CTJ Citizens for Tax Justice

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Preliminary Analysis of Obama's Stimulus Tax Cuts: Could Be Worse, Could Be a Lot Better

President-elect Obama and Congressional leaders are discussing plans for economic stimulus legislation to be enacted in the coming weeks or months. The two-year package being discussed is said to cost around $775 billion and a surprisingly large $300 billion of that would go towards tax cuts. All of it would be deficit-financed.

As explained in a previous report from Citizens for Tax Justice, a large increase in government spending, even if it is deficit-financed, may be justified as a way to boost demand and mitigate the current economic downturn. Most economists believe that the current recession is caused largely by a drop in demand for goods and services. The federal government can increase spending in ways that lead to an immediate boost in consumption so that businesses are less likely to have to cut staff or close, and thus help keep the downturn from reaching a level of severity that is truly destructive and more difficult to reverse.

Tax cuts are generally less effective in stimulating demand than direct government outlays. But tax cuts targeted to the people who are most likely to immediately spend any money they receive, namely low- and middle-income people, are more effective than upper-income tax reductions. Tax cuts for business are far less likely to be an effective stimulus.

The Refundable $500 "Making Work Pay" Credit

One provision likely to be included in the new administration's stimulus package is a tax credit that could — if improved from its current form — be sufficiently targeted to low- and middle-income people to do some good. During his presidential election campaign, Barack Obama proposed what he calls the Making Work Pay Credit (MWPC), a refundable $500 per-worker credit ($1,000 for a married couple if both spouses work). This is the equivalent of each working spouse getting a break from Social Security taxes on up to $8,100 of earnings. The Obama campaign had said that this credit

Impact of Obama's Making Work Pay Credit in 2009

Income Group	Total Tax Cut ($Billions)	Average Tax Cut (Dollars)	Share of Total Tax Cut	% with tax cut
Lowest 20%	$ –7.7	$ –271	12.2%	63%
Second 20%	–10.2	–357	16.1%	71%
Middle 20%	–12.8	–448	20.2%	81%
Fourth 20%	–16.7	–587	26.4%	87%
Next 15%	–14.3	–668	22.5%	85%
Next 4%	–1.6	–283	2.5%	40%
Top 1%	–0.0	–7	0.0%	1%
ALL	**$ –63.4**	**$ –438**	**100.0%**	**74%**
Addendum:				
Bottom 60%	–30.7	–359	48.4%	71%
Top 20%	–15.9	–558	25.1%	72%

Source: ITEP Microsimuluation Model, January 2009

All tax units are included in the figures, including those with no earnings (like retired Social Security recipients) who therefore would not receive a benefit from the Making Work Pay Credit.

would be restricted to low- and middle-income workers.

Obama now proposes to make his work credit part of the stimulus package. Reportedly, the credit would be available to workers with incomes under $200,000 (a remarkably generous definition of low- and middle-income). Another report says the credit would cost $140 billion, presumably over the two-year period that the stimulus legislation would be in effect.

The figures in the table on page one assume that the MWPC is phased out for married couples with incomes of $200,000 and unmarried people with incomes of half that amount. Using this assumption, we estimate that the two-year cost of this proposal is $129 billion (not far off from the reported cost of $140 billion).

The table illustrates the distribution of the MWPC in 2009 among taxpayers at different income levels. While the proposal would get money into the hands of people in the lower income groups, it is not particularly progressive. The wealthiest 20 percent of taxpayers would receive 25 percent of the benefits, while the bottom 60 percent of taxpayers would receive only 48 percent of the benefits. The president-elect and Congressional leaders should work to make the credit more targeted toward families who need help the most and who are most likely to spend the money they receive quickly.

Avoiding the Mistakes of the 2008 Stimulus Tax Rebates

Evidence suggests that only a modest increase in consumption resulted from the rebate checks sent to taxpayers as part of a previous stimulus plan enacted in 2008.[1] Martin Feldstein (the former top economic adviser to President Ronald Reagan) pointed out in an op-ed that the federal government spent $78 billion on the tax rebates in the second quarter of last year but consumption only increased by $12 billion in response, suggesting that most of the money was saved or used to pay down debt.

The MWPC might be more effective than last year's rebate checks if it is targeted better towards families who are facing hard times. Better-off people generally save much more of their income than do low-income people, who have little to save after they have purchased necessary goods and services. Families who are struggling the most have probably delayed many necessary purchases, meaning they are particularly likely to very quickly spend any new money they receive — regardless of whether the money comes in the form of a temporary tax cut or a permanent tax cut.

President-elect Obama and his advisers are considering providing the credit to workers by having employers reduce the tax withholdings they make from paychecks. The idea is that this might lead people to spend the money rather than save it the way that most of last year's lump-sum stimulus checks were apparently used.

Expanding the Child Tax Credit for Poor Families

Enacted during the Clinton administration, the Child Tax Credit (CTC) was significantly expanded as part of the Bush tax cuts. It is now worth up to $1,000 for each child under age 17. But many low-income families do not benefit at all from the CTC, and many others get only partial credits.

