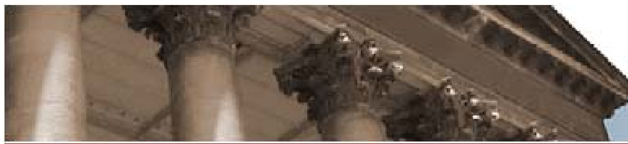


JOINT ECONOMIC COMMITTEE
SENATE REPUBLICANS

SENATOR SAM BROWNBACK, SENIOR REPUBLICAN SENATOR

January 24, 2008

PROVIDING STIMULUS INCENTIVES FOR BUSINESSES

Current discussions of fiscal stimulus measures have focused on provision of rebate checks to households to provide, it is hoped, a Keynesian-style temporary boost to aggregate demand for goods and services in the economy. The hoped-for boost in demand is desired by proponents of fiscal stimulus to confront recent signs of slower economic growth. While, for some, it is a foregone conclusion that the economy is in or is surely headed for a recession, that conclusion is based as much on hunch as on economic evidence. In any case, should Congress find utility in implementing fiscal stimulus measures in the current environment, that decision would likely follow from judgments that monetary policy is currently unusually weak in its ability to head off forces of contraction in the economy. If so, then from a risk-management perspective, it could be useful to employ all instruments of policy that are available—this means use of fiscal stimulus measures as well as monetary policy measures.

By the same principle of diversification across all available policy instruments, undue focus should not be placed on fiscal stimulus packages that rely solely or disproportionately on measures intended to boost consumer spending through tax rebates to households. Consumer spending is, indeed, important. Consumer spending accounts for around 70 percent of the Nation's output of goods and services. However, business investment spending, too, is important and has proven to be especially important around turning points in the business cycle. Given that substantial uncertainty exists in the economics profession regarding the relative efficacy of fiscal stimulus measures aimed at consumer spending and measures aimed at business investment spending, from the principle of diversification in the face of risk and uncertainty, any stimulus package should include measures aimed at promoting both business investment and consumer spending.

This brief report provides a discussion of such measures, drawing heavily on, and sometimes paraphrasing or quoting outright from, a recent report by the Congressional Budget Office (CBO).[1]

General Remarks. There are, at least, two broad ways to help stimulate business spending. One is to provide a general cut in business-income tax rates. A second is to provide tax incentives to stimulate new investment spending by businesses on things like plant and equipment.

A general business tax cut would lead to higher cash flows for businesses, which can affect investment decisions. However, its *stimulative* effect would come largely from how much it increases the attractiveness of new investment.

Some argue against reliance on tax incentives to spur new business investment spending as elements of a fiscal stimulus package. They generally believe that tax reductions focused on investment would have only a limited effect on firms' decisions to invest. First, tax

[1] "Options for Responding to Short-Term Economic Weakness," January 2008, CBO, available at .
http://www.cbo.gov/ftpdocs/89xx/doc8916/01-15-Econ_Stimulus.pdf .

reductions might apply to investment that would have been undertaken even without the incentives. Second, like general business tax cuts, their stimulative effect depends on firms' having tax liability in the first place. If a company has no tax liability, then tax cuts generate no cost reductions or tax savings. According to CBO: "The portion of investment by firms with no tax liability varies, but it is significant. By one measure, the share of investment among firms subject to the corporate income tax ranged over the past few years from a little less than 30 percent to more than 45 percent." Third, the efficacy of some types of investment stimulus, such as accelerated depreciation, may be dampened by the corporate alternative minimum tax (AMT), which can effectively undo cuts in regular corporate taxes.

There are, however, options available to counter each of these potential drawbacks. First, making incentives incremental by limiting them to investment above a certain amount (e.g., above a firm's average investment over some past period) could help focus the tax incentives more narrowly on *additional* investment providing, therefore, a boost to aggregate demand for goods and services in the economy. Second, more businesses might respond to investment incentives if the incentives were refundable or if the period over which firms could carry back the value of the tax benefit and apply it against profits in earlier years was lengthened. (The current carryback period is two years; the current carryforward time is 20 years.) Third, the corporate AMT could be modified to make incentives more effective.

Cut in Corporate Tax Rates. The most common form of a general cut in business taxes is a reduction in the corporate tax rate. Lower taxes on business income means higher after-tax returns to employing labor and capital, which can lead to increased willingness by businesses to employ more workers and invest in more capital.

Secondary effects on investment and labor demand may arise from the impact of taxes on a firm's cash flow. Some firms cannot readily borrow to make their investments or hire more labor. Because tax cuts lead to increased cash flows, they can ease credit constraints of businesses and lead to a boost in hiring and investment.

A cut in corporate rates would not, of course, apply to businesses that are not subject to the corporate tax (sole proprietorships, partnerships, and corporations organized under subchapter S). According to CBO: "Business entities not subject to the corporate income tax earned about half of net business income in 2004." Thus, tax stimulus that applied only to corporations would be less broadly applicable than stimulus that applied to all businesses—for example, through accelerated depreciation, expensing, and investment tax credits.

