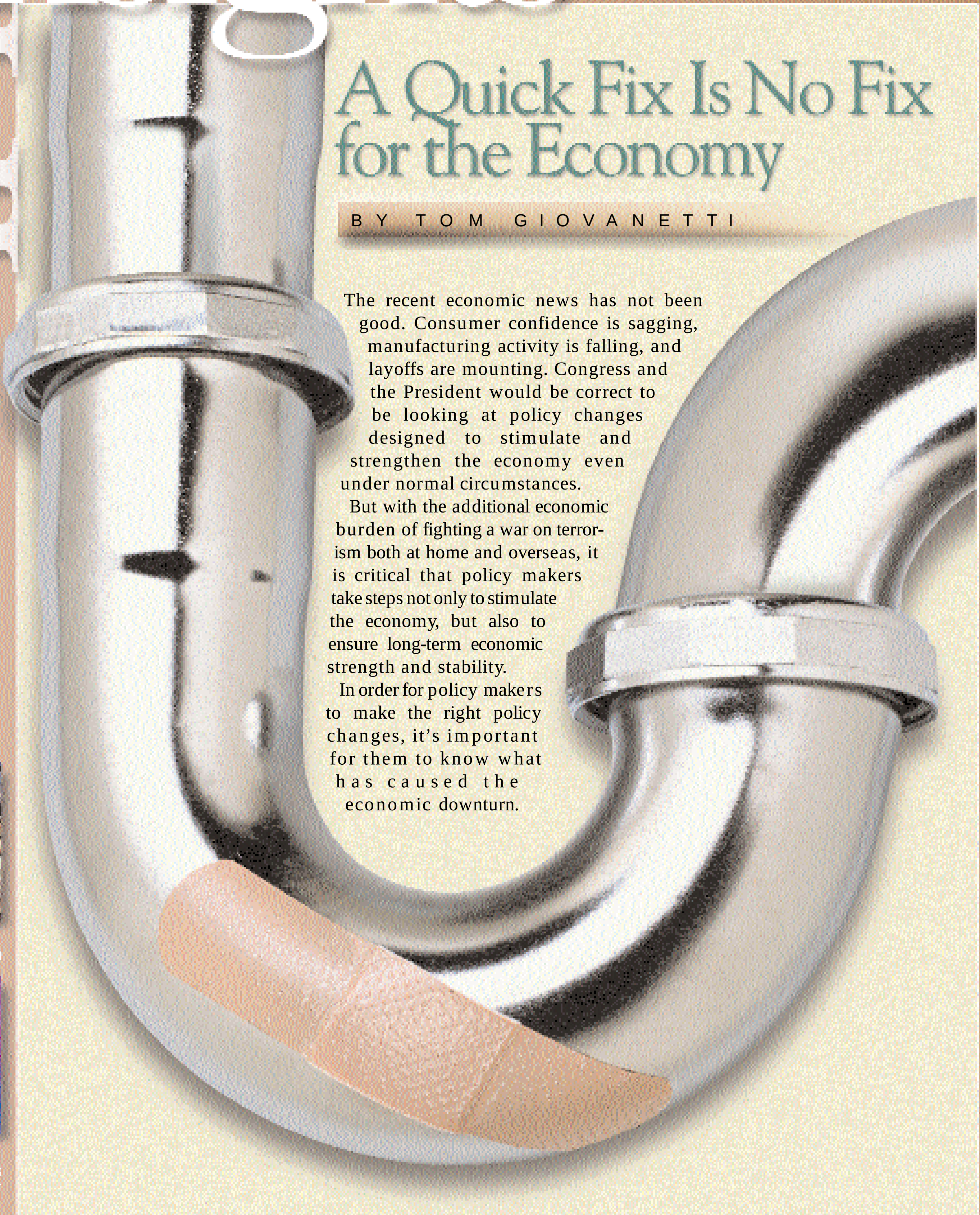
IPI Insights

NOVEMBER DECEMBER 2001

A Quick Fix Is No Fix for the Economy

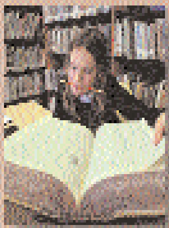
BY TOM GIOVANETTI



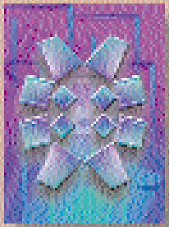
The recent economic news has not been good. Consumer confidence is sagging, manufacturing activity is falling, and layoffs are mounting. Congress and the President would be correct to be looking at policy changes designed to stimulate and strengthen the economy even under normal circumstances.