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[1] The stimulus law enacted by Congress and President Bush last year gave taxpayers tax rebates equal to income tax liability up to a maximum of $600 ($1,200 for married couples) and provided a minimum rebate of $300 ($600 for married couples). It also provided an additional $300 per dependent child. Eligibility began to phase out for taxpayers with incomes of $75,000 ($150,000 for married couples).

The CTC is limited for families who pay federal payroll taxes but who do not earn enough to have federal income tax liability. That's because the refundable portion of the credit is limited to 15 percent of earnings above $12,550 (indexed for inflation). In other words, a working family making less than $12,550 this year is too *poor* to get any child credit. (For a family of three, the poverty line was $17,600 last year.)

It has been reported that Obama's stimulus package might include a provision making the CTC more accessible to low-income families by reducing the earnings threshold for the refundable portion to $3,000, at a possible cost of $18 billion (presumably over two years).

The nearby table illustrates the distribution of the benefits of this change in 2009. We estimate that this tax cut would cost about $15 billion over two years (slightly less than the reported $18 billion cost).

This provision is clearly targeted towards families who would put any new money they receive immediately back into the economy. (This seems especially true since all the recipients would be families with children.) The poorest 60 percent of taxpayers would receive 98 percent of the benefits in 2009. It is also noteworthy that the child tax credit is structured as a work incentive, since the amount refunded to poor families is tied directly to earnings.

Impact of Expanding Refundability of the Child Tax Credit in 2009

Income Group	Total Tax Cut ($Billions)	Average Tax Cut (Dollars)	Share of Total Tax Cut	% with tax cut
Lowest 20%	$ –3.7	$ –128	50.7%	16%
Second 20%	–2.6	–92	36.3%	11%
Middle 20%	–0.8	–28	11.1%	3%
Fourth 20%	–0.1	–4	1.6%	0%
Next 15%	–0.0	–1	0.3%	0%
Next 4%	–0.0	–0	0.0%	0%
Top 1%	–0.0	–0	0.0%	0%
ALL	**$ –7.2**	**$ –50**	**100.0%**	**6%**
Addendum:				
Bottom 60%	–7.1	–83	98.0%	10%
Top 20%	–0.0	–1	0.3%	0%

Source: ITEP Microsimuluation Model, January 2009

All tax units are included in the figures, including those with no children who therefore do not receive a benefit from the Child Tax Credit.

Obama's Proposal Includes Several Unnecessary Tax Cuts for Business

President-elect Obama has decided to include in his plan several tax cuts for business that are likely to be ineffective as stimulus. Some of these are tax cuts that anti-tax lawmakers and business lobbyists often advocate, such as extra depreciation write-offs and extending the carryback limit for net operating losses (NOLs). These are being included in the stimulus package in an apparent attempt to win bipartisan support. Other tax cuts, like the $3,000 credit for each job created, were proposed by Obama during his presidential election campaign.

NOL Carryback

As a general rule, a company operating at a loss in a given year will not have to pay taxes for that year, because its deductions will wipe out its taxable income. Under current law, if a company has excess deductions beyond its taxable income for the year, it can apply those excess deductions (known as "net operating losses," or NOLs) not only against earnings in later years, but also against income taxed in the previous two years. That allows it to get a refund of previously paid taxes.

Obama's stimulus proposal would, reportedly, allow a company to apply those excess deductions to get refunds of taxes paid in the previous *five* years (instead of just the previous two).

There is no reason to think this change would lead to the creation or retention of jobs. Allowing a company to use its tax losses to get a refund of taxes paid in the more distant past does not lower the costs of doing business or make it easier to earn a profit. It would simply hand cash to business-owners who have no recent taxable income. Smart business people will expand their business only if they can profit by doing so, regardless of how much cash they have on hand. A business is likely to lay off workers if it cannot earn enough to cover expenses and enjoy a profit. Simply giving the business some cash with no strings attached will not change that.

This provision would funnel a large portion of its tax cuts to the financial and construction industries, which many analysts believe played a significant part in inflating the housing bubble that led to the current recession.

Bonus Depreciation

The stimulus bill enacted by Congress and President Bush in February of last year included so-called bonus depreciation, allowing businesses to immediately write off 50 percent of the cost of their equipment purchases. President-elect Obama is considering extending this tax break through 2009 and 2010. Several studies cited by the Congressional Budget Office show that this sort of provision does little, if anything, however, to increase economic output. In fact, one of Obama's top economic advisers, Jason Furman, co-authored a report a year ago citing evidence that depreciation tax breaks are ineffective as economic stimulus.

Businesses subtract their expenses from their receipts each year to determine their taxable income. But purchases of equipment and other types of capital are not considered expenses incurred solely in one year. Instead, the amount of the equipment that is used up each year is the annual expense. Since most types of equipment wear out only over a number of years, deductions for these purchases are spread out over a period of time.

Even without "bonus" depreciation, the current rules for writing off equipment purchases allow such costs to be written off much more quickly than the equipment actually depreciates. (Taking a tax deduction earlier rather than later is advantageous to businesses — and costly to the government — because money in hand now is worth more than money gotten later.) In recessions during the Bush administration, corporate lobbyists several times persuaded Congress and the President to augment the already generous write-off rules with so-called "bonus depreciation." The stimulus bill enacted last February is an example of this.

