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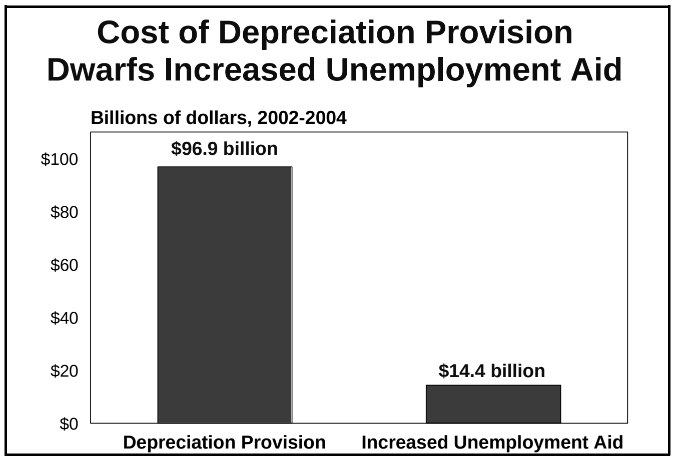
# MULTI-YEAR BUSINESS TAX CUTS STILL DWARF AID TO UNEMPLOYED WORKERS IN NEW HOUSE BILL

by Joel Friedman and Isaac Shapiro

The House of Representatives is scheduled to consider on Thursday, March 7, its fourth version of economic stimulus legislation. Some are portraying the House bill as a dramatic compromise, producing a bill that emphasizes increased weeks of benefits to the unemployed. This is not an accurate characterization. Although the new House bill represents an important step forward from previous versions of the bill in that it no longer includes some costly and ill-designed tax provisions, the lion's share of the bill continues to consist of multi-year tax cuts for businesses that the Congressional Budget Office and other economists have concluded are poorly designed to provide a short-term economic boost. The bill's depreciation provision alone would cost close to $97 billion over the next three years, or nearly seven times the $14.4 billion cost of the provisions providing additional assistance to the unemployed over that period.




- The business depreciation bonus in the House bill would be in effect for three years. CBO has concluded that allowing a depreciation bonus for *three* years rather than one year would sharply reduce the effectiveness of this proposal as economic stimulus. With a three-year provision, firms can delay investment until well after the economy has recovered — thereby defeating the goal of boosting the economy when it is weak — and yet still receive the tax break. Similarly, the bill extends for *five* years a tax break for financial corporations with overseas operations, with 96 percent of the tax cuts received after 2003, when the economy is expected to have recovered.

- The bonus depreciation provision would also worsen the fiscal situation in states — which are facing budget deficits of $40 billion to $50 billion, according to the National Governors Association. Because state tax codes are tied to the federal code, the House bill would lead states to lose $5.1 billion in state tax revenue in the current year and $14.1 billion over the next three years. This would not only exacerbate the fiscal problems in states, many of which are being forced to cut programs or raise taxes to meet balanced budget requirements, but such belt-tightening actions hinder the economic recovery.

Unlike the last two stimulus bills the House passed and the stimulus bill the Senate Finance Committee approved last fall, the new House bill includes *no fiscal assistance whatsoever to states* to offset the state revenue losses that the depreciation provision would cause.

- At a cost of $97 billion over the next three years, the bonus depreciation provision is the most expensive tax cut in the bill. Yet its ultimate cost could be far larger: there is strong reason to believe this provision would not be allowed to expire after three years. By the end of its three-year duration, most of which would have been during a period of economic recovery rather than during a recession, its rationale as short-term stimulus is likely to have faded. Efforts to extend it at that time, backed by powerful corporate lobbying, would be a certainty. Moreover, under the House bill, the measure would be slated to expire *less than two months before the 2004 election,* virtually ensuring there would be maximum political pressure to continue this tax break. If continued, this measure would cost more than $200 billion over the decade, according to Joint Tax Committee estimates.

- The House bill also contains a provision permitting firms to reduce contributions to pension funds for their employees.

Federal Reserve Chairman Alan Greenspan and Congressional Budget Office Director Dan Crippen, among others, have noted signs of improvement in the economy. On March 6, Crippen testified that "The economy is currently rebounding in a remarkable fashion." Today, Greenspan testified that "the recent evidence increasingly suggests than an economic expansion is well underway." The improved economy — including an incipient rise in business investment (see box on page 4) — suggests there is much less need now than there was last fall for proposals whose objective is said to be to encourage business investment to spur recovery from a recession, especially when most of the period over which the proposals would be in effect would be well after the recession has ended.

