IRET *Congressional Advisory*

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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SENATE STIMULUS PACKAGE

The Senate is debating changes in the individual and business portions of the Administration/House stimulus package. The House investment incentive is worthwhile, and is better than the Senate version. Nothing else in either version of the package would do much economic good. It would be better to scrap the stimulus package and extend the 2003 tax cuts. That would do more to boost investment and employment, both in the short run and in the longer run, than the stimulus plans now being proposed.

Individual rebates.

The Administration wants to send rebate checks to many middle- and lower-income taxpayers, arguing that the checks would stimulate consumption spending and thereby strengthen the economy. The proposal has been passed by the House of Representatives, and is being considered by the Senate.

The Administration/House version would base the initial rebate amount on the greater of: 2007 tax liability up to $600 for a single filer or $1,200 for a couple, or (a sort of minimum) $300 for a single filer and $600 for a couple provided they had earned (labor) income of at least $3,000 in 2007. These amounts are increased by $300 for each child under 17. The benefits would be phased out for people with adjusted gross income over $75,000 (single) or $150,000 (married couple). The checks are meant to be a rebate against 2008 taxes, but the Treasury does not yet know people's 2008 tax status, so the initial checks will be sent out based on 2007 tax liabilities and labor income eligibility. When taxpayers file their 2008 tax returns, they will be required to adjust their rebate to reflect their 2008 income tax situation. A few might have to return a portion of the check, while some may get a credit against the 2008 tax owed.

The Senate Finance Committee version would put a spin on the plan. It would give flat rebates of $500 (single) and $1,000 (married) for people with at least $1 in 2007 tax liability, or if they have earned income (labor income) of at least $3,000. The Senate would extend the rebates to many who would not qualify for relief under the House plan by allowing lower-income persons with non-taxable Social Security and veterans' benefits to include them toward meeting the $3,000 labor income requirement. The Senate version has a higher phase-out, starting at $150,000 (single) and $300,000 (married). The Senate Finance Committee version would extend unemployment benefits for an additional three months nationwide and six months in high unemployment states. Not included, but favored by some Members, would be an increase in home heating assistance for the poor (LIHEAP — Low Income Home Energy Assistance Program).

Investment incentives.

Two expensing provisions have been offered to boost investment spending. The House version of the bill would allow businesses to expense 50% of the cost of equipment in the first year, reporting the rest of the cost under regular depreciation rules. To be eligible, the equipment would have to be ordered and placed in service by the end of 2008 (except for certain longer-lived assets, which must be in service

by the end of 2009). This is similar to the temporary 50% expensing provision of the 2003 tax cut. In addition, the bill would increase the Section 179 small business expensing limits for 2008 to $250,000 (from $128,000) for businesses with up to $800,000 in investment purchases (up from $510,000), beyond which limits the expensing is phased out.

The Senate Finance Committee reported out a weaker version of the expensing provision. It would let businesses expense 50% of the value of the asset over the first two years, at 25% a year, with the rest of the cost subject to depreciation. The modest reduction in the up front tax cut would go toward a new provision, allowing firms with unused net operating losses from 2006 and 2007 to carry those losses back 5 years (instead of the 2 years permitted under current law), with a temporary suspension of the current 90% limit on the amount of loses shifted. This would allow businesses to get refunds of earlier tax payments instead of waiting to use the losses to reduce future tax liabilities. Businesses would have to choose between taking the 25%/25% expensing provision or the NOL provision; they would not be allowed both.

The Senate Finance version also contains a variety of energy credits, would temporarily lift the limits on certain federal agency mortgage supports, and would allow an additional $10 billion of tax exempt state bond issues to support home refinancing. (The House version temporarily lifts ceilings on loans backed by Fannie Mae, Freddie Mac, and FHA.)

Analysis of the individual tax cuts.

The rebates. The individual tax cut in the House bill is not well designed to promote economic activity. The checks are more-or-less lump sum gifts that create little or no incentive to work additional hours or to expand a business. The Treasury will send checks calculated on 2007 income tax liability, and it is impossible for people to go back in time to work more in 2007 to qualify for the early rebate check. However, after "reconciling" the rebate against 2008 income on the 2008 tax return next year, a taxpayer who worked in 2008 but not in 2007 could get a credit against tax on his 2008 tax return, but the tiny dollar caps and floors would keep the tax cut from being "at the margin" for most taxpayers. Only a few of the people whose income stops in the 10% tax bracket would find the rebate to be "at the margin", and such individuals produce less than 2% of the national income. Even a dramatic 5% increase in their hours worked would add only one-tenth of one percent to the GDP. Meanwhile, higher-income taxpayers in the phase-out range would face an increase in marginal rates and some minor work and investment disincentives.

