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BONUS DEPRECIATION TAX CUT UNLIKELY TO PROVIDE EFFECTIVE ECONOMIC STIMULUS

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Stimulus legislation enacted in February included a provision that increased the tax deduction which businesses can claim when they purchase certain types of equipment and place it in service during the 2008 tax year. Suggestions are being made that this "bonus depreciation" provision — a form of accelerated depreciation for businesses — be extended through 2009.

It is too early to evaluate how much, if any, economic stimulus the bonus depreciation provision has provided this year, but evidence from similar measures enacted in 2002-2003 suggests not much should be expected. That same evidence also suggests that extending the bonus depreciation provision would be a poor use of funds available for economic stimulus and would reduce the overall "bang-for-the-buck" of a stimulus package, compared with devoting the money to more targeted and effective measures.

Indeed, of the stimulus measures examined by economist Mark Zandi of Moody's Economy.com, accelerated depreciation delivers the *lowest* bang-for-the-buck: Zandi's estimates show that while a dollar spent on accelerated depreciation for businesses will generate only 27 cents of additional demand, a dollar spent on measures such as extending unemployment insurance benefits, providing a temporary increase in food stamp benefits, or delivering fiscal relief to states would generate more than a dollar of additional demand.[1]

One of the main reasons that the bonus depreciation tax break is unlikely to be an efficient method of providing stimulus is that a substantial fraction of the investment for which the tax break is provided would likely have been made anyway and thus does not represent additional demand that stimulates the economy.

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[1] Mark Zandi, testimony before the House Committee on Small Business hearing titled, "Economic Stimulus For Small Business: A Look Back and Assessing need for Additional Relief," July 24, 2008. Bang-for-the-buck estimates reflect the resulting change in Gross Domestic Product in the year after spending occurs.

The 2002-2003 Bonus Depreciation Provisions Had "Only a Very Limited Impact"

Bonus depreciation investment incentives were enacted in 2002 and expanded in 2003 to provide stimulus during the last recession. Subsequent studies of the impact of the 2002 and 2003 bonus depreciation provisions have raised serious questions about their effectiveness.

- A study by two Federal Reserve economists found that based on the available evidence, these measures had at best "only a very limited impact" on investment spending.[2]

- Another study found that these measures "increased output by only 0.1 percent to 0.2 percent."[3]

- The Congressional Budget Office has concluded that the available evidence suggests that the impact of the 2002 and 2003 bonus depreciation measures on investment has been "relatively modest," and "the experience has made many analysts less sanguine about the efficacy of such business tax incentives."[4] Similarly, CBO's director, Peter Orszag, has written that "the experience from bonus depreciation provisions enacted during 2002 and 2003… was somewhat disappointing."[5]

Why Any New Bonus Depreciation Measures May Have a "Very Limited Impact"

In theory, it might be that the 2002 and 2003 bonus depreciation measures had only a very limited impact due to circumstances unique to the last recession. In fact, there are good reasons to question whether bonus depreciation in general is likely to provide effective economic stimulus.

- During an economic downturn, aggregate demand lags, and existing capacity is not fully utilized. Companies that face a decrease in demand for their products have little incentive to expand their capacity, regardless of available tax incentives. If they cannot sell their goods or services, then expanding capacity generally does not make business sense. While some types of temporary tax incentives might encourage some firms to make investments quickly — that is, before the incentives expire — firms typically hesitate to increase investment when they lack confidence in their ability to sell their products.

- In other words, businesses base investment decisions primarily on expectations about their ability to sell their goods and services — i.e., on customer demand — rather than on how much cash they have on hand. A recent Goldman-Sachs analysis made this point, noting that

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2 Darrel S. Cohen and Jason Cummins, "A Retrospective Evaluation of the Effects of Temporary Partial Expensing," Federal Reserve Board, Finance and Economics Discussion Series Working Paper No. 2006-19, April 2006.

3 Congreasional Budget Office, "Options for Responding to Short-Term Economic Weakness", Statement of Peter R. Orszag, Director, before the United States Senate Committee on Finance, January 22, 2008, citing Christopher House and Matthew Shapiro, *Temporary Investment Tax Incentives: Theory with Evidence from Bonus Depreciation*, NBER Working Paper 12514 (Cambridge, Mass.: National Bureau of Economic Research, September 2006).