It would constitute sounder fiscal and economic policy for Congress to dispense with such provisions and to focus now on addressing hardships faced by unemployed workers. Unemployment often continues to rise for a number of months after a recession ends, and Chairman Greenspan stated last week that the Federal Reserve has estimated that the unemployment rate will rise to between 6.0 percent and 6.25 percent before beginning to subside. Moreover, Labor Department data indicate that the number of workers who have exhausted their regular unemployment benefits without qualifying for additional aid has reached record levels.

These issues are discussed in more detail below.

## Problems with House Depreciation Provision

The House depreciation provision would allow businesses to write-off more quickly the cost of various purchases and investments. Last fall and early this winter, a number of economists advised that such a proposal could provide useful near-term stimulus *if* it were made effective for one year. Doing so would encourage firms to accelerate purchases into 2002 to take advantage of this tax break.

But the House bill would make the provision effective for three years rather than one. CBO has warned that lengthening the effective period of this provision would weaken its ability to stimulate the economy. "Temporarily cutting taxes on investment can provide one-time opportunities for saving that may induce firms to advance their investment plans to the present," CBO noted, but it counseled that firms "might not take [such action in the near-term] if they knew that the tax advantage would remain in place and be available to them later."

Keeping this provision in place for three years would result in costs of $32 billion in 2003 and $29 billion in 2004, worsening the budget outlook in those years. If allowed to expire after three years, the provision begins to recoup some of the lost revenues, such that the total cost over 11 years is $16 billion.[1] It is more likely, however, that the provision will not be allowed to expire. Because the tax break would remain in effect long into the expected recovery, it would likely come to be seen as a normal feature of the tax code, thus making its extension at the end of the three-year period more probable. With the provision scheduled to expire on September 11, 2004 — two months before an election — there will be substantial political pressure to continue the tax break. If it were extended and remained in effect throughout the decade, its cost would be more than $200 billion over ten years, a hefty price for a policy of dubious impact.

### Provision Would Worsen the Budget Situation in the States

A depreciation tax cut at the federal level also would cause 46 states to lose state tax revenues because state tax codes are tied to the federal code. The business depreciation tax cut in the House bill would lead states to lose $4.8 billion in state tax revenue in the current year.[2] When the additional revenue losses the District of Columbia and New York City would incur are taken into account, the total revenue loss reaches $5.1 billion. Because the

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[1] Although the cost of the bonus depreciation provision is $96.9 billion through 2004, its cost from 2002 to 2012 falls to $15.8 billion, reflecting the shift in timing of investment decisions and the impact of the bonus on future depreciation deductions.

[2] This estimate is consistent with the $5.4 billion estimate produced in separate analyses by the Congressional Research Service and the Center on Budget and Policy Priorities. The previous estimate was based on last year's Joint Committee on Taxation cost estimate of the depreciation provision. The Joint Tax Committee has now released a new cost estimate of the stimulus bill the House is scheduled to consider on March 7, which reflects a modestly lower cost for the depreciation provision. The $4.8 billion loss of state revenues noted above is consistent with the new Joint Tax Committee estimate. See Joint Committee on Taxation, "Estimated Revenue Effects of the Job Creation and Worker Assistance Act of 2002," JCX-13-02, March 6, 2002.

**Rebound in Business Investment Indicates Less Need for Depreciation Proposal**

An array of new data suggests that there already is an economic upturn. The new data show that the economy actually grew in the fourth quarter of 2001. In addition, inventory levels have fallen to such low levels that forecasters have suggested this could lead to a substantial increase in production. Chairman Greenspan put it this way: "Hence, with production running well below sales, the lift to income and spending from the inevitable cessation of inventory liquidation could be significant."[a] The increase in production, in turn, will likely boost business investment. In fact, the latest government data show that in January 2002, both the shipment of, and new orders for, manufacturing goods increased. This is the second straight month of increases in both areas.

This economic evidence suggests there is much less need now than there appeared to be last fall for government action to boost business investment. This investment appears to be recovering on its own. The economic evidence helps explain why, according to Mr. Greenspan, the Federal Reserve Board itself decided not to lower the federal funds rate in January. It further indicates that Congress should be less eager to intervene here with mechanisms whose economic benefits are suspect, as would be the case with a three-year depreciation tax break, but whose budgetary costs are high, especially in years after the downturn has ended.

