UNITED STATES SENATE
REPUBLICAN
POLICY COMMITTEE

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# Don’t Confuse Spending with Stimulus

Last week, Senate Democrats proposed a $90 billion package of new spending and temporary tax cuts as an alternative to the House economic stimulus package. The package is divided between $20 billion in temporary tax relief and $70 billion in new spending proposals, including:

- $14 billion in checks for Americans who filed tax returns last year but failed to qualify for the full rebate last summer; and

- $16 billion in expanded and extended unemployment benefits to unemployed workers.

Critics might observe that paying people not to work is unlikely to stimulate the economy. Nor does taking a dollar from one person and giving it to another increase national wealth. Arguing for transfer payments to ensure that all Americans are housed and fed is one thing. Arguing that increasing these payments through higher taxes or federal borrowing is somehow an economic stimulus is quite another. It’s not.

## Keynes to the Rescue

To support the stimulus benefits from their plan, the Democratic Policy Committee recently offered up a packet of letters from economists who consistently observe that whatever we do to help the economy, it should be both temporary and targeted at people *least* likely to invest or otherwise do something productive with these resources. Here’s a sample:

> “Tax cuts targeted on consumers likely to spend most of any rebate will best support consumption. A payment from general revenues based on payroll tax liabilities ideally fits this bill.” *Henry Aaron – Brookings Institution*

> “We need to get money quickly into the hands of people who live paycheck to paycheck (or who do not have any paychecks).” *Alan Blinder – Princeton University*

> “It also means the package should include a particular focus on low- and moderate-income households, since they consume (rather than save) a larger share of any new funds that they receive than affluent households do.” *Robert Greenstein – Center for Budget and Policy Priorities*

> "Because low-income workers have a high propensity to consume from additional income, this type of tax relief would be particularly helpful at stimulating spending."
>
> *Alan Krueger – Princeton University*

Aside from being painfully scripted, the problem with these statements is they represent political wishful thinking rather than economic realities. Taking $1 from a taxpayer and giving it to somebody else does nothing to help the economy grow. It doesn't stimulate anything other than one person's consumption at the expense of someone else.

Liberal economists will argue otherwise. According to Keynesian orthodoxy, $1 in consumption can generate lots more economic activity through the magic of the money multiplier. Under the money multiplier, the American who receives the check spends the dollar, and then the storeowner spends the dollar, and then the next guy spends the same dollar, resulting in increased consumption several times the initial subsidy.

This, of course, is nonsense. Ask the question, "Where did the dollar come from?" Maybe the original owner of that dollar was going to invest in a capital good that would provide benefits for years to come. Or they were going to finance research that lets people live longer, more productive lives. Or they put it in the bank, which loaned it to their neighbor to buy a house. In all these cases, the dollar is put back into the economy just like the subsidy. But, whereas the Democrat subsidy encourages immediate consumption of consumer goods, the alternative case provides for the consumption of capital goods that will improve our lives.

Liberal economists contend the new consumption comes from savings, and therefore represents a net increase in aggregate demand. They ignore, however, our modern banking system, where a dollar saved is not stuffed into a mattress or locked in a vault, but used to leverage lending and investment. Taking a dollar out of deposits reduces the ability of banks to make loans (at several times the rate the money multiplier supposedly increases demand, coincidentally).

It's not the *spending* that is important – it's *what* you spend it on that really matters.

## What About Raising Unemployment Benefits?

Another novel argument raised in support of the Democrat "stimulus" package is that increasing payments to people so they can stay out of the workforce longer somehow encourages economic growth. The Congressional Research Service's own Jane Gravelle makes this point, arguing that extending unemployment benefits would "be a more successful policy for stimulating aggregate demand than many other tax/transfer changes." As Ms. Gravelle argues:

"A transfer or tax cut that is spent will increase aggregate demand, which will in turn cause firms to expand production, hire labor, and make capital investments. Wages of workers, which will in turn be spent, will generate another round of spending, which induces another round of increasing hiring and investment. These successive waves of effects are the multiplier effect, but they all stem from the initial spending decision."

