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205 W. Randolph Street • Suite 1305 • Chicago, IL 60606
• www.taxpayersunited.org • E-mail: info@taxpayersunited.org

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Contact: Jim Tobin (773) 354-2076
(312) 427-5128

BIDEN ADMINISTRATION'S SPENDING AGENDA WILL REDUCE PRODUCTIVITY GROWTH

A report just issued by the nonpartisan Washington-based Tax Foundation states that although the president's Council of Economic Advisers released a blog post arguing that the Biden administration's spending agenda would help keep long-term inflation in check, their major financing options will reduce productivity growth.

The main point of the Biden administration's argument is that the infrastructure bill is a supply-side policy that will increase economic productivity, writes the foundation's Alex Muresianu. In theory, it may be true that a shift of the supply curve outwards means an increase in output and a decline in prices.

Other administration supporters have argued for infrastructure from a more demand-side perspective: by increasing government spending, consumers will have more income to spend. When they spend more, then businesses and individuals they purchase goods from will have more money to either consume or invest. This is known as the Keynesian multiplier effect.

"This debate has an important mirror in the economics of tax policy," writes Muresianu. "As my former colleague Scott Greenberg described in 2017, there are two theories of tax reform, as described by politicians."

The first theory is the "folk theory." Under the folk theory, tax cuts can stimulate the economy by "putting more money in people's pockets." Cutting taxes raises disposable income, leading to more consumption and investment; raising taxes reduces disposable income, and therefore reduces consumption and investment.

"All that matters is the bottom-line net change in government revenue," states the report "In this regard, temporary tax cuts are just as helpful as permanent tax cuts, as they end up raising incomes immediately."

The second theory is the neoclassical theory, the supply-side view. Under this theory of tax reform, taxes impact the economy by changing marginal incentives, not by raising the amount of income available to spend. The benefit of a lower tax rate is not from raising spending: with a lower tax rate, the returns to work and investment are higher, and thus people and firms choose to work and invest more.

These theories are not mutually exclusive, states the report. The folk theory is useful in times when the economy is "below potential," such as in a recession when demand is depressed. However, when designing "normal" policy over the long term, the neoclassical framework is a better model.

While the case the White House is making for the infrastructure package is more in line with the neoclassical framework, they should design the tax policies used to fund it under the same principles. If the goal is to stimulate long-term economic growth, raising the corporate income tax rate would be counterproductive, given how private capital investment is sensitive to tax changes.

According to the report, it would make sense to fund infrastructure with user fees, such as tolls, the gas tax, or a tax on vehicle miles traveled. Those funding sources would have a smaller impact on long-term private investment, and in some cases, encourage infrastructure investment to be targeted towards places it will be most productive in terms of usage.

The report concludes, “The Biden administration does have a point about how some components of the infrastructure bill could put downward pressure on inflation in the long term. However, the taxes chosen to pay for those investments would counteract those effects, by reducing investment and productivity growth.”

Source: https://taxfoundation.org/infrastructure-bill-taxes-inflation/