The Stimulus the Economy Needs
By R. Glenn Hubbard
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President George W. Bush's stimulus plan -- narrowly approved by the House yesterday -- has been criticized from the left and from the right. On the left, some say it will raise interest rates. On the right, some hold it doesn't do enough to improve incentives. Neither criticism is correct.

Pro-growth proposals will not increase long-term interest rates. Bond market participants recognize that the modest tax cuts under discussion are a drop in the bucket of global capital. More important, financial markets have absorbed the lesson that a strong economy is the source of federal surpluses and not the reverse. Policies that insure against subpar growth will also insure against sustained reductions in federal surpluses.

Research by Douglas Elmendorf of the Federal Reserve and N. Gregory Mankiw of Harvard University indicates that reduced surpluses for a modest confidence-building package would raise long-term interest rates by only three to five basis points, an insignificant amount. Calculations from Bill Clinton's final "Economic Report of the President" yield the same result, despite former Treasury Secretary Robert Rubin's protestations.

At the same time, Mr. Bush's plan improves incentives to work and invest. It proposes to accelerate all of the marginal-rate reductions already approved by Congress; to adopt partial expensing of capital expenditures as an incentive for increased business investment; to eliminate the corporate alternative minimum tax that now handcuffs new investment incentive; and to reduce taxes for lower- and moderate-income households beyond those cuts already scheduled. Of course, tax reductions to even lower levels would be better. But the perfect should not be allowed to be the enemy of the good.

Supply-side policies are especially important now: The economic effects of the terrorist attack -- the disruption of financial markets and the air transport system, as well as the resulting layoffs -- acted as an adverse "supply shock" to the economy. This shock could substantially reduce the growth rate of gross domestic product during the third and fourth quarters of 2001, intensify pressures on employment and increase the likelihood that the economy is in a recession. Over time we could see shocks to household and business confidence, and increased uncertainty regarding the overall environment.

Wise action now can make a real contribution to future growth. Accelerating reductions in marginal tax rates puts money in the hands of consumers, improves work incentives and lowers the taxes on entrepreneurs and small businesses. Partial expensing -- or lowering the tax on new investments -- targets business investment directly, thereby addressing the fundamental source of economic weakness over the past year. The wide range of economic forecasts for blue chips reflects a divergence of views about the depth and persistence of consumer confidence. This uncertainty over the economy -- due in part to uncertainty over security -- reinforces the prudence of policies that address downside risks for the economy in the quarters ahead.

To be most effective in reducing uncertainty for businesses, such incentives should be adopted quickly. Setting an effective date in the past -- Sept. 11 would be a fitting benchmark -- will avoid the danger of giving businesses reasons to defer investments in order to qualify for the new tax provisions.

Also vital is that the expensing provisions be of sufficient duration. Expensing for a year or two increases uncertainty in business capital budgeting. Short-term investment incentives cause substantial economic inefficiency, because they don't alter the long-run desired amount of capital for a firm. Near-term investment merely replaces investment at a later date. One-year investment incentives distort decisions about types of capital spending, since firms may just find it easier to shift short-lived investments across time, rather than to shift structures or other long-term investments.

Even some longer-term policies have only short-run budget consequences, retaining long-run fiscal discipline. The expensing provisions simply shift business depreciation deductions from the future to the present. Similarly, accelerating the marginal tax rates has only short-run budget consequences.

In the aftermath of Sept. 11, the president wisely is seeking to reinforce the foundations of sustained economic growth, and has proposed a package of measures to provide insurance against downside risks to consumer and business confidence. Such measures would not raise long-term interest rates more than five basis points, and would increase individual and business incentives to work and invest. The economy would benefit from timely implementation of his plan.

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