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CRS Report for Congress

Tax Cuts for Short-Run Economic Stimulus: Recent Experiences

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Summary

Congress recently adopted a short-run fiscal stimulus package, H.R. 5140 which included tax reductions. The President signed the bill, which become P.L.220-185, on February 13 In recent years, three different types of short run fiscal stimulus measures have been enacted: an individual income tax rebate in 2001, a temporary investment incentive (bonus depreciation) in 2002, and dividend relief in 2003. Some analysis suggests that the cash rebate was an effective stimulus, bonus depreciation had a smaller effect, and, on theoretical grounds, dividend relief was unlikely to provide an effective stimulus.

Congress recently adopted a short-run stimulus package which included tax reductions, such as an individual tax rebate or investment incentives. H.R. 5140 as passed by the House on January 29, a Senate Finance Committee proposal, and the final bill adopted on February 7 included an individual tax rebate.[1] All of these proposals included provisions that provided for refundability for taxpayers without income tax liability, for low income earnings in the initial House bill and for low income earners and those with social security income in the Senate proposal and the final bill. Both include bonus depreciation of 50%[2]. Both proposals also included an increase in the ability to deduct equipment costs by small businesses, and the Senate proposal had an extension of net operating loss carrybacks, which was not included in the final bill.

Several types of tax cuts were partially or fully enacted for purposes of short run economic stimulus in the recent past (2001-2003). These tax revisions were the first in some time that were motivated, at least in part, by the need for expansionary fiscal policy.

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[1] See CRS Report RL34341, *Tax Rebate Refundability: Effects and Issues*, by Jane G. Gravelle, for a discussion of the rebate proposals.

[2] Both proposals also include an increase in the ability to deduct equipment costs by small businesses (raising the cap from $125,000 to $250,000), and the Senate proposal has an extension of net operating loss carrybacks from two years to five years.

In the late 1990s, the economy experienced a protracted period of significant growth, and, in the decade prior to that most tax legislation addressed a need for deficit reduction (the objective of most tax change between 1982 and 1997, as was the case in the 1990 and 1993 tax changes) or a desire for structural change (in the 1986 and 1997 tax revisions).[3]

Very different types of stimulus provisions were enacted in the period 2001-2003: the 2001 tax cut was aimed at individuals, but most of its provisions, especially the rate cuts, which were phased in over a number of years, were not based on the recession that was apparent in 2000 and that appeared in the spring of 2001. When concerns about the economy continued towards the end of 2001 and in 2002, the Congress enacted bonus depreciation. And, in 2003, the tax provision advanced to stimulate the economy was a reduction in dividend taxation.

This report discusses the rebate, bonus depreciation, and dividend relief as mechanisms for stimulating the economy in the short run.

The 2001 Rebate

The 2001 tax cut was not primarily enacted because of concerns about a recession and most of the provisions were phased in over a number of years. However, concerns about a slowing economy did motivate the advance tax rebate provided in 2001. Because the tax cut was enacted close to mid-year (in May) it was difficult to provide a tax cut for 2001 that could be reflected appropriately in withholding. By the time withholding changes could be put into place, much of the year would have passed and either withholding changes would be inadequate (deferring tax cuts until returns were filed the following year), or if made larger to compensate for the partial year effect would have resulted in a withholding increase for some taxpayers at the beginning of 2001. The rebate proposal provided for the mailing out of checks to taxpayers in the fall of 2001 that were advance reductions for the introduction of a 10% rate bracket for 2001. They were, however, based on taxpayers' 2000 tax returns and any excess credits did not have to be repaid when returns for tax year 2001 were filed. (Taxpayers whose credits were smaller than those allowed on 2001 returns, however, received additional relief when tax returns were filed). The checks were mailed out between July and October.[4]

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[3] A stimulus provision proposed in 1992 to provide a credit against payroll taxes was vetoed by the President. During the 1960s and 1970s a variety of provisions was enacted that were associated with economic stimulus, including investment credits, rate reductions, and tax rebates. The Joint Tax Committee has released a document that reviews tax stimulus provisions from the 1960s forward. It also has a discussion of potential effects, although some of that discussion relates to longer term effects rather than short term stimulus aimed at countering an economic downturn. See Joint Committee on Taxation, *Overview of Past Legislation Providing Fiscal Stimulus and Issues in Designing and Delivering a Cash Rebate to Individuals,* January 21, 2008.

[4] The details of the plan are discussed in CRS Report RS21171, *The Rate Reduction Tax Credit in the Economic Growth and Tax Relief Reconciliation Act of 2001: A Brief Explanation*, by Gregg Esenwein and Steve Maguire.

The rebate met some important standards for an effective tax cut stimulus.[5] Unlike many stimulus proposals in the past, particularly in the 1960s and 1970s, where the stimulus occurred during the recovery rather than the recession phase (potentially adding to inflationary pressures), its impact occurred during the recession.[6] In addition, tax cuts are most effective as a stimulus if they are spent, and the tax reductions affected lower and moderate income taxpayers who have a high propensity to spend.

At the same time, there was some concern that lump sum payments might be spent in the same fashions as a continued increase in income through tax reductions. There was some evidence that temporary rebates in the past were not spent.[7] It appears, however, that most of the rebate was spent fairly quickly: at least 20% to 40% in the quarter received and two-thirds by the end of the second quarter after receipt.[8]

The Joint Tax Committee study[9] discusses some important administrative issues surrounding a cash rebate. Since 2007 returns have not been filed, a flat rebate would be most easily accomplished if it were based on 2006 returns.

