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Tax Cuts Might Accomplish What Spending Hasn't

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IMAGINE you are a physician and a patient arrives in your office with a troubling and mysterious disease. Some of the symptoms are familiar, but others are not. You have never treated anyone with quite this set of problems.

Based on your training and experience, imperfect as it is, you come up with a proposed remedy. The patient leaves with a prescription in hand. You hope and pray that it works.

A week later, however, the patient comes back and the symptoms are, in some ways, worse. What do you do now? You have three options:

STAY THE COURSE Perhaps the patient was sicker than you thought, and it will take longer for your remedy to kick in.

UP THE DOSAGE Perhaps the remedy was right but the quantity was wrong. The patient might need more medicine.

RETHINK THE REMEDY Perhaps the treatment you prescribed wasn't right after all. Maybe a different mixture of medicines would work better.

Choosing among these three reasonable courses of action is not easy. In many ways, the Obama administration faces a similar situation right now.

When President Obama was elected, the economy was sick and getting sicker. Before he was even in office in January, his economic team released a report on the problem.

If nothing was done, the report said, the unemployment rate would keep rising, reaching 9 percent in early 2010. But if the nation embarked on a fiscal stimulus of $775 billion, mainly in the form of increased government spending, the unemployment rate was predicted to stay under 8 percent.

In fact, the Congress passed a sizable fiscal stimulus. Yet things turned out worse than the White House expected. The unemployment rate is now 10 percent — a full percentage point above what the administration economists said would occur without any stimulus.

To be sure, there are some positive signs, like reduced credit spreads, gross domestic product growth and diminishing job losses. But the recovery is not yet as robust as the president and his economic team had originally hoped.

So what to do now? The administration seems most intent on staying the course, although in a speech Tuesday, the president showed interest in upping the dosage. The better path, however, might be to rethink the remedy.

When devising its fiscal package, the Obama administration relied on conventional economic models based in part on ideas of John Maynard Keynes. Keynesian theory says that government spending is more potent than tax policy for jump-starting a stalled economy.

The report in January put numbers to this conclusion. It says that an extra dollar of government spending raises G.D.P. by $1.57, while a dollar of tax cuts raises G.D.P. by only 99 cents. The implication is that if we are going to increase the budget deficit to promote growth and jobs, it is better to spend more than tax less.

But various recent studies suggest that conventional wisdom is backward.

One piece of evidence comes from Christina D. Romer, the chairwoman of the president's Council of Economic Advisers. In work with her husband, David H. Romer, written at the University of California, Berkeley, just months before she took her current job, Ms. Romer found that tax policy has a powerful influence on economic activity.

According to the Romers, each dollar of tax cuts has historically raised G.D.P. by about $3 — three times the figure used in the administration report. That is also far greater than most estimates of the effects of government spending.

Other recent work supports the Romers' findings. In a December 2008 working paper, Andrew Mountford of the University of London and Harald Uhlig of the University of Chicago apply state-of-the-art statistical tools to United States data to compare the effects of deficit-financed spending, deficit-financed tax cuts and tax-financed spending. They report that "deficit-financed tax cuts work best among these three scenarios to improve G.D.P."

My Harvard colleagues Alberto Alesina and Silvia Ardagna have recently conducted a comprehensive analysis of the issue. In an October study, they looked at large changes in fiscal policy in 21 nations in the Organization for Economic Cooperation and Development. They identified 91 episodes since 1970 in which policy moved to stimulate the economy. They then compared the policy interventions that succeeded — that is, those that were actually followed by robust growth — with those that failed.

The results are striking. Successful stimulus relies almost entirely on cuts in business and income taxes. Failed stimulus relies mostly on increases in government spending.

All these findings suggest that conventional models leave something out. A clue as to what that might be can be found in a 2002 study by Olivier Blanchard and Roberto Perotti. (Mr. Perotti is a professor at Boccini University in Milano, Italy; Mr. Blanchard is now chief economist at the International Monetary Fund.) They report that "both increases in taxes and increases in government spending have a strong negative effect on private investment spending. This effect is difficult to reconcile with Keynesian theory."

These studies point toward tax policy as the best fiscal tool to combat recession, particularly tax changes that influence incentives to invest, like an investment tax credit. Sending out lump-sum rebates, as was done in spring 2008, makes less sense, as it provides little impetus for spending or production.

LIKE our doctor facing a mysterious illness, economists should remain humble and open-minded when considering how best to fix an ailing economy. A growing body of evidence suggests that traditional Keynesian nostrums might not be the best medicine.