But with the additional economic burden of fighting a war on terrorism both at home and overseas, it is critical that policy makers take steps not only to stimulate the economy, but also to ensure long-term economic strength and stability.

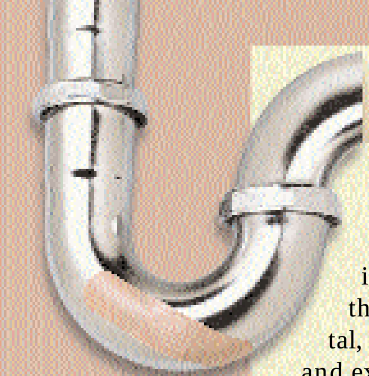
In order for policy makers to make the right policy changes, it's important for them to know what has caused the economic downturn.



INSIDE: Redefining Education



ALSO: Technology Is Nothing to Fear



A Quick Fix Is No Fix for the Economy

Causes of the Current Slowdown

The current economic slowdown is not a result of the September 11 attacks. Rather, the slowdown is the result of declining investment because of the current excessively high tax burden on capital, a result of the tax increases in 1990 and 1993 and exacerbated by bracket creep. Also contributing to the slowdown has been the misguided assumption by both political parties that wealth is more productive in the hands of government than in the private economy.

There is no question that airline disruption, destruction of physical and human capital, shattered confidence and layoffs in the wake of the September 11 terrorist attacks have made conditions worse. But the U.S. economy was already in the doldrums.

> **"When did we decide that public policy should be to fatten the savings account of the federal government at the expense of the savings accounts of Americans?"**

As is widely understood, our economy is driven by investment. The availability of investment capital leads to new business creation and expansion, investment in new plants and equipment, and the hiring of new employees. A recent study by economists Dale Jorgenson and Kevin Stiroh finds that the most important factor in worker productivity is not technology, but the availability of capital.

Unfortunately, today tax policy discourages capital formation. According to a study just authored by Gary and Aldona Robbins for the Institute for Policy Innovation, tax policy is devastating investors and entrepreneurs, who are paying an average of 62.5% out of every additional dollar earned on new investment in taxes to federal, state and local governments. This is by far the highest marginal tax rate on capital in recent memory. Is it any wonder that, with an effective marginal tax rate of 62.5%, investment has slowed?

And investment HAS slowed—dramatically. Since early 2000, there has been a drop-off in investment in equipment. As a result, the economy grew at an anemic 0.8%for the first half of 2001, and output in the business sector declined 0.2 % in the second quarter.

However, before people or businesses can invest, they must first save. But according to a recent study for IPI by economist Stephen Entin, in early 2000, the personal saving rate was nearly zero, a decline from about 9% in the mid-1980s. In fact, the saving rate was still about 2.5% in 1999, just one year earlier.

The fact is that tax policy in recent years has discouraged personal saving and punished investment. Thus, government has taxed away the savings of American workers, and has enriched its own coffers in the form of accumulated budget surpluses. The predictable result has been an economic slowdown. When did we decide that public policy should be to fatten the savings account of the federal government at the expense of the savings accounts of Americans?

In fact, it appears that only government is doing well in the current economy. If you take government spending out of the equation, the private economy has been in recession for some time. Recently it was announced that manufacturing productivity has been negative for more than 12 months—the longest decline since World War II. Something must be done, and it must be something permanent and structural, not simply an attempt to patch the economy with temporary measures.

What About the Recent Tax Cut?

You may be asking, "But didn't we just do this? Didn't we just pass a massive tax cut earlier in 2001 designed to redress these problems?"

Indeed, Presidential candidate George W. Bush recognized that the tax burden is excessively large and harmful to the economy, and addressed the problem by making a large tax cut the centerpiece of his candidacy and the first major initiative of his presidency. Even that tax cut was too small, representing only a 3% reduction in the $44.4 trillion the federal government expects to collect over the next 10 years.

Unfortunately, by the time the legislative process got finished with his proposal, most of the truly potent aspects of the tax cut—the proposals that would stimulate additional saving and investment—were delayed years into the future. More than 60% of the tax cut will not occur until after 2005. Only 5.5% of it, or $73.8 billion, was slated for the current fiscal year, and most of that was the ill-designed tax rebate, a solution that attacked the wrong problem.

The omission of a cut in capital gains taxes, the failure to do anything about the corporate alternative minimum tax (AMT) or depreciation reform, and the delay of much of the tax cut until after 2005 reflect a tax cut designed to have virtually no immediate impact on the economy. So an additional tax cut—a supplemental tax cut, as it were—is still necessary to get the economy back on track.

What Should Be Done?