4 Congreasional Budget Office, "Optoins for Responding to Short-Term Economic Weakness", Statement of Peter R. Orszag, Director, before the United States Senate Committee on Finance, January 22, 2008, http://www.senate.gov/~finance/hearings/testimony/2008test/012208potest.pdf.

5 Peter Orszag, Director of the Congressional Budget Office, "Economic Stimulus", January 22, 2008, http://cboblog.cbo.gov/?p=57.

"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."[6]

- In addition, as the Congressional Budget Office has noted, "some investment projects involve long planning lags, extending well beyond a year or more." If this is generally true, bonus depreciation may be ill-suited to delivering timely, short-run stimulus.

- Finally, firms may come to expect that "temporary" bonus depreciation measures will be extended, as they were in 2003 — and as is being proposed now. If firms believe that they can postpone investment decisions until consumer demand strengthens and still get the investment tax breaks, they will be inclined to defer those investment decisions, thereby rendering the tax incentives ineffective as immediate stimulus.

Other Stimulus Measures Have Better Bang-for-the-buck than Bonus Depreciation

Even if bonus depreciation does provide some stimulus by inducing some firms to accelerate their investment plans in situations where temporary weakness in the economy has caused the firms to postpone planned investments, the stimulus effect of such incentives are likely to be more modest

Relative "Bang for the Buck" of Various Proposals Considered for Stimulus

	Demand generated per dollar of cost
High "Bang for the Buck"	
Temporary increase in Food Stamp benefits	$1.73
Extended UI benefits	$1.64
State fiscal relief	$1.36
Refundable, one-time lump-sum tax rebate	$1.26
Increase Child Tax Credit	$1.04
Non-refundable, one-time lump-sum tax rebate	$1.02
Lower "Bang for the Buck"	
Extended Alternative Minimum Tax patch	$0.48
Dividend and capital gains tax cuts made permanent	$0.37
Corporate tax rate cut	$0.30
Extension of Bush income tax cuts	$0.29
Accelerated depreciation for businesses	$0.27

Source: Mark Zandi, testimony before the House Committee on Small Business hearing titled, "Economic Stimulus For Small Business: A Look Back and Assessing need for Additional Relief," July 24, 2008. Bang-for-the-buck estimates reflect the resulting change in Gross Domestic Product in the year after spending occurs.

[6] Goldman Sachs Weekly, September 21, 2007.

than certain other measures — in particular, than measures that either put the same amount of money directly in the pockets of households who will spend it or that avert spending cuts or tax increases that budget-strapped state governments otherwise will impose. As noted, a substantial fraction of the investment benefiting from depreciation tax incentives would likely have been made anyway and hence would not represent additional demand.

Estimates by economist Mark Zandi of Moody's Economy.com show that bonus depreciation delivers relatively poor "bang-for-the buck" in terms of demand generated per dollar of cost. While a dollar spent on accelerated depreciation for businesses will generate only 27 cents of additional demand, a dollar spent on measures such as extending unemployment insurance benefits or delivering fiscal relief to states would generate more than a dollar of additional demand. Bonus depreciation would consequently be a poor candidate for inclusion in an economic stimulus package designed to achieve the best bang-for-the-buck.

Conclusion

Despite expectations to the contrary, the 2002-2002 bonus depreciation measures apparently had only a very limited impact in stimulating the economy. There are good reasons to think that bonus depreciation measures would have a similarly modest impact if extended through 2009 as some policymakers are considering. Instead, the approximately $7 billion over ten years that a one-year extension of bonus depreciation would cost[7] would be better spent on temporary measures such as expanded unemployment insurance, state fiscal relief, temporary increases in food stamps, and tax rebates — measures more likely to deliver effective economic stimulus that is timely, targeted, and temporary.[8]

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[7] Assuming the bonus depreciation measure is the same as the one enacted in the Economic Stimulus Act 2008.

[8] See "The Four Pieces of Effective Fiscal Stimulus: Unemployment Insurance, State Relief, Food Stamps, and Tax Refunds", Center on Budget and Policy Priorities, January 14, 2008. For a detailed discussion of principles for fiscal stimulus, see Chad Stone and Kris Cox, "Economic Policy in a Weakening Economy", Center on Budget and Policy Priorities, revised January 17, 2008.