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[a] Testimony of Chairman Alan Greenspan before the Committee on Financial Services, U.S. House of Representatives, February 27, 2002.

depreciation provision would remain in effect for three years, states (including D.C. and New York City) would lose an additional $9.0 billion in 2003 and 2004, for a total of $14.1 billion.

Unlike previous versions of the House bill, however, this new iteration includes *no fiscal relief to states* to offset even a portion of the adverse impact of the bonus depreciation on the states. In a letter sent to Congressional leaders on March 7, the National Governors Association said that "in order to protect states from the multi-billion dollar state revenue loss associated with its tax relief provisions, any economic stimulus package passed by the Congress must include a temporary increase in the federal medical assistance percentage (FMAP) for state fiscal relief."

The NGA estimates that state budget shortfalls will total between $40 billion and $50 billion for the current fiscal year. Since states must balance their budgets even in recessions, they are being compelled to institute sizeable budget cuts and/or tax increases. Such actions by states further dampen the economy. Although a number of economists have advised that providing fiscal relief to states to lessen the magnitude of these state fiscal actions would be one of the most effective forms of economic stimulus the federal government could provide, the House bill provides no net fiscal relief and instead makes the budget shortfalls larger in a number of states.

Finally, most states anticipate serious fiscal difficulties to continue at least through 2003, due to lagging revenues and high unemployment levels that are expected to continue for a number of months after the recession ends. Some states, including Alabama, Florida, North Carolina, and Ohio, have already enacted major budget cuts and/or tax measures that will carry

**Cost to States of Depreciation Provision, federal fiscal years 2002 – 2004**
*(in millions of dollars)*

| | | | |
|---|---|---|---|
| **Alabama** | -135 | **Montana** | -52 |
| **Alaska** | -168 | **Nebraska** | -81 |
| **Arizona** | -262 | **Nevada** | not affected |
| **Arkansas** | -129 | **New Hampshire** | -103 |
| **California** | not affected | **New Jersey** | -633 |
| **Colorado** | -210 | **New Mexico** | -95 |
| **Connecticut** | -240 | **New York*** | -2,646 |
| **Delaware** | -74 | **North Carolina** | -469 |
| **DC** | -96 | **North Dakota** | -37 |
| **Florida** | -511 | **Ohio** | -474 |
| **Georgia** | -426 | **Oklahoma** | -115 |
| **Hawaii** | -50 | **Oregon** | -246 |
| **Idaho** | -75 | **Pennsylvania** | -814 |
| **Illinois** | -872 | **Rhode Island** | -45 |
| **Indiana** | -433 | **South Carolina** | -139 |
| **Iowa** | -146 | **South Dakota** | -18 |
| **Kansas** | -137 | **Tennessee** | -262 |
| **Kentucky** | -176 | **Texas** | -810 |
| **Louisiana** | -137 | **Utah** | -105 |
| **Maine** | -72 | **Vermont** | -27 |
| **Maryland** | -283 | **Virginia** | -330 |
| **Massachusetts** | -645 | **Washington** | not affected |
| **Michigan** | -144 | **West Virginia** | -86 |
| **Minnesota** | -427 | **Wisconsin** | -337 |
| **Mississippi** | -133 | **Wyoming** | not affected |
| **Missouri** | -211 | **Total** | **-14,118** |

** The total for New York includes revenue loss for New York City resulting from the interaction between the depreciation provision and the city's income tax, as well as the revenue loss to the State.*

over into 2003. Other states have been able to draw upon reserves and make other budget adjustments to avoid major service cuts and tax increases in 2002, but will not be able to forestall such cuts or tax increases in the 2003 fiscal year. If states (including D.C. and New York City) lose an additional $4.7 billion in 2003 as a result of Congress' extending the depreciation tax cut into a second year, they will have to cut programs or raise other taxes to a greater degree to make up for this loss.

Many state legislatures are meeting now to consider and act on their fiscal year 2003 budgets. Examples of tax changes that governors have recently proposed to help balance their 2003 budgets include increased sales, cigarette and gasoline taxes in Kansas, postponement of an income tax cut in Maryland, excise tax increases in Washington, fuel tax increases in Michigan, and rollback of an income tax reduction in Oregon. Many states also have implemented or are seriously considering reductions in an array of programs in 2003, including cuts in Medicaid and the State Children's Health Insurance Program (SCHIP) that would affect thousands of low-income children and elderly and disabled people. For example, New Mexico may eliminate its

SCHIP program for children entirely.[3] Tennessee has proposed cutting Medicaid eligibility for 180,000 low-income people. Some states, such as Florida and Oregon, are likely to cut coverage for the "medically needy," a group of low-income people who incur catastrophic health care expenses. Some other states will no longer cover disabled workers returning to work and low-income women with breast and cervical cancer. In addition, a number of states, including Indiana, Maine and New Jersey, are suspending measures to reach more of the uninsured.

