Does the Democrats' Stimulus Package Make Economic Sense?

By Uwe E. Reinhardt, NYT October 24, 2008

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With the increasing likelihood of an Obama presidency and another Democratic Congress comes the increased likelihood that macroeconomic policy in the United States will shift from bolstering the supply side of the economy to bolstering the demand side of the economy through added government spending on our badly neglected infrastructure, on alternative energy production, on health care for the hitherto underserved, on unemployment compensation and so on. The $300 billion or so economic stimulus package now being proposed by the Democratic Congress, and endorsed a few days ago by the Federal Reserve chairman, Ben Bernanke, is an augury of this shift.

This shift is apt to draw an outcry from the so-called supply-side school of economics and their political clients, who see tax cuts as the cure-all for any economic ill. So fervent has this school of thought become that one Heritage Foundation economist literally opined on "The NewsHour With Jim Lehrer" on Oct. 20, 2008, that "spending for bridges and for maintenance, again, doesn't create jobs," adding, "It maybe fills in some of the holes there, to use an analogy out of the highway business, but I don't think that those are the things that are well calculated to get the economy moving at a higher level."

It leaves one to wonder how bridges are built and maintained, if not with human labor, and why wider bridges and better roads should not also be viewed as sound supply-side policy. Government spending often takes on the form of investments that enhance the productivity of the rest of the economy.

In a sluggish economy with excess production capacity and inadequate demand to buy all the output that the existing capacity could produce, it makes perfect sense to stimulate growth in gross domestic product and employment through added government spending. Because the rationale for this type of policy intervention had been fully and elegantly put forth by the British economist John Maynard Keynes during the 1930s, it has come to be labeled as Keynesian economics. So widely accepted had the theory become in the post-World War II world that none other than the late, staunchly conservative Nobel laureate economist Milton Friedman offered sometime during the 1960s his famous phrase "we are all Keynesians now."

But sometime during the late 1970s, sluggish long-run growth in labor productivity became of more concern than temporary demand insufficiency, and economists and the political clients they served shifted their focus to the supply side of the economy. That approach, now widely known by the label "supply-side economics," has dominated the discourse on macroeconomic policy among both economists and politicians for more than two decades now. The word "tax increases" has become anathema in the political forum, and tax cuts are still widely promoted as the panacea for any kind of economic problem — apparently even for excess capacity on the supply side. Thus we hear on the political stump, and from supply-side economists as pundits, that not extending the 2001-3 Bush tax cuts for high-income Americans past the currently legislated expiration date of 2010 would be a disaster for not only the United States economy, but the world economy as well.

Supply-side economists arguing thus should go to the data — for example, to the statistical tables of the President's Economic Report to Congress (February 2008). There they will discover that the huge tax cuts in 2001 and 2003 signed into law by President Bush were actually followed by a pronounced decrease in the fraction of G.D.P. devoted to business investment (although the fraction of G.D.P. invested in homes rose apace, begetting the current financial crisis in the mortgage market). Remarkably, the fraction of G.D.P. devoted to business investment also fell after the enormous tax cuts during the Reagan years. Even more remarkably, it rose after the tax increases during the Clinton years.

Properly trained economists have always understood that macroeconomic policy should be aimed at both the supply side and the demand side of the economy. They certainly appreciate and teach their students that over the longer haul the level of marginal tax rates on the income derived from work, saving and investment will affect the hours people work, the fraction of income they save and the decision to invest in business, even though at the level of theory the direction of this impact is not always predictable.

But it is fair to wonder how tax cuts for high-income individuals will stimulate an economy in deep recession, when the breadwinners of many lower-income households lose their jobs and most households find their budgets so stretched that they must cut back on consumption spending. Specifically, I would challenge supply-siders to explain why the owners of small businesses — say, restaurants — would expand the capacity of their establishments or build new restaurants at a time when customers stay home, even if they were given a tax cut on the income from their restaurants. How exactly do tax cuts actually work at the ground level in recessions, other than perhaps through the demand side, by putting money into people's pockets?

There is no telling what tax cuts, especially for the rich, will buy and what added employment they will produce. These tax savings might be spent on domestically produced goods or on investments in productive capacity, although the latter is less likely at a time of demand insufficiency. The tax savings might also be used to buy foreign-made goods, like Cartier watches or Ferraris or homes in Italy. Or they might be invested in offshore mutual funds. Who knows, then, in what country the tax cuts will create jobs?

By contrast, using public funds to rebuild the nation's tattered infrastructure or to give health care to low-income uninsured will be spent, dollar for dollar, to create jobs at home, because neither health care nor materials and labor for infrastructure are imported in significant quantities.

At the moment, in my view, we had better all be Keynesians.