Economic Policy Institute

Briefing Paper

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INVESTMENT-LED STIMULUS

A PLAN FOR SHORT-TERM RECOVERY AND LONG-TERM ECONOMIC GROWTH

by Jeff Faux

The U.S. economy faces major problems in both the short and long term. Currently, it totters between an anemic recovery and a double-dip recession. Over the longer term we face a continuation of the unsatisfactory pre-recession trends of slow income growth, flagging productivity, and eroding international competitiveness.

This paper outlines the case for a modest, politically reasonable, fiscal strategy which will stimulate employment and production growth in the short run and expand public and private investment in the longer term.

1. DEFICIT PARALYSIS

The current federal deficit has trapped policymakers into believing that any effort to stimulate growth through expansive fiscal policy will do more harm than good because it will burden the economy with more debt in the long run and, thereby, raise interest rates. Indeed, some have been so mesmerized by the deficit that they advocate a deflationary policy of budget-cutting even though we are still in recession and in spite of the virtual consensus among economic forecasters that the next few years will see continued slow economic growth. As history shows, the result of attempting to slash the deficit at this point would be higher levels of unemployment, lower government revenues, and, in all probability, higher deficits.

In effect, recent economic policy reflects an implicit acceptance of pain, suffering, and loss of production *today* in exchange for a hope that unnamed

benefits will somehow automatically appear in some unspecified tomorrow. The scenario of hope goes like this: **1)** eventually short-term interest rates or inventories will be low enough to spark a recovery; 2) this recovery will be strong enough and last long enough to eliminate the fiscal deficit at some point in the future; *3)* at some even more remote point in the future, we may begin to address the longer term economic problems by investing in human, physical, and technological resources.

This policy -- based on hoping for the future, rather than planning for the future -- is fatally flawed. First, any realistic projection of budget and growth capacity in the **1990s** suggests that *such a scencuio precludes a meaningful investment program before the 21st century*. This will inevitably mean a further deterioration of U.S. competitiveness and living standards.

Secondly, rigid distinctions between short-term and long-term growth are artificial. The long-term risks of permitting today's economy to remain stagnant or at low levels of growth are considerable. By shrinking the incomes of business, consumers, and governments, recessions deny business the prospect of sales, which is the most important stimulant to investment. Recessions also lower national savings, reducing the country's ability to finance investment. And bankruptcies and mass layoffs shatter the organization of people and skills that makes up the most important asset of a business firm. The longer a temporary recession lingers, the more permanent damage it does.

The idea that nothing can be done to stimulate growth today without hurting the economy tomorrow is an error. The large fiscal deficit does limit our room for fiscal maneuver. Nevertheless, as the following argument suggests, there is still some room for action, and it makes economic and political sense to take advantage of it.

2. INVESTMENT-LED GROWTH

A fiscal stimulus requires the creation of net additional spending, i.e., an increase in the fiscal deficit. Without an increase in the deficit there is no economic juice to "jump start" the economy. Certainly, any effort to reduce the deficit right now would be dangerously misguided; it would reduce demand in the economy and slow growth further.

The question is whether we can design a stimulus for the short term that would do more *good* than *harm*, i.e., would provide long-term benefits for the economy regardless of whether or not the economy picks up later in *the first* or second quarter.

Attempting to stimulate the economy through tax cuts does not meet this criterion. Despite claims to the contrary, there is no evidence that cuts in capital gains taxes or an expansion of IRA benefits to all taxpayers will stimulate investment.

The case against a capital gains tax cut is well established. The experience with the 1986 tax reform when venture capital investment rose to record heights after the capital gains tax benefit was eliminated is but one of many pieces of evidence. When pressed, even the most fervid advocates of a capital gains tax cut admit the effect will be minuscule at best. In testimony before the Joint Economic Committee, Michael Boskin, Chairman of the Council of Economic Advisers, conceded that, even under his optimistic assumptions, the Administration's proposal would have an effect on investment equivalent to a drop in interest rates of "probably 10 basis points, or something like that, [perhaps] 15." (Thus, for example, a drop from 7 percent to 6.85 percent.) To put this into perspective, a drop in the prime rate between October 1990 and October 1991 of almost 250 basis points (7.81 percent to 5.34 percent) was not sufficient to induce a halt in the slide of business investment.

Proposals to stimulate the economy with cuts in middle class taxes repeat the error of the early 1980s when, in effect, the public sector went into debt in order to finance private consumption, leaving us with both a fiscal and a trade deficit. Proposals to cut ***both taxes*** on capital gains and on the middle class are contradictory; they attempt to increase savings and consumption at the same time.

