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ENDING FISCAL FLUSTER ... AND ANXIETY

A broad coalition of representatives of many major economic policy organizations came together in late September with a common message and program for economic recovery.

The political establishment now favors economic "stimulus." Stimulus is a nice, positive sounding (in most cases) word, but it doesn't tell us with any specificity what we should do for the economy. Those of us who are active in the policy coalition have been meeting with White House officials and key members of Congress to help them in their efforts to obtain constructive rather than destructive stimulus.

Many politicians and news commentators, and even some economists who have not outgrown their adolescent Keynesianism, say economic stimulus is achieved by more government spending. They miss the basic point that, for the government to spend more money, it must tax more, borrow more or inflate the currency, all of which are harmful to real economic growth. If it were possible for the government to spend the economy into prosperity, the communists would have won the Cold War, and the socialists would have trounced the more limited-government countries like the U.S.

In fact, it is not difficult to understand how economic growth occurs. For the economy to grow faster, it needs to have an increased supply and/or improvement in the quality of labor, and/or more productive capital. Nothing else does it. Productivity increases and economic growth come about from new innovations that result mainly from higher-quality labor and improved machinery.

As Congress moves forward with the "economic stimulus" package, members should be asking if each element in the package is going to increase labor supply, productive capital investment and productivity. President Bush has proposed accelerating the already passed tax cut. This change will reduce the penalties on working and investing so it will increase growth. Unfortunately, the Ways and Means Committee only accelerated the lower rates and not the top rate. The greatest economic benefits come from reducing the highest marginal tax rates because such a reduction has the greatest incentive effect, and the least revenue effect.

The president has also proposed improving business depreciation allowances and getting rid of the corporate minimum tax (AMT). The Ways and Means Committee wisely accepted these changes which will reduce the tax bias

against capital investment and improve business cash flow, thus enabling business to hire more workers and buy more new machinery.

The president's advisers insist their package contains "enough stimulus" and it will "improve confidence." As one who once was an economic forecaster, I can say with certainty that neither I nor the president's advisers know if these changes will be enough to get the economy growing. I hope they are right, but what if they are wrong?

A prudent economic policymaker ought not to only do the minimum that might revive the economy after the terrible shock it has received. What we should do is to take all those actions that we know will do no harm and may do considerable good.

Specifically, we should reduce the capital-gains tax rate by at least 5 points to 15 percent, since virtually all serious economists who have looked at the issue agree that such a rate cut will not result in a revenue loss and may encourage much more investment, particularly in needed risky high-tech ventures.

The Ways and Means Committee did partially rectify the administration's mistake, of not including a capital-gains rate cut in its recommendations, by making a modest reduction in the capital-gains rate and slightly increasing capital-loss deductions.

Some have been concerned that the government might provide "too much" stimulus, or provide it after the recovery has taken hold. These are legitimate concerns, which the coalition has addressed. The Fed has the difficult problem of providing sufficient money so we do not have continued deflation while at the same time being careful not to produce so much money as to give us future inflation.

There also is the legitimate concern that a tax package might come too late to have much of a positive impact on the economy in the near future. That is why we have only recommended tax changes, as noted above, that would be good tax policy even without the present emergency, and making the tax reductions effective immediately.

There are also many regulations that do far more harm than good, and they ought to be removed immediately. The Clinton administration saddled the economy with: counterproductive telecommunications policy that left us behind in the bandwidth race; a retrograde antitrust policy that might result in the unnecessary bankruptcy of US Air and other disasters; and regulations on foreign entities that invest in our markets, causing hundreds of billions of dollars of needed foreign investment to flee our shores. These policies were counterproductive when enacted and are poison now.

Most of all, the Congress ought not to be proposing policies in the name of fighting terrorism, which either have nothing to do with terrorism, or would actually make it easier for terrorists. There are provisions in the "financial terrorism" bill that would penalize low-tax countries that are strong allies and have had nothing to do with terrorism, and deny needed financial privacy to people subject to corrupt and/or terrorist-backed regimes. These provisions would weaken our economy and those of many of our friends, and would cause a great and unnecessary erosion of our civil and economic liberties.

Finally, additional government spending not absolutely needed to increase our defense or provide for necessary humanitarian aid weakens our economy by directing resources from their most effective use, which is most often private investment. The president and many of his advisors seem to believe that, in the name of bipartisanship, they should go along with additional spending they know to be counterproductive and accept a weakening of necessary tax and regulatory changes. This exchange of long-term economic growth for short-term political capital is a bad trade. It will slow the recovery and also hurt the president politically in the long run.

The president, with his extraordinary approval rating, ought to spend some time explaining economic truths to the American people, the Congress, and the media during this time of national crisis.

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