Wow. All that activity just because some unemployed worker with a high propensity to consume went out and bought some potato chips and a six-pack.

The problem with Ms. Gravelle's analysis is three-fold. First, like the economists who wrote to the Democratic Policy Committee, she ignores the debit side of the ledger. The dollar given to the low-income worker (non-worker) comes from somewhere. Where is the stream of economic activity stopped because the federal government decided it had better uses for the taxpayer's dollar?

Second, Ms. Gravelle ignores the whole notion of rational expectations. Rational expectations is economic-speak for recognizing that people aren't stupid. They plan ahead, and they base their decisions on available information about the future. Extended unemployment benefits and subsidy checks are designed to be temporary windfalls. They are not a permanent part of the economy. Those executives who are supposed to increase production based on increased aggregate demand *know* the jump in demand is temporary. They aren't going to increase their company's investment in anything.

Third, Ms. Gravelle ignores the behavioral impact of extending unemployment benefits. Even economist Alan B. Krueger (as noted above, cited by the DPC in support of its spending proposal) admitted before the Senate Budget Committee on October 22nd that increasing UI payments discourages the unemployed from rejoining the workforce:

"Offsetting the salutary 'consumption smoothing' effect of unemployment benefits, many economists have also documented a distortionary effect: as benefit generosity increases, workers tend to remain unemployed longer. Higher benefits apparently reduce the amount of effort people devote to searching for a job. In addition, research indicates that some employees and employers game the system, placing workers on rotating temporary layoff so they can receive benefits while on vacation.[1]

"But research has found that the average duration of unemployment spells rises if benefit duration is expanded, and effort devoted to searching for a new job declines as a result.[2] Relatively short benefit durations is one reason why the unemployment rate is lower in the U.S. than in Europe. If the current downturn is short lived, then extending the duration of UI benefits at this time could inadvertently raise the amount of unemployment above where it otherwise would be. . . . it might make a great deal of sense to legislate extended benefits conditional on the unemployment rate surpassing a specified level (e.g., 6 percent) after a specified date in the future (e.g.,March 2002). Such a policy will not extend benefit duration unless the downturn lingers, and therefore reduce the risk that extended benefits inadvertently prolong the length of the downturn." (See footnotes)

Higher benefits encourage workers to stay out of the workforce longer, hindering – not helping -- the ability of the economy to grow. This is a cost our current unemployment system carefully balances with the need to provide a safety-net to workers who have lost their jobs. It's a balance constantly maintained by the fifty states as they set and adjust the benefits paid to unemployed workers. It's a balance the Democrat proposal would destroy.

## Senate Should Focus on Growth and Jobs

The Senate may adopt some provision(s) as part of an economic stimulus package to put money in the pockets of low-income workers at a time when consumer spending is down. Depending on how bad the economy gets, this may help dislocated workers keep their homes and feed their children.

But nobody should be fooled – borrowing or taking money from one group to give to another will not stimulate the economy. It beats creating another new entitlement program, but it won't stimulate anything but more federal spending.

If the Senate wants to stimulate the economy, it needs to focus on those provisions that encourage investment and job creation– including repealing the corporate AMT, increasing allowable depreciation, and accelerating the reduction in individual marginal rates. Those are the incentives that encourage positive behavioral changes like working harder and investing more.

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Note: In his testimony, Alan B. Krueger cited the following two studies:

[1] Anthony B. Atkinson, John Micklewright, "Unemployment Compensation and Labor Market Transitions: A Critical Review," Journal of Economic Literature, Vol. 29, December 1991, pp. 1679-1727]

[2] Lawrence Katz and Bruce Meyers, "The Impact of Potential Duration of Unemployment Benefits on the Duration of Unemployment." Journal of Public Economics, XLI, 1990, pp. 45-72.