Worksheet 17.2

Fiscal Stimulus passes Congress!

In February of 2008, as the US economy officially entered a recession that it would remain in for 18 months, the US government approved a first round of fiscal stimulus consisting entirely of tax cuts to American income earners. The stimulus planned consisted of the following:

Tax rebates to 137 million people: A rebate of up to $600 would go to single households making less than $75,000. Couples making less than $150,000 would receive rebates of up to $1,200. In addition, parents would receive $300 rebates per child. Tax filers who do not owe income taxes but have at least $3,000 in income would get a $300 rebate.

These payments were intended to put cash in the hands of millions of Americans at a time when our economy was experiencing slower growth.

Business tax breaks: The bill would temporarily provide more generous tax benefits for small businesses in 2008 and let large businesses deduct 50% more of their assets if purchased and put into use this year. In other words, businesses investing in new capital would pay lower taxes for the year.

Politicians from both of the US government's ruling parties joined forces on this act of expansionary fiscal policy. The hope, of course, was that with more money in their pockets, Americans would start spending again, firms would start investing, and these increases in expenditures would shift the US economy towards a path of expansion, increasing employment and output.

At the time, there were many concerns over whether this stimulus package would have its desired effects. Would Americans spend their rebate checks in the way Congress hoped they would do? Some feared that low and middle-income households would take their new disposable income right to Wal-Mart and buy Chinese imports, or put a large proportion of it into savings, or pay off existing credit card debt, three actions which would represent 'leakages' from America's circular flow, leading to no new income or output.

Savings and spending on imports would do nothing to stimulate the US economy, therefore, before concluding that the tax rebates would help fend off a US recession, economists must consider the American peoples' marginal propensities to save and to import. Only new spending on American goods and services would contribute to aggregate demand.

The tax incentive for businesses investing in new capital may have had a greater impact on domestic employment in the US. Capital goods such as heavy machinery tend to be made in America by American workers, so encouraging firms to invest in new capital would be more likely to have a positive demand-side effect on US income and employment. Furthermore, more capital for US businesses is likely to increase productivity of workers in those firms which have invested, leading to greater income and output: this is the desired 'supply-side' effect of stimulating business investment. When aggregate demand and aggregate supply increase simultaneously, economic growth is the result.

Unfortunately, the provisions aimed at encouraging business investment represented only around one third of the total stimulus package. Most of the $170 billion ended up in the hands of households, which ultimately used the bulk of this stimulus to pay off debts and for savings. A year later, under a new president, the United States launched a much larger stimulus ($800 billion!) that itself turned out to be too small to return the US to strong growth.

Questions:

1. How does a tax rebate to households impact domestic spending compared to a tax incentives for firms to undertake new investment?
2. How does a low marginal propensity to consume undermine the expansionary effect of a tax cut such as this?
3. Why would a stimulus including increased in government spending have been more likely to increase employment in the US than one consisting only of tax cuts?