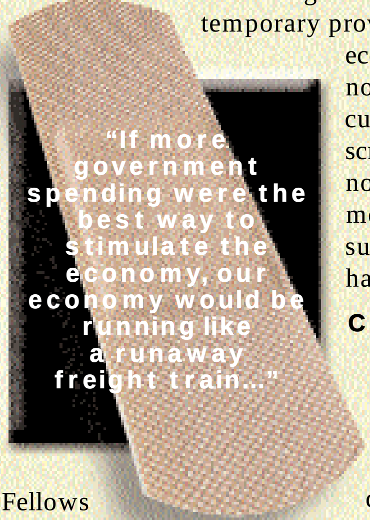
The stimulus package should be as large as politically possible. This, of course, is a fundamentally different view of reality than that held by a number of institutions in Washington, which will charge that the tax cut that came out of the Ways and Means committee is too large, and that it contains too many tax cuts for business and for the wealthy.

This is nonsense. The bill is almost certainly too small, representing a decrease of less than 1% of government revenue over the period. History demonstrates that there has NEVER been a tax cut that was too large. The powers that be in Washington are always biased in favor of increased government spending and against tax cuts, so, by definition, any tax cut is almost certainly squeezed smaller by politics than it otherwise ought to be.

If the purpose of the tax legislation is to stimulate the economy, then the contents should be designed to accomplish exactly that, rather than to redistribute wealth or to make sure everyone gets something. Emphasis should go to those items that are proven to stimulate economic growth, especially changes in tax policy that would represent an incremental move in the direction of tax reform. In this regard, IPI has advocated cutting the capital gains tax, accelerating the rate cuts in the Bush tax cut, eliminating the alternative minimum tax (AMT), and depreciation reform through a move toward expensing.

A recent IPI Issue Brief by Gary and Aldona Robbins reveals that these provisions will have the most "bang for the buck" in an economic stimulus plan.

Opponents will argue that the capital gains tax cut, for instance, is poor policy because it will simply encourage the liquidation of long-held assets rather than stimulate new investment. But this, again, is nonsense. A cut in the capital gains tax rate is also an immediate increase in the rate of return to capital, which stimulates increased investment, not reduced investment. Further, if long-held assets are liquidated, they will not be "stuffed into a mattress." That capital will be immediately redeployed into the most productive investments available, which represents a net gain for the economy. Further, a reduction in the capital gains tax rate represents an immediate increase in the valuation of the stock of U.S. capital. And that's good. Even better, IPI Senior Research Fellows Gary and Aldona Robbins find that a cut in the capital gains tax results in over $10 in added GDP per dollar of tax cut, the most potent possible device for economic stimulus.



Opponents also will argue against eliminating the corporate AMT, a noxious part of the tax code, arbitrarily taking away tax deductions and credits to which corporations that have played by the rules are otherwise entitled. Even worse, the AMT strikes hardest at companies in an economic slowdown, when they can least afford it. As virtually all economists concede, companies don't really pay taxes—people pay taxes. Imposing a high tax rate on a corporation when it can least afford it simply results in that corporation laying off more employees, paying smaller employee bonuses, or hiring fewer new employees than it otherwise would. In contrast, eliminating the corporate AMT leads to $5.61 in additional GDP for every dollar of tax cut, according to the Robbins' study.

What Should Be Avoided?

First of all, we must recognize the fundamental reality that policy changes should focus on stimulating new investment, not increasing spending. If more government spending were the best way to stimulate the economy, our economy would be running like a runaway freight train, given the enormous increase in government spending in the past several years.

And consumers have been spending plenty of money for the last few years as well. Policies that are designed to increase consumer spending are simply time-shifting future consumer spending into the present. They don't do anything to grow the economy. So measures to increase spending, whether by government or by consumers, will have little or no beneficial effect on the economy.

Second, changes in tax policy should be permanent, not temporary. Failing to defeat tax cuts, or overwhelmed by public sentiment in favor of tax cuts, those in Washington who are preternaturally opposed to tax cuts in any form, at any time will fall back and argue that any such tax changes should be temporary, rather than permanent. But this simply represents their philosophical opposition to tax cuts, their satisfaction with the current high-tax regime, and their adherence to the failed ideas of Keynesian economics.

The argument that a stimulus bill should contain only temporary provisions is based on the assumption that the economy is fundamentally sound, that there is nothing wrong with federal policy, and that the current slowdown is simply a blip on the radar screen. But that assertion ignores the recent economic evidence regarding saving and investment, and fails to explain why successive interest rate reductions have failed to have the expected impact on the economy.