But there are two reasons why bonus depreciation is ineffective in stimulating the economy. First, even if it does lead to more investment and business expansion, it will not happen quickly enough. The whole point of stimulus legislation is to pump money into the economy very quickly to boost demand before the downturn sinks to a level that is more destructive and more difficult to reverse. Business investments generally take a long time to plan and any investments made in response to a new tax break might not be in place for a couple years.

Second, even putting aside the timing issue, bonus depreciation does not result in much new investment. A 2004 report from CTJ, Corporate Income Taxes in the Bush Years, found that the expanded write-offs for accelerated depreciation included in the 2002 and 2003 tax cut bills failed to increase capital investments.

The report examined 275 of America's largest corporations in 2001, 2002 and 2003. The worldwide investment by these companies fell by 15 percent during these years. (The Commerce Department reported that total investment for all U.S. companies fell 7 percent in this period.) Remarkably, the 25 corporations that reported the largest tax savings from accelerated depreciation actually *reduced their investment more* than the other 250 corporations studied.

These 25 companies reduced their total property, plant and equipment investments by 27 percent, in the aggregate, from 2001 to 2003, while the other 250 companies only decreased their investment by 8 percent. Of the 25 companies, 11 did increase their investments while 13 reduced theirs (and one did not report its investments).

25 Companies with the Largest Depreciation Tax Breaks vs. Investment Changes, 2001 to 2003

Company ($-millions)	2001-03 Dep. tax breaks	Investment Change
SBC Communications	$ 5,755	–53%
Verizon	4,473	–35%
Devon Energy	4,358	–51%
ExxonMobil	2,926	+29%
Wachovia	2,766	+120%
General Electric	2,612	–40%
ConocoPhillips	2,368	–3%
AT&T	1,539	–45%
Citigroup	1,490	+38%
Valero Energy	1,415	+148%
Burlington Resources	1,359	–48%
JPMorgan Chase	1,355	NR
Pepco Holdings	1,350	+144%
U.S. Bancorp	1,341	+124%
Apache	1,235	+4%
FPL Group	1,232	+9%
Burlington Northern Santa Fe	1,214	+18%
Weyerhaeuser	1,196	–8%
BellSouth	1,145	–47%
Exelon	946	–6%
Boeing	916	–65%
Public Service Enterprise Group	893	–33%
CenterPoint Energy	881	–46%
Union Pacific	876	+11%
Fifth Third	836	+104%
Total these 25 companies	**$ 46,477**	**–27%**
Other 250 companies	24,442	–8%
All companies	**$ 70,919**	**–15%**

A 2006 Federal Reserve study reached a similar conclusion to CTJ's findings, finding that the tax break had "only a very limited impact . . . on investment spending, if any."

Obama's New American Jobs Credit

During his presidential campaign, Obama proposed a $3,000 "New American Jobs Credit" that companies would receive for each new employee hired. This credit would be refundable, meaning businesses that have no taxable income but that still hire some new employees would receive money from the IRS. Obama and his advisers are reported to believe that this would cost around $40 to $50 billion (presumably over two years).

Unfortunately, it is very difficult to imagine how this policy could be implemented effectively.

For one thing, some companies are going to increase their workforce even without this tax credit but would nonetheless receive the benefits. It's difficult to imagine that $3,000, a fraction of the cost of hiring a new employee, will prod many companies to make hires that they would not otherwise make. And such a credit would not stop companies that are destined to shrink (like automobile manufacturers) from laying off employees, since apparently only companies with an expanding, or at least stable workforce would be eligible.

There is also potential for companies to use manipulative planning to claim the credit even when they have not truly created any new jobs. A two-year job-creation credit was implemented in the 1970s during the Carter administration, but when it expired, few complained for this very reason.[2]

The $3,000 credit that Obama proposes would be particularly prone to problems because it would be refundable. The IRS could end up writing checks to a lot of businesses with lobbyists who want to keep the cash flowing for longer than two years. One possible result is that it could become one of the "tax extenders," or temporary tax cuts that Congress inevitably extends every couple years in order to placate business interests.

Congress and the New President Have Many Options to Stimulate the Economy. They Should Not Waste Money on Ineffective Schemes.

As explained in a previous CTJ report, there are many ways to use government spending to pump money directly into the economy in ways that will immediately boost consumption, such as increased Food Stamps, unemployment insurance benefits, "shovel ready" infrastructure projects, health-care reform, and aide to cash-strapped state governments who must otherwise cut back spending and lay off workers. If tax cuts must be included in the stimulus package, Congress and the new president should limit them to ones targeted to the families who are mostly likely to immediately spend any money they receive. The proposed improvement in the Child Tax Credit is targeted in this way, and the Making Work Pay Credit could be modified so that it is better targeted as well. Tax breaks for business, on the other hand, are unlikely to help stimulate the economy and mitigate the current recession.

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[2]Martin Sullivan, "Obama's Not-So-New Jobs Tax Credit," *Tax Notes*, October 20, 2008.