
Taxes and the Economy

Making Our Money Count

By Donald Hopps, Ph.D.

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The Institute for Washington's Future is a 501(c)(3) organization that engages in research, public policy analysis, education, and sustainable enterprise development in the Pacific Northwest. The Institute is committed to addressing the problems of continuing environmental degradation, the loss of family-wage jobs, and economic marginalization of low-income people in our society.

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Economic recessions invariably spawn proposals for tax cuts and the present recession is no exception. Our current president has now happily joined in this hoary tradition, proposing to restore a significant amount of the public's revenue to the wealthy. Like its predecessors, his proposal is based much more on intuition than fact. It seems intuitive that putting money in the hands of investors will create new products, keep the factories churning, and generate jobs.

In Washington state this same "no new taxes" tune plays for a slightly different dance. Led by our governor, politicians have rejected the possibility of considering the excellent report of their Tax Structure Study Commission. In addition, the governor has opposed tax increases to help balance the budget. All based on an idea which seems like it should be right, but one that does not stand up under scrutiny.

One only needs to reflect on the facts of our present situation to know this intuition is flawed. Our present dismal economy follows on several years of significant tax cutting, particularly on the state level. In fact, our last three major recessions (early 1980s, 1990s and the present) have all followed immediately upon major tax cutting periods. Moreover, our present recession has come in a period of extremely low interest rates; a much greater incentive for the willing investor to invest than any tax cut. So far, investors have declined.

The two most important reasons that tax cuts are either neutral or negative in their effect on the economy reflect two basic economic realities. First, a tax cut takes money out of the economy. We pay for every tax cut with the loss of government investment in our economy. Every tax cut means less money to hire teachers to educate our children, construction firms and workers to repair our roads, and rangers to staff our parks and protect our wildlife. This economic debit balances whatever credit is gained by putting money in the private sector. In other words, a tax cut does not add money to the economy. It simply is a transfer from one economic sector to another.

Second, in a down economy, economic stimulation comes from and through increased consumption. Increased investment follows after consumption outstrips the capacity of current production (and inventory) to satisfy it. Practical experience more often than not reflects this logic. After recession, investment will lag the demand generated by consumption by months. In our present situation, President Bush has all but gotten on his knees to get investors to join last year's faltering recovery. But they didn't. Why not? The slow pace of the recovery did not nor has it yet generated good investment opportunities. Low interest rates or tax cuts aside, basic economics and investor behavior rather than presidential desires govern investment decisions.

Experience does not prove the theory that given a tax cut, wealthy investors will rush to invest. Rather, their behavior is quite different. First, possible investments compete with other choices, such as a new home or overseas travel, and with themselves. Even if the recipient is inclined to invest, will they invest in risky new production or safe real estate. Or, will they "bank it" until better investments appear. Second, tax reductions take time to take effect. The recipients take even more time to decide what to do with the money. This is especially true if we are talking about a substantial amount of money which the recipient is not going to spend on immediate, basic consumption. Thus, the use of money gained by wealthy private parties through tax reductions takes even more time to flow into the economy; much more time than if the government simply spent the money directly.

The reality is tax cuts do not stimulate a lagging economy, they spur a rising economy. If anything, the tax cuts of recent times served more to build pressure in overheating economies than to enhance needed growth.

John Maynard Keynes was right. The best thing government can do to stimulate an economy is to spend its revenue. Why? Because spending can be better targeted to needs. Spending has immediate economic impact. Most of all, spending increases consumption and generates jobs both directly and indirectly. Put in concrete terms, it is better for a lagging economy for the government to hire a hundred teachers than it is to give a wealthy investor \$5 million to squirrel away. In our present situation in Washington state how many jobs will we lose by refusing to increase taxes and cutting programs instead? How much money will not be spent in our economy? How long will it take for enough investment to arrive to recoup these losses? The answer is months after a recovery begins. And according to economists, the start of that recovery is still months away.

This leads to a very counter-intuitive conclusion, a conclusion that violates all of today's conventional thinking. In today's lagging economy, it would be better for economic stimulation to take back the tax cuts and increase governmental spending. While this conclusion is more plausible than opting for tax cuts, it is in itself too simplistic. It assumes all spending is equally positive. A tax cut that goes to low- and moderate-income individuals will generate far more stimulation per dollar than purchasing weapons, or paying interest on governmental debt. However, any direct payment—an unemployment check, social security, or a tax rebate—is more effective than a tax cut.

The bottom line is that prudent use of the advantages of governmental spending could have very positive economic impact. Positive results would be enhanced by following these simple rules:

- **First, do no harm.** Do not raise taxes or fees on business activities as such, like the grossly unfair and counter productive Washington Business and Occupation Tax. Do not cut unemployment, education and social welfare programs. These kinds of actions take money and spending out of the economy.
- **Second, use revenue to maintain and/or enhance direct payments to individuals.** Increasing payments to low- and moderate-income people are better economic stimulants because these payments will be spent on immediate and basic consumption, spreading money quickly to local businesses. Extending unemployment benefits or social welfare payment are better than any tax cut.
- **Third, spending should be concentrated where it produces the most employment.** That is, the priority should be given to programs that fund labor-intensive rather than capital-intensive activities. For example, education is labor-intensive. The justice system tends to be capital-intensive. Road maintenance and improvement tends to be more labor-intensive than developing new facilities.
- **Fourth, increase taxes on “dormant” money.** The best taxes to increase during a recession are on unproductive income and wealth. These include actions like: raising estate or dividend taxes, closing tax loopholes, and/or ending unproductive tax exemptions and business subsidies. Where there is already an income, sales or property tax, targeted surtaxes other than general increases would be more appropriate. But, in the main, any increases in general taxes should be avoided.

We need a better understanding of the role of government in the economy, or more appropriately, the political economy. Government is a major actor in any economy—a major investor, a major producer, and a major consumer. Taxes support all of these activities. Our focus needs to be much more on how well the government performs in its role as an economic actor than on tinkering with taxes.