On the other hand, public spending on areas that clearly represent investment in the future has a clear advantage to the economy over a tax cut in terms of both a short-run stimulus and long-run investment, both public *and* private.

In the short run, when the objective is to stimulate domestic spending, consumer-oriented tax cuts are inferior to public investments. Roughly 5 percent of tax cuts would be immediately saved, and thus never enter the spending stream.

Moreover, a larger share of the tax cut-induced new spending would be siphoned off in the purchase of imports. And, unlike public spending, tax cuts cannot be easily targeted to sectors and geographic areas where unemployment is highest.

One point that is often overlooked in the debate is that the stimulative effect of consumer tax cuts will be diluted if they are spread out over a year. For example, a net stimulus of $20 billion in cuts in payroll or income taxes will directly increase disposable income only about $400 million per week, with the last installment twelve months away. The first dollars of an equivalent public spending stimulus will hit the economy a little later than the first dollar of a tax cut, but the total $20 billion could be spent faster than with a tax cut. Of course, a lump-sum tax cut is always possible, but it would be seen as an unprecedented quick-fix election year giveaway.

The conventional objection to public spending as an anti-cyclical measure is that it takes too much time for the actual spending to materialize (projects must be designed, contracts awarded, etc.). But today state and local governments have substantial numbers of ready-to-go projects that have been put on hold because of the recession-induced decline in tax receipts (construction projects abandoned, schools and training centers shut down, infrastructure repairs planned but not completed). The fiscal squeeze has left states and cities with a capacity to absorb and disburse funds quickly.

But it is the longer-term value of public investments that make them the better instrument of fiscal stimulus. Even if growth should suddenly rebound, making stimulus superfluous, the direct benefit of public investments and their stimulative effect on private investment would still yield economic dividends.

It has now become clear to most people that the neglect of public investment -- human capital, physical infrastructure, civilian technology -- in recent years is a significant drag on the nation's productivity and competitiveness. Whether compared with our own more prosperous past or with the investment performance of our major competitors, the rate at which we are investing in the future is inadequate. And each year that we postpone a serious expansion of public spending in these areas, the burden on the economy becomes heavier and more expensive to solve.

Recent research by economists David Aschauer, Alicia Munnell, and others has confirmed that there are direct links between spending on public infrastructure and the growth of private investment, productivity, and profits. Aschauer, for example, found that in the long run each additional dollar of public infrastructure investment raises private investment by 45 cents. And evidence continues to accumulate that there are substantial returns to the nation from spending on education, training, early childhood programs, and civilian research and development (R&D). Statisticians may quibble over the precise numbers, but we know they are now positive and large -- in part due to the decades of neglect of public investment. Thus, as a stimulant to private investment, public spending on human and physical infrastructure is superior to a capital gains tax cut.

Moreover, given the depletion of public capital over the past decade and the strategic role it plays in stimulating private investment, at this point in our economic history, directly increasing domestic public investment is a quicker and more reliable path to the goal of raising both public and private investment in the U.S. than is radical deficit reduction. The primary economic case for giving priority to deficit reduction is that it will raise the national savings rate so as to permit more private investment. But, although savings facilitates investment, it does not stimulate it. When an economy is operating well below capacity, as we have been operating for the last three years, private investment will respond quickest to the new direct demand for goods and services generated by a public investment program.

Projections of public investment needs vary. EPI economists estimate that just to keep the gap from widening between needs and current spending for a narrowly defined list of public investments (education, training, physical infrastructure, civilian R&D) would require a bare minimum of $60 billion in additional federal spending this fiscal year. Others estimate that the shortfall is much larger.

Could we justify increases in the deficit at this time? Almost everyone would agree that it is perfectly appropriate for government to borrow in order to invest in the future. To the extent that an investment makes the nation more productive, increased tax revenues will be available to pay off the loan. Indeed, if the federal government's budget were kept in a more orderly, business-like manner, it would

separate its operating accounts (current spending) from its capital accounts (investment in the future). Thus, up to a point, the size of the deficit is not as important as the uses to which it is put. Especially at a time of high unemployment and low rates of capacity utilization in the business sector, raising the deficit by making investments that would increase national productivity in the long run is clearly justified.

Yet, it is said that expanding the deficit will "spook' the financial markets, undermining investors' confidence in stable prices over the long term, which in turn will lead to higher interest rates. A key assumption is that, in response to a higher deficit, the Federal Reserve will raise interest rates in order to choke off future inflation generated by faster growth. These higher interest rates will discourage future investment.

