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Not All Stimuli Are Created Equal

The best plan is a cut in the payroll tax.

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When it comes to fighting recessions, there's a tendency to see "fiscal stimulus" packages as wasteful, as a form of "throwing money at the problem." The critics have a point. But the conclusion that therefore we should do nothing is also wrong. Instead, careful attention should be paid to the details. Just as a family pinched for cash might find borrowing for the purchase of a new car or appliance prudent while taking a vacation in Las Vegas wouldn't be, some government programs to combat recession make sense while others do not.

Three criteria are crucial for evaluating fiscal stimulus packages. First, does the program target the weakness in the economy that caused the recession, or is it largely peripheral? Second, are the funds going to be spent in a timely fashion? Third, does the program fundamentally strengthen the economy going forward into the expansion phase? A look at the economy's current circumstances suggests that a large fiscal stimulus is needed, but a badly designed one will, in the words of an old song, merely leave America "another day older and deeper in debt."

The cause of the current recession is buried in the balance sheet of the private economy, particularly the financial sector and the household sector. The government and the Federal Reserve have begun a number of programs to fix the balance sheet of the financial sector, some more effective than others.

The main challenge facing the new administration and Congress is how to handle the inevitable efforts of Americans to fight the effects of the financial crisis by saving. It would be foolish to stop this adjustment with government policy both because any efforts to do so would fail and because the restoration of a healthier household balance sheet is essential to the long-term recovery of the economy. Instead, the government must focus on how to ameliorate the effects that the resulting reduction in household spending will have on the economy.

The household saving rate is likely to rise by roughly 7 percentage points, from roughly one-half of one percent of disposable income to between 7 and 8 percent. The majority of this adjustment is likely to occur well before the end of 2009, with some further modest increase thereafter. Our estimate suggests a drop in consumer demand of roughly $500 billion in 2009 and a further drop of roughly half that figure in 2010. These frame the quantitative parameters for an appropriate fiscal stimulus.

The bulk of government spending programs that have been suggested involve transfers of federal resources to state and local governments. While any or all of these programs might qualify as meritorious in their own right, they collectively fail the tests of well targeted stimulus.

Note first that such spending programs do not directly address the household balance sheet problem. The history of such programs overwhelmingly suggests that states and localities will simply substitute federal funds for their own resources for the vast bulk of the money spent. As such, little net impact will be had on household balance sheets.

These programs also generally fail the test of timeliness. Consider the phrase "shovel ready" being used to describe many of these programs. By definition a shovel-ready project is one that state or local government has already spent a good deal of money developing and is likely to continue spending on. On the other hand, infrastructure projects that actually will produce net new spending are never shovel-ready. Most of the spending will end up occurring at the peak of the business cycle when it is not needed, not at the bottom.

By contrast, there are some ongoing federal spending programs that can be quickly ramped up during a recession. Most notable is defense procurement. There is wide agreement that we have run down our defense infrastructure substantially. Much of this can be remedied by simply increasing the pace of existing production programs. Think of it as "assembly line-ready" instead of shovel-ready. Defense spending also gets around the problem of federal dollars supplanting other spending, as only the federal government is involved.

The third test involves whether projects assist the economy in entering the expansion phase. In general, government spending programs divert resources from the private sector as it tries to expand. Some infrastructure projects genuinely assist the private sector by making it more efficient. One such project now being discussed is the creation of a national energy grid. This has been tried before, but failed to get through the legal roadblocks thrown in its path by environmental groups and private landowners. Thus, a project may be highly desirable, but not timely. It may be a good idea, but it is not stimulus.

The question to ask about any infrastructure project being sold as "stimulus" is why the project hasn't been done already. The most common answer is that the state and local political process didn't find that the benefits met the costs--a sure sign that the project is not likely to pay for itself during the expansion phase of the business cycle. Another test of the genuineness of the stimulus intent is whether the federal political process is willing to let go of its own political interests in an effort to maximize the stimulus effect. For example, will Congress waive the Davis-Bacon requirements that drive up costs and reduce the job creating benefits of infrastructure spending? Will they abandon earmarks?

The final argument made for federal funding of infrastructure spending by states is that it is needed to prevent or offset cuts that states will have to make in a weak economy. This argument essentially concedes the points made above, that such spending is really just a safety net for the public sector. It is at best job preserving, not job creating.

Permanent tax cuts offer a much better option. The incoming chairman of the Council of Economic Advisers, Christina Romer, has estimated that the macroeconomic benefits of tax cuts can be two to three times larger than common estimates of the benefits related to spending increases. The relative advantage of tax cuts over spending is even clearer when the recession is centered on the household balance sheet. Some relatively minor changes, like making the current 15 percent tax rate on dividends and capital gains permanent, would not only help household cash flow, but also put a floor under equity prices much as their introduction did in 2003. This would help protect against further wealth destruction and balance sheet deterioration.

But the centerpiece of any tax cut should be employment taxes: in particular, a permanent halving of the current 12.4 percent Social Security payroll tax on the first $106,800 of wages, split evenly between workers and employers. The direct revenue effect of that would be a bit under $400 billion per year, roughly in line with the present quantitative needs of the economy. It also meets our three tests of effective stimulus.

First, the funds would flow directly to households through higher take-home pay and indirectly through a reduction in the cost of employment. Economic studies conclude that the benefits of a reduction in the employer portion of the payroll tax are ultimately received by employees. But the immediate effect would be an improvement in the cash flow of credit-starved businesses (as well as being a marginal incentive to keep employment up).

Second, the funds would be extremely timely, with the benefits hitting the economy with the first paycheck after the plan was implemented.

Third, by lowering the taxation of labor, the plan would help produce a higher-employment recovery than would otherwise be the case.

Since the tax cut should be permanent to have maximum effect, the biggest challenge would be how to make up for the lost revenue once the macroeconomic need for fiscal stimulus had passed. In the short run, effective fiscal stimulus requires that government revenue drop, thereby enriching the private sector, and with the Treasury making the Social Security trust fund whole by way of intergovernmental bookkeeping. Longer term, however, spending cuts or a new source of revenue would be needed.

Given the agenda of the incoming administration, the best source of such funds would be a greenhouse emissions tax.

It would be a much more efficient way of achieving the desired environmental objectives of the administration than any of the regulatory or "cap and trade" ideas now being considered. Such programs have failed in Europe since they are so easily gamed. Unlike regulations or cap and trade, moreover, an emissions tax can be phased in and calibrated as macroeconomic conditions permitted, specifically as the unemployment rate declined.

The country would be getting the stimulus it needed in the short run. In the long run it would enjoy a permanent improvement in its tax system, with higher taxes on things it wants to discourage (pollution and oil imports) and lower taxes on things it wants to encourage, specifically employment. A greener America with higher employment is a lot better than simply being another day older and deeper in debt.

Lawrence B. Lindsey is a former governor of the Federal Reserve. His most recent book is What a President Should Know ... but Most Learn Too Late.