backgrounder* No. 2208, November 12, 2008, at *http://www.heritage.org/Research/Budget/bg2208.cfm.*
7. Riedl, "Why Tax Rate Reductions Are More Stimulative Than Rebates."
8. Riedl, "Why Government Spending Does Not Stimulate Economic Growth."
9. J. D. Foster, Ph.D., "Growth, Deficits, and the Future," Heritage Foundation *WebMemo* No. 2150, December 3, 2008, at *http://www.heritage.org/Research/Economy/wm2150.cfm.*

The Heritage Foundation
LEADERSHIP FOR AMERICA

Implement non-stimulative tax cuts. To be sure, letting Americans keep their money rather than sending it to Washington means it is more likely to be used wisely. But if the additional goal is to spur economic growth, any tax "jolt" will have little impact if it means narrow tax breaks restricted to families who engage in activities that Washington decides are worthy or checks from Washington for the millions of Americans who are not even paying income tax today.[11] Short-term tax holidays will not rekindle economic growth; only long-term reductions in marginal tax rates on capital and work will accomplish that goal. Long-term tax rate reductions—as opposed to short-term jolts—are needed because the important economic decisions that will trigger a real recovery depend on more investment.[12]

Bail out states that mismanaged their own finances. Congress is reportedly considering using stimulus funding to bail out states dealing with their own budget shortfalls. This makes little sense as a matter of economic policy. State spending does not suddenly become stimulative because it is funded by Washington instead of state governments. Increasing federal borrowing to keep state taxes from rising is like running up a Visa card balance to keep the Mastercard balance from rising. The overall costs do not change; only the address receiving the payment does.[13]

Fail to learn from the experience of other nations. History at home and abroad demonstrates that strategies relying on increased spending to stimulate the economy will inevitably fail. Indeed, such lessons also suggest that such strategies make things worse by diverting scarce resources away from productive use in the private sector. For instance, in the 1990s, Japan rapidly increased government spending in an effort to recover from its economic downturn, but this led to slow growth, low industrial production, and a decline in the overall standard of living.[14]

—Nicola Moore is a Research Coordinator for the Roe Institute for Economic Policy Studies at the Heritage Foundation. This paper is a compilation of excerpts from research by Heritage scholars Brian M. Riedl, William W. Beach, J. D. Foster, Ph.D., Ronald D. Utt, Ph.D., and Stuart M. Butler, Ph.D.

10. Ronald D. Utt, "More Transportation Spending: False Promises of Prosperity and Job Creation," Heritage Foundation *Backgrounder* No. 2121, April 2, 2008, at *http://www.heritage.org/Research/Budget/bg2121.cfm.*
11. Alison Acosta Fraser and Curtis S. Dubay, "Cutting Taxes to Promote Growth and Restore Fairness: A Memo to President-elect Obama," Heritage Foundation *Special Report* No. 29, December 3, 2008, at *http://www.heritage.org/Research/Taxes/sr29.cfm.*
12. Stuart M. Butler, Ph.D., "Permanent Tax Relief—Not Tax 'Holidays'—Stimulates Economic Growth," Heritage Foundation *WebMemo* No. 2152, December 3, 2008, at *http://www.heritage.org/Research/Taxes/wm2152.cfm.*
13. Riedl, "Why Government Spending Does Not Stimulate Economic Growth."
14. Ronald D. Utt, Ph.D., "Lessons on How NOT to Stimulate the Economy," Heritage Foundation *Backgrounder* No. 1495, October 22, 2001, at *http://www.heritage.org/Research/Budget/bg1495.cfm.*