

January 9, 2002

## **CBO EVALUATES MAJOR STIMULUS PROPOSALS IN NEW REPORT**

by Andrew Lee and Joel Friedman

A new Congressional Budget Office report, “Economic Stimulus: Evaluating Proposed Changes in Tax Policy,” assesses the potential of various tax proposals to provide economic stimulus. Evaluating these proposals in terms of their “bang for the buck” — that is, their ability to provide effective stimulus relative to their revenue costs — CBO concludes that:

- Relative to other proposals under consideration, a month-long holiday for the *employee’s* share of payroll taxes could have a large bang for the buck. If the employer’s share of payroll taxes were also subject to the holiday, as proposed by Senator Pete Dominici, the proposal would be less cost effective.
- Proposals that offer a moderate bang for the buck include extending the rebate to low- and moderate-income tax filers who did not receive the maximum rebate last year and providing tax incentives for businesses to undertake new investment.
- The least effective stimulus proposals are those that would accelerate reductions in marginal income tax rates, repeal the corporate Alternative Minimum Tax, reduce capital gains tax rates, and allow deferred taxation of certain (subpart F) income earned overseas by multinational corporations from financial activities.

CBO points out that to produce short-term economic stimulus, a tax provision must quickly encourage consumers to increase spending or businesses to undertake new investments.

- CBO finds that the type of “temporary cut in personal taxes most likely to produce economic stimulus would be one that put more resources into the hands of lower-income taxpayers,” because lower-income households are more likely to spend additional income and this spending boosts the economy.
- Similarly, all business tax cuts do not automatically generate stimulus. To be effective, they must encourage firms to make new investments. In the case of these investment incentives, moreover, CBO concludes that extending the period for which the tax break would apply — for instance, from one year to three years — would reduce its effectiveness as stimulus, because businesses would have less incentive to invest in the first year, when the economy is most in need.

Based on the findings of the CBO report, it appears that the most recent version of the House-passed stimulus legislation (H.R. 3529) — which the Administration has endorsed and reportedly may incorporate in its upcoming budget — would be highly inefficient at providing cost-effective economic stimulus in the near term.

- The legislation includes three of the four proposals that CBO concludes would offer the least effective stimulus — accelerated implementation of the 25 percent income tax rate, sharp reductions in the corporate AMT, and deferred taxation of subpart F income. Together, these provisions total \$81.1 billion over ten years, accounting for more than half of the cost of the House-passed bill.<sup>1</sup>
- The legislation weakens the effectiveness of its business investment provisions by keeping them in effect for three years — rather than for one year — thereby allowing firms to delay investment decisions until after the economy is recovering and still take advantage of the tax break.

By comparison, the Senate Finance Committee proposal would yield substantially more effective stimulus. It excludes all of the proposals that CBO identifies as having a small bang for the buck and limits to one year the period that its business tax incentives would be in effect.

## **CBO Analysis of Specific Proposals**

### **Holiday for employee share of payroll taxes**

CBO concludes that a month-long holiday for the employee share of payroll taxes could offer a large bang for the buck in terms of providing economic stimulus, but that there is also uncertainty about its effects. The proposal would stimulate consumption by increasing paychecks and reaching many low-income workers. CBO raises some concerns, however, noting that it may be “both time-consuming and costly” for small employers to reprogram their payroll systems to accommodate the holiday. The holiday would also apply only to those employed during the specific period covered by the holiday, excluding workers unemployed during that time.

CBO also emphasizes that if the holiday were expanded to include the employer’s share of payroll taxes — as in the payroll tax holiday proposed by Senator Domenici — its cost-effectiveness would be diminished. It points out that “a holiday for the employer’s share is unlikely to produce much stimulus” but would add significantly to the cost of the proposal. CBO points out that including the employer’s share of payroll taxes in a payroll tax holiday “would be unlikely to result in additional take-home income for workers because the time frame would be

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<sup>1</sup>In addition to the cost of the three provisions noted above, the total includes the \$6.3 billion ten-year cost of a temporary increase in the individual alternative minimum tax, which is included in the bill specifically to prevent more taxpayers from being subject to the individual AMT as a result of accelerating implementation of the 25 percent income tax rate.

### Key Principles of Economic Stimulus

The CBO report highlights how to best provide fiscal stimulus through tax cuts. CBO points out that tax cuts provide effective short-term stimulus by increasing demand — that is, boosting consumer spending and business investment. Tax cuts that are typically touted for their supply-side effects, therefore, are inappropriate for short-term stimulus because “they do not directly address the current problem of the economy’s short-term inability to use its existing capacity to produce goods and services.”