It is important to understand that such anxieties about the long-term consequences of an anti-cyclical deficit increase are rooted in conjecture, not in convincing evidence.

As economist Herb Stein, chairman of Richard Nixon's Council of Economic Advisers, recently wrote in the *Wall Street Journal*, "No one really knows what affects the confidence of investors, or by how much." Stein wonders if a $50 billion deficit stimulus results in increased sales, worked off inventories, and rising profits: "Are investors going to bang their foreheads and say: 'Egad, the deficit is rising. We better hunker down, sell bonds, and stop investing?" It is unlikely for a number of reasons. First, inflationary pressures are presently absent from the economy and, following most economic forecasts, will be for at least the next **18 - 24** months even if we assume that a recovery has already started. Second, there is no clear historical connection between federal deficits and long-term interest rates. For example, federal deficits as a percent of GNP doubled between fiscal 1989 and 1992 while both short- and long-term interest rates declined. Over the last decade interest rates and the deficit as a percent of GNP have gone in opposite directions more often than not. *Third*, over the long run, public investments add to supply capacity which helps resist inflation. *Finally*, the presumed effect of a higher deficit on the market is primarily a guess as to what the Federal Reserve will do. Since the Fed has consistently overcompensated for inflation fears by keeping interest rates high, the market's anxieties are understandable. But these anxieties are a function

of Federal Reserve policies set by a group of people appointed by the President and confirmed by Congress. If economic policy is paralyzed because Congress and the President are afraid of what the Fed will do, then the answer is not to prolong the recession, it is for both Congress and the White House to have a talk with Alan Greenspan.

Still, whatever the fear is based on, the fear of deficits is widespread. Not having been exposed to a serious national debate over the uses, as well as the misuses, of government borrowing, the public is distrustful of deficit spending in principle. Should we dip back again into a recession, the political calculation may change. But in the face of a $365 billion deficit, there will have to be a much more drastic deterioration of the economy before a majority in Congress will vote for more spending if the consequence is a permanent increase in the fiscal deficit.

3. THE SPECIAL INVESTMENT FUND

However, we need not add to the long-term debt burden in order to get the stimulative benefits of at least an immediate modest increase in the rate of public investment. The prospect of reduced military spending permits us to borrow from the Peace Dividend and pay it back over the next five years. This would create a temporary deficit now, when it can help stimulate the economy, matched by a surplus later in the recovery, when some dampening of inflationary pressures may be needed.

The first step is to identify savings from the military budget over the next five years.

Based on analysis by the Congressional Budget Office (CBO) and the work of defense experts William Kaufmann of Harvard and John Steinbmner of the Brookings Institution, a cumulative reduction of $135 billion in budget authority over five years is a feasible and credible target. This amount should be isolated from the rest of the budget in a Special Investment Fund (SIF), with a legislative life of five years.

Because of the pattern of contracting in the military sector, spending cuts will lag behind reductions in budget authority. Therefore, a Peace Dividend of $135 in budget authority works out to an actual cut in military spending of about $100 billion over the same period. (Although over a longer term, the spending cuts will

approximate the budget authority reductions.) Moreover, the cuts will be back-loaded, i.e., most of the spending reductions will come in the later years. CBO estimates a pattern of "build-down" which begins in the first year with only $3 billion in savings.