Conclusion

The goal of policy makers should be to create a framework that encourages long-term, stable, predictable economic growth, not to extend temporary incentives and then withdraw them in the future. Attempts to improve the economy through policy should focus on permanent improvements in incentives for both individuals and businesses to save and invest. Only when tax policy is stable and predictable will individuals and especially businesses make the kind of long-term investments that will contribute to stable economic growth. Critics commonly assail U.S. businesses for not thinking long-term, but how can businesses think long-term when the ground is constantly shifting beneath their feet as policy makers change the rules?

Policy makers should learn from the past. Every capital gains tax cut has resulted in increased economic growth and additional federal revenue. Temporary tax policies create uncertainty and represent the failed idea that government can manage economic swings. Low taxes create economic growth, and high taxes (like those today) create economic stagnation. We should follow the pro-growth tax-cutting prescriptions employed in the 1980s under Ronald Reagan, and set off another economic boom that will ensure the strongest possible economy when it is most needed. IPI

Tom Giovanetti is the president of the Institute for Policy Innovation

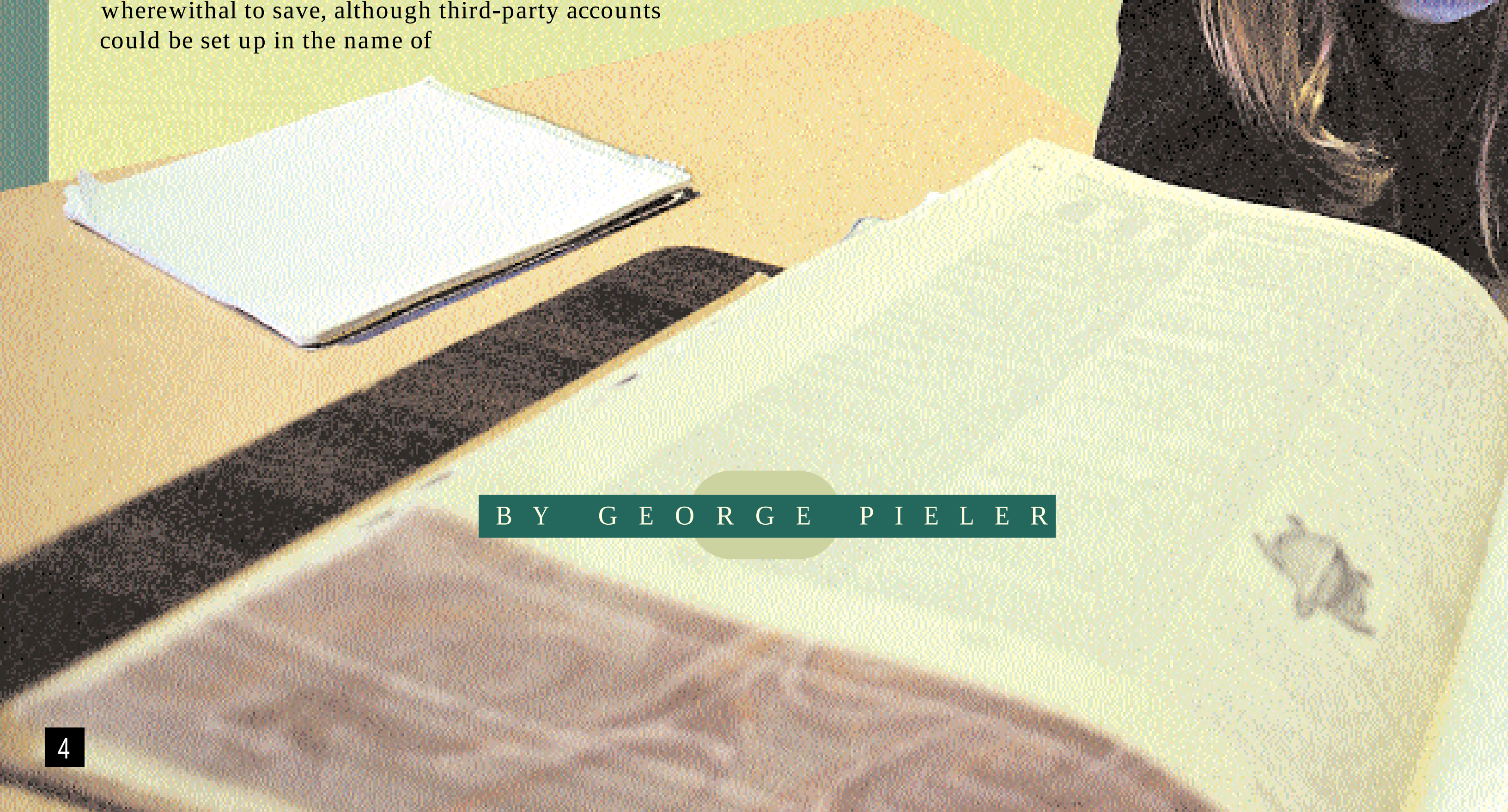
REDEFINING EDUCATION

Parents have never been completely satisfied with the government school system, but only 10% of families, on average, choose to leave the 'official' system for private, religious, or home schools. But in the 2001-2002 school year, there are more options than ever available to families that want 'something better' in K-12 education. Here are just a few of the new developments that are challenging the education *status quo* by injecting a bit of innovation and competition.

