Evaluating President Bush's Tax Stimulus Package

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This note evaluates President Bush's new proposals for stimulating the economy via tax cuts. We evaluate the proposals relative to a series of principles for effective stimulus proposals that we developed in earlier work.[2] Similar principles have been endorsed by the Democratic and Republican leaders of the House and Senate Budget Committees in a recent statement.[3]

The principles are derived from the idea that an effective tax stimulus package needs to do two things: maximize the extent to which it directly stimulates new economic activity in the short-term; and minimize the extent to which it indirectly restrains new activity by driving up interest rates. To meet these goals, policy makers should:

- Set an overall stimulus budget first.
- Design business incentives to provide incentives for new investment, rather than windfalls for old investment.
- Design household tax cuts to maximize the effects on short-term spending.
- Focus on temporary (one-year) items for businesses and households, not permanent ones.
- Maintain long-term fiscal discipline.

The Administration's proposed tax stimulus package includes five items: A permanent tax subsidy (through partial expensing) of business investment; permanent elimination of the corporate alternative minimum tax; permanent changes in the rules applying to net operating loss carry-backs; acceleration of some of the personal income tax reductions scheduled for 2004 and perhaps for 2006; and a temporary household tax rebate aimed at lower- and moderate-income workers

We find that the Administration's proposals (with the exception of the temporary household rebate) are generally not consistent with the principles for a sound stimulus package. Most importantly, the Administration's business proposals would be *permanent* – even though temporary investment incentives would have bigger investment effects in the short-run and lower budget costs. In addition, the proposed acceleration of the personal income tax reductions would be poorly targeted for generating stimulus, because of its patterns across time and across

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[2] See William Gale, Peter Orszag, and Gene Sperling, "Stimulating the Economy Through Tax Policy: Principles and Applications," http://www.brook.edu/views/papers/gale/20011005.htm and "Tax Stimulus Options in the Aftermath of the Terrorist Attack," http://www.brook.edu/views/articles/gale/20011008.htm, or *Tax Notes*, October 8, 2001.
[3] Revised Budgetary Outlook and Principles for Economic Stimulus," Senate Budget Committee (Senator Kent Conrad, Chairman; Senator Pete V. Domenici, Ranking Member) and House Budget Committee (Rep. Jim Nussle, Chairman; Rep. John M.Spratt, Jr., Ranking Member), October 4, 2001.

households. Furthermore, the Administration's proposals may not maintain long-term fiscal discipline.

The Administration's proposal could be improved dramatically by making all of the permanent business cuts temporary, and by forgoing the option to accelerate the previously enacted tax cut.

Permanent partial expensing of business investment

Adopting a permanent tax subsidy for business investment has two disadvantages relative to a temporary incentive. The temporary incentive has lower costs, thus limiting any upward pressure on interest rates from the long-term costs of permanent changes. And even apart from their lower budgetary costs, temporary investment incentives are generally considered *more* effective for short-term stimulus than permanent ones. The temporary incentives lead firms to substitute investment into the period in which it enjoys a larger tax benefit. This point is not controversial: It has been endorsed, for example, by Glenn Hubbard, the Chair of the President's Council of Economic Advisers. In a paper he co-authored with Kevin Hassett, Hubbard argued that, "Temporary investment incentives can have even larger short-run impacts on investment than permanent investment incentives...."[4] It is not clear why the Administration is proposing a permanent investment incentive when a temporary incentive would be more effective in stimulating the economy in the short run and less expensive in the long run.

Permanent elimination of the corporate alternative minimum tax

Unlike investment incentives, which only give tax breaks to firms that are undertaking new investment, eliminating the corporate alternative minimum tax would give tax cuts to firms irrespective of whether they are investing at all. Thus, it is very poorly targeted as a stimulus measure.

The corporate alternative minimum tax (AMT) applies when corporations owe no corporate income tax because of substantial deductions or other tax preferences, relative to their income. The elimination of the corporate AMT would effectively reduce the tax rate on corporate income. But the vast the majority of such income represents a return to *previous* investment, not new investment. For example, according to data from the Bureau of Economic Analysis, the value of non-residential structures, equipment, and software amounted to more than $10 trillion at the end of 1999.[5] Yet annual investment in such areas amounts to roughly $1.3 trillion. If the return from existing capital is equal to the return from new investment, and if

[4] Kevin Hassett and R. Glenn Hubbard, "Tax Policy and Investment," in Alan J. Auerbach, Fiscal Policy: Lessons from Economic Research, MIT Press, 1997, p. 369. Hassett and Hubbard also note that policy-makers have difficulty effectively timing the applications of fiscal stimulus, and therefore argue that a temporary investment incentive could be applied at an inappropriate moment. That concern, however, raises questions about the Administration's support for investment incentives as part of it short-run stimulus package, rather than about the choice of a permanent versus temporary incentive as a stimulus tool. After all, a putative permanent investment incentive would begin at the same time as a temporary one would. From the point of view of stimulating the economy in the short run, the key question is which one would produce a larger effect over the next year or so.