In terms of tax proposals to increase consumer spending, CBO states that “tax cuts that are targeted towards lower-income households are likely to generate more stimulus dollar for dollar of revenue loss — that is, be more cost-effective and have more bang for the buck — than those concentrated among higher-income households.” CBO reaches this conclusion based on available evidence that suggests lower-income households “tend to spend more of any additional income they receive than do higher-income households.”

CBO finds that one-time rebates may not be as effective at encouraging spending as incremental increases in paychecks, such as by lower withholding. Evidence suggests that consumers may consider more closely how they will use a rebate, leading them to save it or use it to pay down debt, while they are more likely to spend additional amounts when they are added to their paychecks incrementally.

CBO also finds that business tax cuts do *not* automatically create jobs or spur new investment. Rather, CBO points out that a tax cut that merely increases the after-tax income of businesses “does not encourage them to spend more on labor or to produce more because firms base their decision to produce output on their ability to sell it.” Similarly, CBO finds that business tax cuts must be well targeted in order to encourage new investment, noting that “the more that a business tax cut is focused on income from new capital as opposed to income from old capital, the more effective it will probably be in stimulating new investment.”

Additionally, CBO states that: “Temporarily cutting taxes on investment can provide one-time opportunities for saving that may induce firms to advance their investment plans to the present, a step they might not take if they knew that the tax advantage would remain in place and be available to them later.” Thus lengthening the effective period of investment tax incentives from one year to three years, for instance, would weaken its ability to provide stimulus.

too short for the economy to adjust wages and salaries in response. Similarly, the reduction in wage costs that the employer experienced would be too brief to make it worthwhile to increase hiring.”

**CBO Ranking of the Potential Effectiveness of  
Various Economic Stimulus Tax Policies**

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**Large “Bang for the Buck”**

Holiday on employee share of payroll taxes

Holiday on state sales taxes

**Medium “Bang for the Buck”**

Extend rebates to low- and moderate-income households

Temporary incentives for business investment

**Small “Bang for the Buck”**

Accelerate marginal rate cut (reducing the 27 percent rate to 25 percent)

Repeal corporate AMT

Deferral of tax on certain multinational corporate income (subpart F)

Reduce capital gains rates for individuals

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Source: Congressional Budget Office, “Economic Stimulus: Evaluating Proposed Changes in Tax Policy,” January 2002, Table 1, p. 27.

**Sales tax holiday**

CBO believes that the impact of sales tax holiday — whereby states would suspend their sales taxes for a fixed period, and the federal government would reimburse the states for the lost revenue — is very uncertain. It could provide a large bang for the buck, as temporarily eliminating sales taxes would provide a strong incentive for consumers to increase spending. But CBO finds that the delays associated with implementing such a holiday would “significantly undercut” the effectiveness of the proposal. For instance, CBO states that a sales tax holiday “would require action by the states that have sales taxes, which in some cases would mean calling legislatures into special session. The delays inherent in that process might make it impossible to implement timely stimulus. Consumers might actually delay some of their spending while awaiting action by the states, thereby worsening the downturn.”

## **Extended rebates**

Extending rebates to those who did not fully benefit (or benefit at all) from the original rebates issued last year under the enacted tax cut would provide a moderate bang for the buck, according to CBO. This provision stimulates consumption by putting money into the hands of lower-income households, who are more likely to spend additional income and thus boost the economy. On the other hand, CBO points out that it is unclear how consumers will respond to the rebates, noting that the rebates are relatively small and evidence suggests consumers are more likely to spend income from bigger paychecks than from rebates. On the other hand, these shortcomings are mitigated by the targeting of this proposal on low- and moderate-income tax filers. This provision has been included in all of the major economic stimulus proposals.

## **Investment incentives for business**

The Administration's plan and the House-passed bill would allow businesses to write-off (or "expense") 30 percent of the cost of certain new investments for each of the next three years. The Senate Finance Committee bill calls for 10 percent expensing for only one year. By specifically targeting new investment rather than rewarding income earned from old investments, this type of proposal offers a strong investment incentive.<sup>2</sup> However, CBO notes that extending beyond one year the period covered by this type of investment incentive "would reduce its bang for the buck because it would decrease businesses' incentive to invest in the first year and increase the total revenue cost." Thus, proposals that extend for three years would be less cost-effective than a one-year provision.