One of the most important changes in education policy comes not from the education sector, but from the Bush tax cut. That wide-ranging legislation allows families to create new IRA-type accounts to help fund precollege schooling (such accounts were already available for college savings). Up to $2,000 per child, per year can be set aside in these accounts, which earn interest tax-free so long as withdrawals are used for private school tuition, tutoring, educational software, home schooling, or similar expenses. What's more, third parties (like grandparents) can also contribute to these accounts with the same tax advantages.

While there are obvious limits to these new education IRAs (they don't help families that lack the wherewithal to save, although third-party accounts could be set up in the name of lower-income children, controlled by the parent or guardian), the Coverdell accounts (named by Congress in honor of the late Sen. Paul Coverdell [R-GA], originator of this legislation) are the first across-the-board benefit under federal law that aids families seeking alternatives to government schooling. What's more, these accounts so far lack the strings, restrictions, and regulations that often are imposed on private schools under voucher plans, and even under some tax-credit proposals.

Sticking with the tax front, Florida and Pennsylvania this year joined Arizona in offering special tax credits for donations to scholarship funds that aid students attending private schools. Each plan is different (Florida and Pennsylvania provide only corporate tax credits, Arizona provides credits only to individuals), but each is designed to minimize direct government entanglement with private schools by supporting donations to non-profit organizations. However, it's worth noting that the Florida law does impose significant regulatory requirements on schools that benefit from the scholarship funds. In addition, a similar proposal in Virginia this year was pulled back after it became linked with efforts



BY GEORGE PIELER

Coverdell IRA for Precollege Education Costs

Congress and President Bush have enacted, as part of the Bush tax cut, a new IRA expansion that allows families to save tax-free for elementary and secondary private (or supplementary) schooling costs.The following is an explanation of what that program means to you.

What you can save: Up to $2,000 per year, per child, in a savings account set up to fund private school costs (precollege—college already was covered) or supplementary costs like tutoring and computer software.

What are the tax benefits: Interest on these education IRAs accumulates tax-free, and no tax is ever due (that is, federal income tax) so long as withdrawals are used only for education purposes.

Who can donate: Parents, guardians, grandparents, other family members, friends, businesses, and charities—in short, just about anybody can contribute up to the annual limit to an account set up in the name of a specific child.

Limits: The tax benefits are phased out for so-called 'wealthy' married couples (income between $190,000 to $220,000, at which level the benefit is withdrawn). Lower phase-out limits apply for single taxpayers.

to enforce that state's Standards of Learning in the private school community. Still, the tax-credit-for-scholarships idea is a promising one, and may yet prove a vital adjunct to the growing movement toward privately-funded voucher-type programs.

In the meantime, private sector entrepreneurs have not been idle either. The major growth area continues to be for-profit vendors to government school systems or individual schools, such as Edison Schools, Tesseract, and National Heritage Academies. Most of these companies have followed in the wake of the charter school movement, which has spread to nearly 40 states—allowing private or non-profit organizations to open up alternative schools, or overhaul existing ones, under public authority. But education entrepreneurs have also taken over management of schools, or curriculum development, on a case-by-case basis even without charter authority.

A more recent development is the emergence of educational services that can be sold directly to parents *or* to school systems, like the Bill Bennett-Michael Milken-David Gelernter k12 web-based curriculum, designed to cover everything (all core subjects, testing, research, experiments) needed to take a student all the way through high school. While home schoolers are a major target of k12, so are states with laws that enable 'virtual charter schools' to be run with the k12 system. K12 joins textbook publishers, testing services, and tutoring and test-preparation companies in offering web-based education services, most of which are available to families at a wide range of costs and degrees of customization.

Parents should also be aware of the growing availability of testing data and school-evaluation services over the Web, as well-documented by the Heritage Foundation's Tom Dawson. Dawson cites Colorado's Independence Institute as leading the way in posting comparative school data for families to research on line, with the Colorado government following along (as do Pennsylvania and Kentucky). Private and nonprofit also are beginning to post comparative school data. One caveat—a diversity of information sources on a particular school is always a good idea, since governments are not always objective in evaluating their own performance!