Nor would the tax cuts work to boost sales and production by giving people money to spend. The government would have to borrow such a tax cut back to continue its own spending. There would be no initial increase in "disposable income" beyond the amount that the public must return to the Treasury to buy the additional government debt made necessary by the tax reduction.

Since the rebates will not noticeably affect work or saving incentives (in spite of the notional tie to 2008 taxable income) nor boost total spending and output, it really does not matter to whom they are given from an economic perspective. If the total dollar amount of the money distribution were the same in either case, one might as well adopt the Senate plan and make more people happy.

Tax cuts do stimulate the economy if they are structured to make it more rewarding to work additional hours, or to save, invest in, and operate additional capital. To encourage additional activity, the tax cut must be effective on the marginal dollar earned, such as marginal tax rate reductions in all brackets. Such changes increase the supply of factor inputs and result in higher output. The added output, and the payments to the factors for producing it, constitute higher income.

As noted earlier (and explained in IRET Congressional Advisory 236), the rebates would not, by themselves, stimulate over-all spending in the economy. The tax reduction would be matched by

an increase in federal borrowing. Other things equal, the Treasury would have to borrow additional money from the public equal to the rebate amount even as the checks are mailed out, leaving the public with no additional purchasing power to spend. Only if the Federal Reserve were to buy the added debt with new money would there be additional "aggregate demand," but the added spending would not be due to the rebates per se.

One thing is clear: the rebates will increase federal borrowing. Someone's saving is going to be used to buy the added debt. For every dollar of rebate check used for consumption, some other dollar has to be saved to buy the federal bonds. If those other dollars would have been used for consumption, there is no added consumption. If those other dollars would have been lent to investors, there will be less investment. The necessary effect of taking money from savers and giving it to consumers is that either there is no effect on GDP, or there is more consumption but less investment, and thus less GDP in the future.

Another possibility is that the added debt might be sold to foreigners, apparently enabling U.S. consumers to spend more. In that case, there would be several possible outcomes. One is that the foreigners would buy Treasury debt instead of other dollar assets they had planned to buy, such as newly issued stock or bonds of U.S. businesses. That would reduce U.S. business investment, which would offset the added consumption spending. Another is that foreigners would increase their lending at the expense of their purchases of U.S. exports. Again, there would be no gain in U.S. output. In fact, one likely outcome is that there would be some increase in U.S. consumers' purchases of imports (such as consumer electronics), resulting in additional dollar earnings by foreigners and additional foreign purchases of U.S. government debt. This does nothing to boost U.S. output.

Other Senate provisions for individuals. Some in the Senate have suggested that the payments should be directed more to the poor who are hard hit by higher fuel costs, or to others who might tend to spend the rebates rather than save them. Would that boost spending? No. People who save do not reduce spending in the economy. The financial markets gather the saving and lend it to borrowers, who use the money for either consumption or investment. Either way, there is spending.

If current federal assistance programs are not doing an adequate job, then targeting the rebates to the poor or to those pressed by higher food and energy prices might serve a social objective. This could be accomplished through temporary increases in LIHEAP or in food stamps. It would not, however, do anything special for the economy by giving money to the people most likely to spend it.

The Senate plan would expand the maximum duration of unemployment payments. That would benefit many people in difficult straights, but would not be costless. The extended benefits would allow people with employment options to wait longer for more attractive jobs, to resist moving, and to shun jobs at a lower pay level. Extended payments would cause people to remain unemployed longer than otherwise, and would increase the unemployment rate. With the additional unemployment relief, the Senate is angling for a bigger package than the House. This increase in the total cost of the package would increase the national debt and future debt service costs to no good purpose.

Rather than extend unemployment compensation, it would be better to redesign the whole package to stimulate job creation, productivity gains, and higher wages. That would best be done by lowering taxes on labor and capital income at the margin. This would best be accomplished by making the 2003 tax cuts permanent.

Analysis of the business provisions.

The expensing and carry-back provisions are being described by the proponents of the legislation as encouraging investment by raising business cash flow. This is the wrong way to view them. Just as with individual tax reductions, business tax cuts do not stimulate activity merely by giving a business

more money to spend, as if businesses mechanically invested, say, 70% of every after-tax dollar they take in, and pay out 30% as a dividend. Rather, business projects are evaluated by looking at the projected returns on the incremental investment projects.

