

Bush Stimulus May Have Only Modest Effect

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Abstract

In principle, a well-timed and carefully designed economic stimulus package can help avert or minimize a recession. In practice, timing a fiscal stimulus is nearly impossible since forecasters usually "predict" economic turning points only long after they have occurred. Len Burman and Jeff Rohaly discuss past experiences and current issues with economic stimulus packages in this *Wall Street Journal* Real Time Economics blog entry.

Introduction

In principle, a well-timed and carefully designed economic stimulus package can help avert or minimize a recession. In practice, timing a fiscal stimulus is nearly impossible since forecasters usually "predict" economic turning points only long after they have occurred.

What do we know from past experience? The 2001, 2002, and 2003 tax cuts were sold, at least in part, as tonics for a flagging economy. In retrospect, timing of the 2001 tax cuts was nearly perfect, but were they effective? Probably not. Most of the tax cuts went to high-income taxpayers, who tend to bank additional income rather than spend it. The most promising element was a tax rebate of up to \$600 sent to almost all taxpayers even before they had filed tax returns. But a study by Shapiro and Slemrod found that only about one-quarter of rebate recipients actually spent the money. Most was saved or used to pay down debt and thus did little to boost demand. And taxpayers faced a lot of confusion in reconciling the advance payments with their actual taxes due when they filed tax returns.

In 2002, lawmakers tried another promising approach. They temporarily increased the amount businesses could immediately deduct on new machines and equipment in an effort to spur companies to speed up planned investment. But the "bonus depreciation" was allowed through the summer of 2004, providing little incentive for uncertain companies to hasten purchases. Worse yet, the 2003 legislation increased the deduction again and extended the deadline, rewarding procrastinators. If companies remember that history, a new temporary investment subsidy could actually turn out to be counterproductive, as companies might postpone investment in hopes of getting a juicier subsidy a year or two down the road.

So now what? The worst idea of all would be to make the Bush tax cuts permanent in the name of economic stimulus. This would have no direct effect until 2011, long after the current threat of recession has passed and most of the benefit would go to those least likely to spend. Advocates say that extending the tax cuts would provide investors certainty about provisions like lower tax rates on capital gains and dividends. But if taxpayers respond to those lower future tax rates by saving more, that means less consumption right now. Higher saving might be good for the economy over the long term, but over the short run, it is the opposite of the Keynesian prescription.

And the resulting budget deficits would eventually drag the economy down.

<http://blogs.wsj.com/economics/2008/01/10/bush-stimulus-may-have-only-modest-effect/>

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