## Tax Breaks for Financial Corporations with Foreign Operations

The House bill also would extend for five years a tax break for multinational corporations engaged in banking, finance, and insurance activities overseas. This provision would benefit these multi-national financial corporations handsomely by allowing them to defer from taxation certain income earned overseas.[4] But it would do little to stimulate domestic investment. In its recent report, CBO concluded that allowing deferred taxation of this overseas income "would provide little stimulus (because it would primarily affect income from existing capital and foreign rather than domestic economic activity)."

Moreover, *less than four percent* of the $9.0 billion in tax cuts this measure would provide to financial corporations would come in fiscal year 2002. Over 96 percent of these tax benefits would come in years after that. This further diminishes any minor stimulative effect the measure might have.

The five-year extension the House bill would provide for this tax break is more favorable treatment than the two-year extension the bill provides for other expiring tax provisions.

## Reduction in Employer Pension Contributions

The House plan also includes a provision that would allow firms to reduce pension contributions to pension funds for their employees. This provision was not considered in the Senate, nor was it in the original House-passed stimulus measure. It appeared for the first time in the stimulus bill the House passed in December.

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[3] Under SCHIP, states may chose to expand Medicaid or establish separate state programs as a way to provide expanded coverage for low-income children. New Mexico elected to use Medicaid and may drop its Medicaid expansions.

[4] Under current law, U.S. firms are taxed on some types of income earned by foreign corporations they control, regardless of whether the income is distributed back to the United States. The purpose of these rules is to prevent international firms from using internal organizational shifts and distorted internal pricing practices to hide income from U.S. taxation. A temporary provision, which expired at the end of 2001, exempted income earned in banking, finance, and insurance from these rules and therefore effectively provided a subsidy to income that is earned abroad and not distributed back to the United States. It is this provision that the House bill would extend for five years.

Funding requirements for defined benefit pension plans depend on an interest rate: The higher the interest rate, the lower the pension contributions a firm is required to make, since a higher interest rate means that smaller contributions to a pension fund are needed to provide workers a given level of pension benefits in future years. Accordingly, firms are allowed to make lower pension contributions when interest rates are high but must make larger contributions when interest rates are low. Since interest rates have fallen in the past few years, the required contributions to defined benefit plans have risen, balancing the lower contributions that many firms made when interest rates were high.

The House bill would artificially raise the assumed interest rate that is used to determine the required level of pension contributions for the next two years, thereby reducing the contributions that firms are required to make. Some adjustment to the assumed interest rate may be justified because the 30-year bond is disappearing, but the adjustment included in the new package appears to exceed what can be justified on this basis and to reduce the level of pension contributions that firms are required to make on behalf of their employees by more than is warranted.[5]

## Conclusion

The new House bill is being mischaracterized as a measure that is primarily intended to provide extended benefits for the unemployed. A front page story in one of the nation's leading newspapers, for instance, included the headline: "House Relents in Fight Over Stimulus: Bill Focusing on Aid for Jobless Backed."[6] Contrary to these reports, however, the new House bill remains dominated by multi-year tax cuts for business that the Congressional Budget Office and other economists have criticized as providing a low "bang for the buck" in terms of stimulating the economy. Although the House has now dropped some ill-advised and costly provisions that were part of previous bills, the new bill continues to call for allowing large depreciation deductions for businesses for the next *three* years rather than for one year (undermining the provision's short-term effect and raising its costs considerably) and extending for *five* years a tax break for financial corporations with overseas operations (with 96 percent of the tax cuts received after 2003). From 2002 to 2004, the cost of the depreciation provision alone is nearly seven times the cost of the additional unemployment insurance aid in the bill. Further, with the depreciation provision scheduled to expire two months before the 2004 election, there would be strong pressure to extend this costly tax break, creating a permanent loss of revenues that the budget can ill-afford over the long run.

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[5] Peter Orszag and David Gunter, "Note on Proposed Change in Assumed Interest Rate for Defined Benefit Pension Plans," The Brookings Institution, February 2002.

[6] Juliet Eilperin and Glenn Kessler, "House GOP Relents in Fight Over Stimulus: Bill Focusing on Aid for Jobless Backed," *The Washington Post*, March 7, 2002.