The expensing provisions. The House's 50% expensing provision (taken as 25% a year for two years in the Senate version for equipment ordered in 2008) would raise projected returns, and would be good policy as part of a permanent tax reduction. If that is not possible, it would be a good idea to pass it, and then make it one of the "extenders", such as the R&D credit, that is renewed periodically near the end of the year. If effective for one year only, it would mainly shift investment from 2009 to 2008, postponing the investment slump but not curing it. Increasing the cap on expensing by small businesses affects more investment "at the margin," boosting incentives to invest for businesses doing less than the new ceiling, but it does not affect marginal investment of larger amounts at bigger firms. It is fine as far as it goes, but also suffers from not being made permanent.

Expensing a portion of investment allows businesses to recognize more of the cost of acquiring equipment for tax purposes nearer to the time it is incurred (instead of making them wait for 3, 5, 7, 10, or 20 years). That raises the present value of the reported costs, and reduces the present value of the tax owed (by reducing the delay-related loss of the time value of money). It makes investment in new equipment less costly, and increases the amount of capital a business can afford to own and operate. The House version, being faster than the Senate, would do more to reduce the present value of the tax, and more to boost incentives.

Note that the higher business costs claimed in year one are offset by lower depreciation claims, and higher tax payments, in later years. From a government accounting perspective, the revenue loss in the first year is offset by higher taxes collected in later years. The government's tax loss is only the reduction of the present value of the tax stream due to the difference in timing (equal to the present value gain to the businesses).

The partial expensing provisions, while applicable to additional investment in 2008, would mainly shift capital goods orders from 2009 into 2008. They would not raise the after-tax rate of return on a business's entire stock of capital permanently. There would be no incentive to acquire and operate a larger quantity of capital over time. There would be a tendency not to replace obsolete or worn-out equipment in 2009, restoring the size of the firm's capital asset base to levels normal for the ongoing, less generous tax treatment.

Why is that? A one-shot dose of expensing is "at the margin" in a limited sense. It is "at the margin" on investment this year, but not "at the margin" on the long term size of the business. Any additional investment made in 2008 for eligible equipment (20 year or less asset life) would get the tax reduction. However, what matters is not only the annual investment that a business makes, but the total size of its capital stock. No one machine or tool is ***the*** marginal machine. Rather, the company has to decide whether to own and operate, say, 20 machines/trucks/computers or 21 of them. It is the change in size of the stock of capital, not any one of the pieces, that is "the margin". Suppose the tax break is given on the purchase of one or two new machines bought now, but there will be no permanent improvement in the tax treatment of replacement or additional machines or tools in the future. The business will have no reason to maintain a larger capital stock over time, and will allow the stock to drop back to normal.

The NOL carryback provisions. One has to strain to find examples of how the Senate carry-back provision would reduce the cost of investment for a business, and increase equipment spending. Here is the best (pitifully weak) case to be made for it.

Some businesses are not currently profitable. They would be unable to use any deduction (either the 50% special write-off or regular depreciation

allowances) for investment outlays until their pre-tax earnings return to positive territory. The delay in being able to deduct their costs would reduce the value of the deduction, raise the effective tax rate on the investment project, and reduce the companies' incentive to invest.

Some companies are unprofitable in 2008 because of current losses or net operating losses that have been carried forward from 2006 and 2007 because they were too large to be carried back and used on income in earlier years. That is, the losses exceeded their profits in tax years 2004-2006, as far back as they could shift them under current law 2-year carry-back provisions. For a few of these companies, a 5-year carry-back would eliminate the remaining NOLs, and give them positive pre-tax income for 2008, and make them able to use the regular depreciation write-offs in 2008. This would marginally increase the incentive to order new equipment. Companies with large losses from earlier years, or that are losing more money on current operations than could be carried back even 5 years, or that expect losses to continue for some time, would still have no incentive to increase investment. They would have more cash flow, but the cost of new investment and its projected profitability would not be improved. In such cases, the increased cash flow would logically be used to reduce debt.

How many companies fit these criteria? No one can say. It is certain, however, that the Finance Committee never asked the question, and that it is looking at the problem in an inappropriate manner. Just giving a business additional cash flow from past activities will not induce it to make an investment that is not inherently sound going forward.

The energy and mortgage provisions. The energy credits would divert resources from higher value use and reduce economic output. The mortgage assistance would be a pure income transfer and would interfere with the necessary corrections in housing sector.

Conclusion

The stimulus package is no substitute for a permanent extension of the 2003 tax cuts. Extending the 2003 tax cuts today would do more for jobs, wages, investment, and economic output, in both the short run and the long run, than the stimulus package being rammed through the Congress. The package seems designed more to boost the public image of the White House and the Congress than to boost the economy. The public will see through the charade.

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Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.