# A Nonpartisan Fiscal Plan for a Lackluster Economy

Recent analysis suggests that tax cuts favoring the middle class provide greater stimulus than equivalent increases in government expenditures.

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John Maynard Keynes (1936) first suggested that macroeconomic ills could be traced to the misalignment of what he called aggregate demand (the economy's wont for consumer goods, business investment, government expenditure or net exports). Government could influence aggregate demand by manipulating government expenditures of goods or services or by adjusting tax rates.

For good or bad, liberals, progressives, and Democrats have, in the main, sided with efforts to influence aggregate demand through government expenditures whereas conservatives, free marketers and Republicans, in the main, sided with appropriate tax policy. The solution is, of course, an appropriate mix of the two but one would not know that by the political debates for one over the other. Often the debate comes down to which policy provides the 'biggest bang for the buck'.

Conservatives resist sudden (automous) increases in government expenditure as a means of stimulating economic growth because of the adverse effect on the government's deficit. However, they demonstrate less resistance for investment type government projects, i.e., defense hardware, roads, bridges, schools, that is. Infrastructure. Liberals resist tax cuts as giveaways to the rich rather than economic stimulus dubbing such policies as Trickle Down Economics.

Although the term does not appear in any reputable academic text Trickle Down Economics refers to Keynes' original point that reducing tax rates can provide incentives (through increases in after-tax income) for both individuals and businesses to increase their productive endeavors by allowing each to retain a greater proportion of their earnings. More jobs means more income and greater expenditures that, in turn, generates additional income and spending in a diminishing fashion as these benefits work their way through the economy. The derision extends to the Laffer Curve that critics often mistake as a separate theory but is merely a *tautology* that can aid in the explanation of relevant tax policy.

The trickle down critics fail to recognize that the process they so deride is the very same that passes down benefits of autonomous increases in government expenditures. That is, increased government expenditures directly benefit first recipients who, in turn, pass on these benefits in a progressive fashion to others in the economic chain.

The issue boils down to which 'multiplier' is the greatest, expenditure or taxation? That is, how much will each influence aggregate demand and thus GDP? Romer (2010) provides a highly detailed and definitive study that suggests the taxation multiplier exceeds the expenditure multiplier. Our purpose here is to provide additional evidence that selective tax cuts can provide economic stimulus in excess of equivalent increases in government autonomous expenditure. This evidence, however, does not rule out government infrastructure spending as a means of inducing economic growth.

EXPENDITURES VS. TAX CUTS: AN EXPERIMENT

Past macroeconomic policy success, or lack thereof, is often in the eye of the beholder. There is little bi-partisan agreement on the results of past experience. Conservatives claim that the Regan tax cuts in the early 1980's engendered a prolonged peacetime expansion of US GDP (true) while liberals claim it was a massive tax break for the wealthy. It's entirely possible to reduce tax rates and find that tax revenues rise, fall, or stay the same. Which of the three consequences will occur depends on the nature, magnitude and time period involved. Our own analysis indicates that the tax revenue paid by the top 5 percent of income earners increased substantially in the six plus years after the Regan cuts enactment even though their associated tax rate was significantly reduced. Additionally, a separate analysis of 2001 – 2010 US data indicates that a one percent reduction in the top one percent tax rate would generate an estimated $25 billion (2010 dollars) in additional revenue.

According to the Congressional Budget Office (2014) the fiscal stimulus ($820B) passed by Congress in the first year of the Obama Administration (2009) produced little improvement in employment or GDP. Little wonder why as nearly half of the stimulus package was funding for extended unemployment benefits and other public assistance. These benefits are called 'transfer payments' as they simply take funds out of some individuals' pockets and put them in the pockets of other individuals with no net effect on GDP. Once more, there were few 'shovel ready' projects to fund.

For present purposes we trace GDP, government expenditures (G) and tax rates (t) over a 43-year period (1968-2010) in the US. We find that, as expected, GDP is positively related to government expenditures and inversely related to income tax rates. Our investigation differs from others in that we break down income taxes by income group rather than for the household sector as a whole. By imputing a dollar value to these results we find that a dollar of tax reduction devoted to certain income groups produces a greater effect on GDP than a commensurate increase in government expenditure. The effect is progressively greater for middle-income groups (second, third and fourth quintiles). We were unable to calculate the effect on the first quintile as the disparity of incomes was too great. Of course, the effect of tax reduction on the fifth quintile is zero, as it pays little or no income taxes. These results are consistent with, but not the same as, those of the Romer study.

Our study also suggests that while the fiscal impact of tax cuts is greatest for the three middle-income groups it appears to be less so for the upper income groups. That is, tax cuts for middle-income groups may produce greater stimulus than that for upper income households. This result should appeal to those who champion tax cuts for the middle class. Paired with plans for infrastructure spending properly designed tax cuts may provide a robust inducement for economic growth.

Very often those advocating significant tax cuts claim that the cuts will pay for themselves (in terms of ultimate tax revenues). That, of course, is an empirical issue but it misses the point. No one ever claims that expenditure increases pay for themselves (in terms of future tax revenues). The relevant point is how much does each encourage economic growth? In an earlier work, (Cloninger, 2016) we showed that economic growth acts as a leveler of income inequality as could appropriate tax policy. There is no reason these forces cannot work together if properly coordinated.