Finally, a quick reminder that not only did Congress and President Bush create the new Coverdell IRA accounts, they provided families a one-time tax rebate ranging from $300 to $600, which could well be deployed towards improving a child's education. For that matter, the Bush tax cut also doubles the child tax credit from $500 to $1,000 (phased in over 10 years, unfortunately), also a strong incentive for parents to take charge of their childrens' education. IPI

George Pieler is the director of the IPI Center for Education Freedom

BARTLETT CLELAND

THE FEAR-THE-FUTURE CROWD IS BACK

In the early 19th century a group of well-meaning but misguided Englishmen known as the Luddites dug in their heels and tried to resist the Industrial Revolution. Fearing that technology was moving too fast and the social displacement that would result, the Luddites waged a 15-month period of civil disobedience. Fortunately they failed to forestall the Industrial Revolution, which brought unparalleled prosperity, and all the benefits that come from prosperity.

The past two hundred years has been an age of wonder with constant life-changing inventions and mind-stretching advances. But every step forward has had its accompanying Luddites—the skeptics, the fearful, and opportunists who express their outrage at progress. Today, their latest fear is nanotechnology.

Nanotechnology is the manipulation of materials at the molecular level with the intention of manufacturing new and better products. By manipulating these tiny particles, researchers can build products atom-by-atom, including cell-sized machines. The development of these techniques will eventually trigger another technology revolution, one far beyond anything seen today.

Nanotechnology will spawn dramatic technological change. For instance, imagine paving the nation's highway system with nano-solar collectors, turning every street and highway in the nation into a gigantic solar collector. Manufacturing will be streamlined to exactness because products will be designed and built with molecular precision. Materials will be stronger, lighter, more conductive, and more durable. The current man-sized cables on the Golden Gate Bridge could be replaced with cables the size of a thumb. Tire treads could be enhanced to prevent accidents. Think of the potential in medicine when microscopic machines circulate through the body, scouring your veins and arteries clean of plaque, preventing stroke and heart attack. Imagine a squadron of nanoprobes constantly on the lookout for cancer cells to destroy.

But already the fear-mongers are lining up to proclaim that nanotechnology will bring about the end of all humanity—a familiar refrain from those who fear the future. Much as Chicken Little did, these folks scream that the sky is falling even before they know the facts.

The fearmongers claim that some rogue nanotech machine will run wild, replicating itself faster than it can be controlled, and performing some task to a degree that harms humanity, such as consuming raw materials or using up oxygen, or some nightmare scenario like that. But these are the same kinds of nightmare scenarios that have accompanied every new technology. Remember how computers were going to go mad and control the world? Remember how robotics was going to put all manufacturing workers out of jobs and result in chronically-high unemployment? It didn't happen. Technology's track record is one of progress, not destruction. And any displacement caused by technology has proven to be "creative destruction," creating newer and better jobs than those made obsolete.

This is not to say that technology is essentially good, but neither is it evil. In fact, no technology has an intrinsic moral value. It is the users of technology who decide whether it is used for good or for evil. Consider nuclear weapons. Because the "good guys" developed this technology first, the world was spared a global nuclear war, unless, of course, one believes that Hitler would have exercised restraint in the use of nuclear bombs to further his goals.

The future worth fearing is one where the good guys don't get there first, and the "bad guys" better understand, control, and access superior technology. Restraints on the development of technology by the civilized world only gives the upper hand to those who are not going to obey the law anyway.

Putting aside the impractical debate of whether there is any knowledge that humanity should not pursue, the practical reality is that advances in technology will be pursued. As long as attaining the greater knowledge or perfecting a superior technology leads to a perceived advantage—military, economic, or otherwise—someone somewhere will be in pursuit. As a result, hundreds of policy choices will have to be made as these technologies are developed. Some are being addressed today, but many are not. This is tragic, because, as we have said, not only is there tremendous potential for life-enhancing improvements in nanotechnology, but it is critical that we get there first to prevent others who do not share our values from controlling this technology.

For policy makers, much of this is uncharted territory. But this uncharted territory provides a great opportunity to frame debates in ways that are helpful to understanding the social impact of technological change. For instance, taxation and regulation can potentially slow progress and innovation and lessen the promise of technology.

With numerous federal agencies issuing multiple rulings, with Congress writing and passing legislation that often bears little resemblance to reality, and with the courts issuing judgments that may be legally valid but technologically bankrupt, then regulation of new technologies may only be a matter of time. Many will try to regulate the advancement of nanotechnology for their own, or because of their fears. But policy makers should resist the temptation to regulate nanotechnology.

