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GOKHALE: Stimulus now but slowdown later

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Under the recent extension of George W. Bush-era tax cuts, whether continuation of already-low income taxes wil amount to a "stimulus" is debatable - most people were already expecting it to pass. But the legislation includes a cut in 2011 Social Security payroll tax rates from 6.2 percent to 4.2 percent on wage earnings up to the taxable lim This is an unambiguous stimulus because it is new, unexpected and financed out of an increase in the nation's debt

The Social Security trust funds supposedly lose nothing from the payroll tax cut. How? To make up for the lost revenues, the Treasury will deposit IOUs into the trust fund for free. In other words, Social Security benefit payments can continue as before and the trust funds won't be exhausted any sooner than 2037 as projected by its trustees earlier this year. Thus, the government will receive fewer revenues from the Social Security ex-cash-cow and must make up for the loss by other means: substitute other taxes, reduce government spending or create larger deficits and debt. But the government just extended low Bush-era income taxes, reduced estate taxes and introduce investment tax credits - so the tax-substitution option is out. And given the weak ongoing economic recovery, the option of cutting government spending is also closed. That leaves only higher deficits and debt. What can we expe from such a $100-billion-plus payroll tax stimulus? A small and short-lived, miragelike economic recovery.

Economic logic suggests that a deficit-financed tax cut would stimulate economic activity in the short term as people choose to work more hours when taxes are low because they can keep and spend more of their hard-won earnings. Employers may anticipate the increased consumer demand and hire more workers to increase production As excess production capacity declines, employers also may seek to expand it - ramping up investment demand. Higher investment and consumption could jump-start a "virtuous process" to pull the economy from its current lov activity state. This train of events, including a reduction in unemployment to normal levels, could get President Obama re-elected in 2012, help the Democrats recover from recent electoral losses and thwart the key Republican goal of capturing the nation's top political office.

And then what? If you're a lawmaker, especially a Democratic one - your response to this question is easy to guess "Who cares?" If, however, you respond, "Shoot, we just dug ourselves a deeper hole," you would be correct. That's because even as economic growth picks up, interest rates will increase faster and the debt created by the payroll-ta cut stimulus will grow faster than the capacity of the economy to pay it off - none of which is good news for long-term economic growth.

It means either taxes must be increased eventually - permanently and by more than before the debt-financed payro tax cut because now there is more debt to service - or government spending must be reduced - also permanently an by more than if we had not enacted that stimulus because of increased debt-service costs. Both of those unavoidab future policies would act as drags on economic growth: With less take-home pay, people would choose to work les - take longer vacations and retire earlier - as the economics Nobel laureate Ed Prescott has documented. Producers would scale back output, employment and investment in anticipation of reduced demand, reversing the short-term virtuous process. Because taxes eventually must be higher (or government expenditures smaller) the economy mus gravitate toward a slower rate of steady and sustainable growth than it would without the debt-financed payroll-tax cut stimulus.

The Social Security payroll tax cut is the key element in the recently enacted package, with a sleight-of-hand transfer of free Treasury IOUs used to preserve Social Security's long-term solvency. Through it, we're awarding ourselves less economic pain - lower taxes, the same amount of Social Security benefits and the same amount of government largesse - and we stand to benefit from a temporary and politically motivated gain in short-lived economic growth and employment. We're also promising future taxpayers more economic pain through more debt higher taxes, reduced public services and, consequently, slower economic growth and more unemployment.

The incensed opposition to the wasteful illogic of the Troubled Asset Relief Program (TARP) needs to be revived and directed toward the payroll-tax-cut stimulus policy. If you, perchance, do not realize and appreciate this right now, you very likely will later.

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