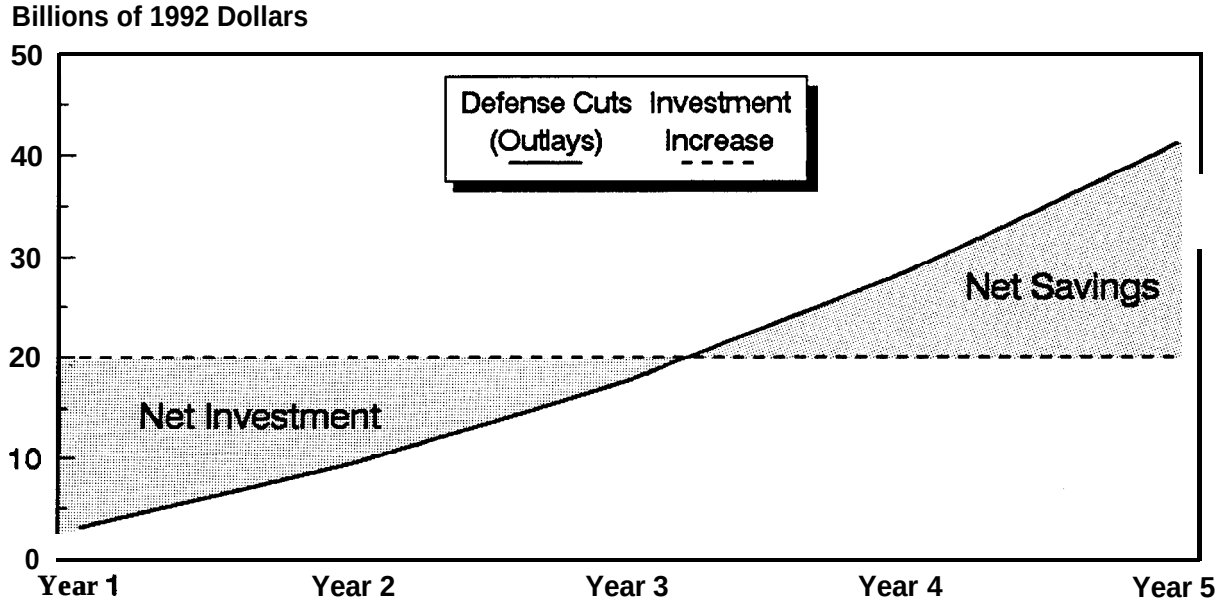
Both for long-term development and short-term stimulus reasons, the equivalent domestic investment spending should start at a quicker pace -- let us say an annual rate of $20 billion for the five-year period. If we immediately spend out the Peace Dividend at the rate of $20 billion a year the gap between the increase in domestic investment and the decrease in military spending will provide a maximum stimulus to the economy in the first year. The stimulus will then diminish until it becomes negative in the fourth and fifth year, when the military cuts would be greater than the domestic investment. This "surplus" would be used to pay off the deficit stimulus of the first two years.

The Special Investment Fund
(in billions of 1992 dollars)

Year	military cut	domestic investment	net stimulus
1	$3	$20	$17
2	10	20	10
3	18	20	2
4	**28**	**20**	**-8**
5	41	20	-21
Totals (Over five-year period)	$100	$100	0

As the table and figure (on p. 9) show, the SIF deficit would stimulate now when we need it. The suppressive effect of the SIF surplus would occur later in the recovery when the economy was stronger and when inflationary pressures would make it sensible to slow down demand. Over the five-year period the effect on the budget deficit would be neutral.

'Forward-Funding' $100 Billion from Defense to Domestic Investment



Note: The Defense Budget Authority cut necessary to achieve this level of Outlay savings is roughly $135 billion over the five years.

The years do not have to correspond to either fiscal or calendar years. Indeed, the whole point would be to get the stimulus out quickly. Certainly, it would make no sense to wait until the beginning of the next fiscal year in October 1992.

Because it does not increase debt in the long run, this modest temporary increase in the deficit cannot have any effect on long-term interest rates. A seventeen billion dollar stimulus in the first year represents less than a 5 percent increase in the 1992 deficit. It adds less than 1 percent -- roughly 0.6 percent -- to the national debt and only on a temporary basis. A ten billion dollar deficit in the second year is even less of a short-term burden. If anything, this proposal can be criticized for not providing enough stimulus.

Some may object that we cannot be sure that the surplus in years four or five will in fact be dedicated to paying back the deficit of 1992 and 1993. But this is precisely the virtue of isolating the SIF from other revenues. Congress and the

President would be signing a political IOU that would require that defense cuts not be used for other purposes. And if there is suddenly some new and extraordinary crisis which requires a reversal of the military cuts? In that case, the President and the Congress would be forced to do what they should have done in the 1980s -- raise taxes to pay for an expansion in the military budget.

In effect, the Special Investment Fund acts like a capital budget. Government, like any business or homebuyer or student, is justified in borrowing if the proceeds go to productive investment. The problem with the increased government borrowing of the last decade was that it was dedicated to financing military spending and tax cuts, which increased private consumption for largely upper income taxpayers. The SIF assures that the proceeds of the Peace Dividend will not be so recklessly wasted.

The sarne principle, of course, could be applied to other investment-type spending based upon secured future income. Highway and other trust funds, for example, could be "forward funded," i.e., spending accelerated now and decelerated later.

Finally, nothing in this anti-recession strategy precludes a middle class tax cut that is "revenue neutral'-- such as the Gore-Downey proposal. Nor does it preclude a revenue-neutral shift in business taxes, which would lessen the burden on long-term investments and raise taxes on income from short-term speculation. Neither does it preclude an overdue effort by Democrats to support a more stimulative monetary policy.

It is a sensible step that provides net benefits for the economy, much more so than tax cuts or deficit reduction, no matter what happens to growth over the next few months.

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