Nanotechnology holds great promise for many areas of life. Those who fear the future will continue to whip up fear and concern rather than to engage in logical and productive analysis. Because to fear the future rather than to shape it correctly is a sure means to a disastrous outcome. IPI

Bartlett Cleland is the director of the IPI Center for Technology Freedom.

IMPACT

Hill Briefing Promotes Stimulus

Rep. Jennifer Dunn provides a moment of comic relief to this very serious topic. Enjoying the humor are IPI Senior Research Fellows Aldona and Gary Robbins.

The most important post-attack, domestic policy issue facing Congress has been the economic stimulus package. Everyone agrees that a stimulus is necessary; the question has been how do we get the most bang for the stimulus buck.

In October, the Institute for Policy Innovation held a Capitol Hill briefing, moderated by IPI President Tom Giovanetti, that provided congressional staffers and the media with that answer.

The program, held in the Cannon Caucus Room, began with comments from House Majority Leader Dick Armey (R-TX), followed by Rep. Jennifer Dunn (R-Wash.), discussing the stimulus package already passed by the House.

Their presentations were followed by IPI economists Gary and Aldona Robbins, who discussed the findings of their new IPI Issue Brief "What's the Most Potent Way to Stimulate the Economy?" And Club for Growth president Steve Moore released his new IPI study "A Capital Gains Tax Cut: The Key to Economic Recovery." All three argued that Congress would get the most pro-growth stimulus from a significant capital gains tax cut, followed by depreciation reform and repeal of the Alternative Minimum Tax (AMT).

Empower America Chief Economist Larry Hunter, Institute for the Research on the Economics of Taxation president Steve Entin and Lone Star Foundation president David Hartman provided comments on the studies and the need for a strong, pro-growth stimulus.

Lone Star Foundation President David Hartman presents the need for a strong, pro-growth agenda.

House Majority Leader Dick Armey explains the House version of the stimulus package.

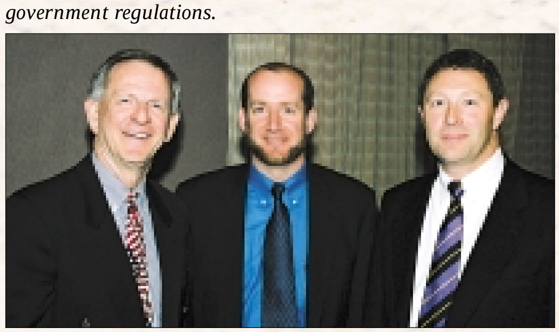
Club for Growth President Steve Moore and Empower America Chief Economist Larry Hunter discuss the details of the stimulus package.

Privacy Debated in Dallas

"Does Privacy Have a Future In the Electronic World?" was the question posed in a recent debate in Dallas, Texas, sponsored by the IPI Center for Technology Freedom, the Dallas Democratic Forum and the Dallas Bar Association. Pete Winn, Assistant U.S. Attorney for the Northern District of Texas moderated the lively debate between Peter Swire and Jim Harper.

Mr. Swire, the former Chief Counselor for Privacy in the Clinton Administration, advocated the institution of more federal regulations to protect individual privacy. Mr. Harper who is the editor of the web-based privacy think-tank, Privacilla.org, maintained that sufficient regulations exist. Although he admits that some of those regulations need better enforcement, heaping on more would be a detriment to the free market system.

(left to right) Panelists Jim Harper and Pete Winn listen on as Peter Swire argues his case advocating more government regulations.



Among the attendees was Dennis McCuistion, host of PBS's The McCuistion Program, *shown here with debater Jim Harper and IPI President Tom Giovanetti.*

