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NET OPERATING LOSS MEASURE UNDER CONSIDERATION IN SENATE HAS LOW BANG-FOR-THE-BUCK AS STIMULUS

No Justification for Waiving PAYGO for the Provision

By Aviva Aron-Dine

According to news accounts, the Senate will soon consider a housing stimulus package (S. 2636), introduced by Senator Reid earlier this month.[1] While the package primarily targets the housing market, it also includes a measure dealing with business net operating losses.

A business experiences a "net operating loss" when its tax deductions exceed its income. Under current law, businesses may use their net operating losses to reduce their previous two years' taxable income, in which case they receive refunds of taxes paid in those years. Businesses also may use these losses to reduce their taxable income in any of the next 20 years.

Senator Reid's proposal would extend the "carryback" period from two years to five years for net operating losses that were or are incurred in 2006, 2007, or 2008.[2] A similar provision was included in the Senate Finance Committee version of the first economic stimulus package but was not included in the final legislation.

In a recent report on options for economic stimulus, the Congressional Budget Office gave the proposal to extend the loss carryback period its lowest cost effectiveness rating (out of three possible ratings).[3]

- The primary channel by which business tax cuts can stimulate a weak economy is by creating incentives for new investments to be made quickly. But, as CBO noted, "by themselves, carryback and carryover effects are unlikely to generate substantial changes in investment in the short run." The Senate proposal to extend the loss carryback period to five years would allow businesses that would otherwise have to carry *forward* some of their unused 2006, 2007, and 2008 tax deductions — that is, use them at some point in the future — to instead benefit from

[1] See, for example, Chuck O'Toole, "NOL Carryback, Mortgage Bonds in Senate Dems' Housing Stimulus Plan," *Tax Notes*, February 15, 2008.

[2] Loss "carrybacks" have a higher value than "carryfowards" because they are paid out immediately, instead of years in the future. In addition, companies cannot be certain that they will have an opportunity to use all of their loss carry forwards.

[3] Congressional Budget Office, "Options for Responding to Short-Term Economic Weakness," January 2008, http://cbo.gov/ftpdocs/89xx/doc8916/01-15-Econ_Stimulus.pdf.

these deductions immediately. However, because the provision applies to net operating losses that were incurred in 2006 and 2007, a large share of its benefits would go to reward investment and production that have *already taken place*. That does not provide an incentive for *new* business investment.

- Moreover, even in the case of net operating losses that are incurred in 2008, most of the tax deductions carried back would be either depreciation deductions for investments made in earlier years or deductions for 2008 investment and production that would have taken place anyway, with or without the added tax break.

In short, the net operating loss measure would be a highly inefficient incentive for spurring increased investment now.[4] While some have suggested that it would encourage new investment in housing, it is poorly designed for encouraging new investment in any sector of the economy.

Since the proposal would do little to reward new investment, its main effect would be simply to boost businesses' after-tax income. And evidence suggests that business tax cuts that merely increase firms' after-tax income do not provide meaningful economic stimulus. As a recent Goldman Sachs analysis notes, "companies don't spend money just because it's there to spend. To justify outlays for new projects, the expected returns have to exceed the costs, and that usually requires growth in demand strong enough to put pressure on existing resources."[5]

The most promising strategy for boosting business production and investment during an economic downturn consequently involves measures to boost *consumer* demand so that people buy more of the products that firms produce. Simply providing firms with more cash generally will not help much.

During the debate over the first economic stimulus package, members of Congress agreed to waive the Pay-As-You-Go (PAYGO) rules, which require that any tax cuts or entitlement increases be offset. Policymakers judged that it was important to provide stimulus in a timely manner and that a need for offsets would have delayed the package.

The decision to waive PAYGO for stimulus should not be abused, however, to permit Congress to enact other tax cuts without paying for them. Whatever the merits of a longer net operating loss carryback period, it is not an effective economic stimulus measure. It should therefore be subject to the usual test for tax (and spending) policies: if it is worth enacting, it should be worth paying for.

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[4] CBO does note that a loss carryback extension might be expected to have more stimulus effect if it were carefully targeted to *new* investment. For example, the extended carryback period could be limited to deductions stemming from the "bonus depreciation" measure included in the first stimulus bill. In that case, only new investment would benefit. This approach would also have the advantage of enabling businesses experiencing losses during the downturn to utilize the bonus depreciation provision. As explained above, however, the Senate provision is not targeted to new investment.

[5] GS Weekly, September 21, 2007.