[5] Bureau of Economic Analysis, "Fixed Assets and Consumer Durable Goods for 1925-99," corrected tables, June 15, 2001, http://www.bea.doc.gov/bea/dn1.htm. The $10 trillion figure reflects the current cost estimate of the net stock of private, non-residential structure, equipment, and software.

existing capital is just as likely to be subject to the corporate alternative minimum tax as new capital, roughly 90 percent of the benefits from eliminating the corporate alternative minimum tax would accrue to old investment rather than new investment. In other words, elimination of the corporate alternative minimum tax is an extremely blunt and inefficient approach to encouraging new investment in the short run. It would also cost roughly $20 billion over the next decade by some estimates.

Changes in the rules applying to carrying back losses

Under current law, corporations can offset current losses against previous income taxes for up to two years. The Bush Administration's proposal would allow such loss carry-backs for up to five years. Like the corporate AMT cuts, this proposal would reward old capital, not new investment, and thus may do little to stimulate new investment. For example, the proposal would provide tax subsidies to firms that had high profits three or four years ago, that had ceased investing, and that were currently experiencing losses. Such firms may or may not use the additional funds to undertake new investments; the tax subsidy is provided regardless of how the firms decide to use the funds. To be sure, this proposal (unlike corporate AMT repeal) would provide funds to firms that are losing money and help them weather the economic downturn. But there is no reason to make such a change permanent. Even if the goal is to provide more cash to firms with current losses, the objective could be achieved at much lower long-term budgetary cost – and therefore with less negative impact on interest rates – by making any change in the carry-back rules be temporary.

Acceleration of the tax reductions for higher-income households

Another component of the Administration's proposals would accelerate to January 1, 2002, the income tax rate cuts -- or some portion thereof -- currently scheduled to occur on January 1, 2004, and January 1, 2006. This proposal violates the principle that any household tax reductions should maximize the effect on demand in the short run, and it may *undermine* fiscal discipline in the long run. First, the proposal does not maximize the effect on demand in 2002. The ten-year cost from accelerating the reductions scheduled through 2006 would amount to more than $120 billion, yet only a small percentage of the costs would accrue in 2002. Furthermore, the accelerated rate cuts would only apply to high-income households -- those who are in the top 25 percent of the income distribution. The marginal propensity to consume income among the higher-income group who would benefit from the acceleration is below that of lower- and moderate-income groups. Since most of the cost would occur after 2002, and since the amounts that would flow to individuals in 2002 would be concentrated among those with relatively low propensities to consume, accelerating the tax cuts would have a low bang-for-the-buck.

Second, the ultimate objective of the proposal may have the effect of undermining long-term fiscal discipline. Accelerating the rate cuts would have the political effect of helping to lock in further tax rate cuts for the highest-income taxpayers. Yet in the near future, Americans will need to reconsider such further reductions in tax rates for high-income taxpayers, as the economic and budget outlook after the terrorist attack and the current slowdown become clearer. Careful consideration will have to be given to the policy adjustments necessary to maintain a sound long-term fiscal position (particularly in light of ongoing anti-terrorism costs). Steps that

would be perceived as reducing policy-makers' flexibility to re-establish fiscal discipline could actually be counter-productive in the short run, by causing long-term interest rates to remain substantially higher than they otherwise would.

A temporary household tax rebate aimed at lower- and moderate-income workers

The final component of the Administration's tax stimulus package is the only one that represents a sound short-term stimulus item. The Administration is apparently willing to endorse another round of temporary household rebates, targeted on lower and middle income households. Economic research suggests that these households have tendencies to spend a greater proportion of any new income than high-income households do – and the more the rebate is spent, the more effective it is as a stimulus. Since it is temporary and maximizes its effect on demand, this proposal represents the most auspicious component of the Administration's package.

Conclusion

With the exception of the household tax rebate aimed at lower- and moderate-income workers, the Administration's proposed tax stimulus package is flawed. It includes permanent changes that are *less* effective at stimulating the economy in the short run than temporary changes but *more* expensive. And its acceleration of the recently enacted tax cuts for higher-income taxpayers is poorly targeted and potentially counter-productive. A more effective stimulus package would combine the household rebate aimed at lower- and moderate-income workers with a *temporary* incentive for business investment.