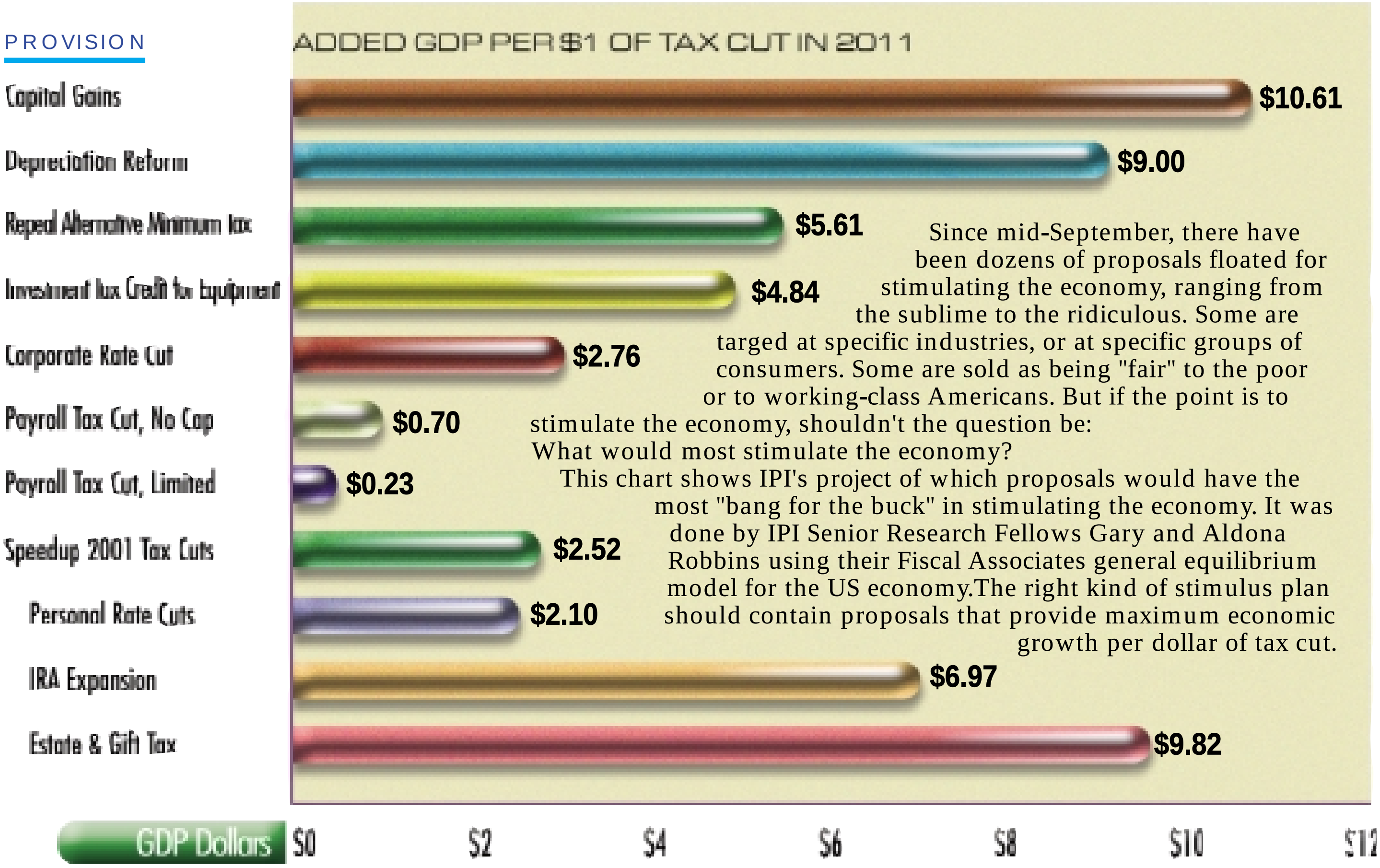
IPI Live!

IPI personalities have been busy on the airwaves revealing how free market solutions provide the right answers for today's tough policy problems.

IPI Senior Research Fellow Aldona Robbins was featured on Bloomberg following the September 11 terrorist attacks to discuss their impact on fiscal policy.

IPI's Visiting Scholar Dr. Merrill Matthews discusses patient rights on CNN

Economic Stimulus Proposals: What Gives the Most "Bang for the Buck?"



Since mid-September, there have been dozens of proposals floated for stimulating the economy, ranging from the sublime to the ridiculous. Some are targed at specific industries, or at specific groups of consumers. Some are sold as being "fair" to the poor or to working-class Americans. But if the point is to stimulate the economy, shouldn't the question be: What would most stimulate the economy?

This chart shows IPI's project of which proposals would have the most "bang for the buck" in stimulating the economy. It was done by IPI Senior Research Fellows Gary and Aldona Robbins using their Fiscal Associates general equilibrium model for the US economy.The right kind of stimulus plan should contain proposals that provide maximum economic growth per dollar of tax cut.

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Direct all inquiries to:
Institute for Policy Innovation
250 South Stemmons, Suite 215
Lewisville, TX 75067
972•874•5139
FAX: 972•874•5144
Email: ipi@ipi.org
Website: www.ipi.org

Publisher...............Tom Giovanetti
Editor.................. Betty Medlock
Design................. S/Concepts

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Institute for Policy Innovation
250 South Stemmons, Suite 215
Lewisville, TX 75067

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