While such proposals create an incentive for firms to invest, CBO notes that an uncertain economic outlook could nonetheless deter businesses from investing. CBO states that "even very attractive incentives may be insufficient to induce firms to invest if they expect a downturn to be long or if other factors make them uneasy about the prospects for future sales of expenses." Furthermore, CBO points out that tax incentives for new investment "will still reduce the cost of investment that would have taken place anyway." Thus firms are rewarded with a tax break for investments that would have been made in any case. (While creating a tax incentive that only targets investments above a certain level would be more cost-effective, such incremental incentives are hard to design and difficult to implement, according to CBO.) As a result, CBO rates business incentives that rely on partial expensing as offering a moderate bang for the buck.

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<sup>2</sup>Both the House and Senate measures include expensing provisions to encourage investment by small businesses, but CBO found that these proposals "would have little effect on investment demand."

### **Accelerating marginal rate cuts**

CBO finds that proposals to accelerate marginal tax rate reductions enacted last year but not scheduled to go into effect until 2006 — for instance, implementing the 25 percent rate beginning in 2002, as included in the most recent House-passed bill — would not be effective stimulus. It states that “compared with other personal tax cuts, the first-year stimulus that this proposal would generate relative to its total revenue loss is probably small.”

CBO reaches this conclusion for two principal reasons. First, these rate cuts would only benefit the top 30 percent of taxpayers — leaving out 70 percent of taxpayers, including lower-income households who would be more likely to spend additional income and thus boost the economy.<sup>3</sup> Second, the costs of this provision extend through 2006, with the result that three-quarters of the total cost occurs in 2003 through 2006. Not only are these costs poorly targeted in terms of stimulus, occurring in years when the economy is expected to be in recovery, by they also add unnecessary costs in years when the budget outlook has deteriorated and deficits are now expected.

### **Eliminating the corporate AMT**

Eliminating the corporate AMT would be ineffective stimulus because it provides little incentive for businesses to undertake new investment. CBO notes that eliminating the corporate AMT “does little by itself to change the near-term incentive for businesses to invest. Its bang for the buck is small because it primarily reduces taxes on the return from capital already in place rather than provides an incentive for new investment.” Only new investment by business provides stimulus to the economy.

The revised House-passed stimulus bill (H.R. 3529) does not repeal the corporate AMT, but sharply reduces it by eliminating adjustments for depreciation and limitations on net operating losses and foreign tax credits. These changes do not improve the provision’s effectiveness as stimulus, according to CBO. The CBO report points out that because the change in the treatment of depreciation under the corporate AMT is permanent, it would not create an incentive for firms to accelerate future investment into present, which is needed to provide near-term stimulus. Similarly, “the revised treatment [under the corporate AMT] of net operating losses and foreign tax credits would do little to make new domestic investment more attractive to firms.”

### **Deferral of tax on subpart F income**

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<sup>3</sup>In other analyses, the Center has noted that, based on CBO data, accelerating marginal rate reductions would benefit only the top one-quarter of *tax filers*. This is consistent with the statement above from the CBO report that the proposal would benefit only the top 30 percent of *taxpayers*. The difference reflects the fact that some tax filers have sufficiently low incomes that, after allowable deductions and exemptions, owe no income tax and thus are not considered taxpayers under the CBO definition. The proposal would benefit a smaller share of tax filers than of taxpayers.

Since 1998, a provision has been enacted each year that allows multinational corporations to defer the taxation of income earned through certain banking, finance, and insurance activities by subsidiaries overseas that, under normal (subpart F) rules, would be taxable in the year that it is earned. Deferred taxation effectively provides a subsidy for this income earned abroad. This exception to the subpart F rules expired at the end of 2001. The Senate Finance Committee proposed extending this exception to the subpart F rules for one year, along with a number of other temporary tax provisions that expired at the end of 2001. On the grounds that the provision would yield economic stimulus, the stimulus bill the House passed in October would have made the provision permanent, while the recent House stimulus bill extends the provision for five years. CBO concludes that allowing deferred taxation of subpart F income “would provide little stimulus (because it would primarily affect income from existing capital and foreign rather than domestic economic activity).” This provision would benefit multinational corporations engaged in banking, finance, and insurance activities overseas, but do little to stimulate domestic investment.

### **Capital gains tax cut**

CBO concludes that “capital gains tax cuts would provide little fiscal stimulus.” First, benefits would accrue to higher-income households, which are less likely to spend additional income. Second, reducing capital gains tax rates increases the rate of return on saving and thus encourages increased saving, not consumption. This provision consequently makes little sense in the context of short-term economic stimulus, where what is needed is a boost in consumption, not an increase in savings. Although the House included a capital gains tax cut in its original stimulus measure, the provision was dropped from the most recent version.