The 2002 Bonus Depreciation

Following the September 11, 2001, attacks, concerns once more arose about the economy. A tax package proposal that included a business tax cut in the form of reduction in the corporate alternative minimum tax and an acceleration of rate reductions failed to achieve passage in 2001. In 2002, a bill was adopted and the centerpiece, as far as tax provisions were concerned, was a temporary, two-year, provision for bonus depreciation. This provision, responding to a concern about lagging business investment, allowed businesses to deduct 30% of the cost of most business equipment purchases when incurred rather than depreciating them over several years (typically five to seven years). Bonus depreciation was increased to 50% in 2003 and extended through 2004.

Among the business tax incentives, a temporary investment subsidy should have the most "bang for the buck."[10] By directing the subsidy at investment, the stimulus does not provide a windfall for existing capital. By making the provision temporary there is an

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[5] See CRS Report RS21126, *Tax Cuts and Economic Stimulus: How Effective Are the Alternatives?*, by Jane G. Gravelle, for further discussion. See also Congressional Budget Office, *Options for Responding to Short-Term Economic Weakness*, January 2008, pp. 4-9.

[6] See Congressional Budget Office, Ibid., p. 7, for a discussion and references to evidence that the fiscal stimulus packages in the 1960s and 1970s were not well-timed.

[7] Ibid., p. 10.

[8] See David Johnson, Jonathan Parker, and Nicholas S. Souleles, "Household Expenditures and the Income Tax Rebates of 2001," *American Economic Review*, vol. 96, no. 5 (December 2006), pp. 1589-1610.

[9] Joint Committee on Taxation, *Overview of Past Legislation Providing Fiscal Stimulus and Issues in Designing and Delivering a Cash Rebate to Individuals*.

[10] These issues are discussed in more detail in CRS Report RL31134 , *Using Business Tax Cuts to Stimulate the Economy*, by Jane G. Gravelle.

incentive to make investment now rather than later. Nevertheless, a study of the effect of temporary expensing by Cohen and Cummins at the Federal Reserve Board found little evidence that bonus depreciation was effective in stimulating investment.[11] They suggest several potential reasons for a small effect. One possibility is that firms without taxable income could not benefit from the timing advantage. In a Treasury study, Knittel confirmed that firms did not elect bonus depreciation for about 40% of eligible investment, and speculated that the existence of losses and loss carry-overs may have made the investment subsidy ineffective for many firms, although there were clearly some firms that were profitable that did not use the provision.[12] Cohen and Cummins also suggested that the incentive effect was quite small (largely because depreciation already occurs relatively quickly for most equipment), reducing the user cost of capital by only about 3%, that planning periods may be too long to adjust investment across time, and that adjustment costs outweighed the effect of bonus depreciation. Knittel also suggests that firms may have found the provision costly to comply with, particularly because most states did not allow bonus depreciation.

A study by House and Shapiro found a more pronounced response to bonus depreciation, given the magnitude of the incentive, but found the overall effect on the economy was small, which in part is due to the limited category of investment affected and the small size of the incentive.[13] Their differences with the Cohen and Cummins study reflect in part uncertainties about when expectations are formed and when the incentive effects occur.

One issue that these studies do not provide insight to is the desirable length of time to allow the temporary provision. If the time is too long, the provision is not very effective because the stimulus may be delayed, but if it is too short firms do not have time to make adjustments.

Cohen and Cummins also report the results of several surveys of firms, where from 2/3 to over 90% of respondents indicated bonus depreciation had no effect on the timing of investment spending.

Overall, bonus depreciation did not appear to be very effective in providing short-term economic stimulus. It is possible, however, that a stimulus during current times, when losses are not as large as they were in 2002-2004 when the economy was already in a recession, could be more successful.

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[11] Darryl Cohen and Jason Cummins, *A Retrospective Evaluation of the Effects of Temporary Partial Expensing*, Finance and Economics Discussion Series 2006-19, Federal Reserve Board, Washington, D.C. April 2006. They compared investment increases for shorter lived and longer lived assets (longer lived assets received a larger incentive) and investment closer to expiration to test the effects.

[12] Matthew Knittel, *Corporate Response to Bonus Depreciation: Bonus Depreciation for Tax Years 2002-2004*, U.S. Dept. of Treasury, Office of Tax Analysis Working Paper 98, May 2007.

[13] Christopher House and Matthew Shapiro, *Temporary Investment Tax Incentives: Theory With Evidence from Bonus Depreciation*, National Bureau of Economic Research Working Paper 12514, Cambridge, MA., September 2006.

The 2003 Dividend Relief

The third provision that was advanced as a short term economic stimulus was an Administration proposal to eliminate taxes on dividends in 2003. Eventually a proposal that reduced the tax rates on dividends from ordinary rates to 15% was adopted as a temporary measure; a reduction in the top capital gains tax rate from 20% to 15% was also adopted.

While the provision was based on grounds of boosting the stock market and stimulating the economy, this provision would not, on theoretical grounds, be considered an effective short term stimulus. A short run stimulus must increase spending if it is to be effective, and, for a tax reduction, that increase must be either in consumption or investment. However, dividend tax relief is not likely to increase consumption spending because it tends to accrue to higher income individuals who are likely to save it. It is not an effective investment incentive because it benefits savers, not those directly making investments, and the translation from saving to investment would actually be contractionary in the short term. Thus, although the provision was advanced as a short term stimulus provision it is unlikely to be as effective for this purpose as other alternatives,[14] and the Congressional Budget Office study does not discuss it.[15]

[14] For a more complete discussion, see CRS Report Rl31824, *Dividend Tax Relief: Effects on Economic Recovery, Long Term Growth, and the Stock Market*, by Jane G. Gravelle.

[15] Congressional Budget Office, *Options for Responding to Short-Term Economic Weakness*.