Incentives for New Investment. Investment incentives may be designed to be incremental. One of the biggest shortcomings of investment incentives is that although they may apply only to new investment, they still may accrue to new investment that would have been made anyway. To counter that shortcoming, some proposals have been advanced to make business investment incentives apply only to investment above a certain baseline amount. This would focus the incentives on new investment and, consequently, new spending in the economy. A possible downside would be that this approach introduces an additional level of complexity.

Taxes on new investment can be reduced by allowing accelerated depreciation or expensing of new investment, or with an investment tax credit (ITC). Accelerating depreciation or allowing for expensing of new investment would stimulate investment by helping to postpone a business's tax liability when it invests in additional plant and

equipment by concentrating tax liabilities associated with returns from the investments farther off into the future. Taxpayers benefit from any mechanism that defers tax liability, so deferral makes that investment more attractive. An investment tax credit allows a firm to reduce its tax liability in a given tax year by a percentage of the qualifying investment it places into service during that year. The effect, through deferral of tax liability, on the attractiveness of new investment is much the same as with allowances for accelerated depreciation or expensing.

Possible incentives for New Investment:

- **Depreciation and Expensing.** Businesses subtract expenses from gross income when determining taxable income. But outlays for capital investment during a year are not treated as a current expense in current tax code. Rather, the corresponding expense is the value of the capital that is used up, or depreciated, during that year. Actual economic depreciation and depreciation allowed for tax purposes may differ, however. When depreciation reported for tax purposes is faster than actual economic depreciation, it is said to be accelerated and provides an advantage to firms because it reduces their reported taxable income in the near term.

  The extreme case of accelerating depreciation is expensing—allowing the entire cost of an investment to be deducted as an expense in the year it is made. Under current law, expensing is generally targeted at small businesses. Businesses can currently expense up to $125,000 for the cost of equipment placed in service in that year. However, those deductions are reduced by the amount that the business's total qualifying investment expenditures exceed $500,000.

  In the early 2000s, policymakers expanded the depreciation rules to provide partial, but temporary, expensing of a number of capital assets, most of which had a depreciable life of 20 years or less. In 2002, the Jobs Creation and Workers Assistance Act allowed businesses to expense up to 30 percent of qualified investments purchased between September 10, 2001, and September 11, 2004. The Jobs and Growth Tax Relief Reconciliation Act of 2003 increased the deduction to 50 percent of qualified investments purchased after May 5, 2003, and before January 1, 2005. The provisions for partial expensing expired on January 1, 2005.

  Researchers have used two features of this recent policy innovation to estimate the effects on investment of the partial-expensing provisions. First, certain types of assets qualified for partial expensing, but other types of assets did not. By comparing firms' investment decisions in the two classes of assets, researchers can identify the amount by which the tax subsidy may have increased investment. Second, the expectation that the policy would expire should have created incentives for firms to increase their investment before the expiration date but reduce it after that date. Examining the timing of investment decisions around the expiration date is another way that researchers can infer the impact of partial expensing.

  One study found that the partial expensing provisions increased output by 0.1 percent to 0.2 percent and increased employment by 100,000 to 200,000 jobs. Research on partial expensing suggests that it may have encouraged more investment in capital assets that qualified for the tax subsidy than in assets that did not qualify. Research findings have not, however, found solid evidence that it affected the timing of investment around the expiration date.

- **Investment Tax Credit.** The ITC provides incentives that are similar to those of accelerated depreciation and expensing. Like them, it increases the after-tax return on investment by reducing the present value of taxes on the income the investment generates, and it increases the after-tax cash flow immediately realized by the firm that does the investing. There are several differences, however. First, an incremental ITC—one that applied only to investment above a specific base level—would generally be easier to design than incremental versions of the other investment incentives. Second, an ITC has a much greater differential effect on short- and long-lived investments. That is, a given credit would increase the after-tax return on short-lived investments much more than on longer-lived ones.

  The ITC was part of the tax code from 1962 through 1985. During this time, firms were generally permitted to offset as much as 50 percent to 90 percent of their tax liability with a 10 percent credit on qualifying equipment purchases. The ITC was complex, however, and not all investment qualified. Furthermore, the limitations placed on its scope created a variety of legal ambiguities regarding its application. Several analyses indicate that the ITC, as it was applied in the past, was not successful as a tool for stabilizing the economy. This was partly due to its timing and the fact that it was, over much of its existence, considered permanent. Persuading businesses that an ITC enacted for stimulus is temporary might be difficult, which in turn could undercut its effectiveness.

- **Operating Losses and Carryback Provisions.** Investment demand can also be influenced by provisions in the tax code regarding the use of net operating losses (NOLs) in other tax years. A firm that is losing money does not incur tax liability, and when the economy slows, more firms incur losses and are therefore less able to utilize tax deductions associated with new investment incentives.

  However, the tax code permits firms to carry back their losses to previous years and reclaim taxes previously paid. The carryback provision not only increases the after-tax return on investments but also increases cash flow. The carryback is currently limited to two years and remaining net operating losses may be carried forward for 20 years.

  Extending the carryback period beyond two years could increase the incentive to invest. It would also increase cash flow to firms that might be especially constrained in borrowing, which could boost investment. By themselves, carryback and carryover effects are unlikely to generate substantial changes in investment in the short run, but they are an important complement to temporary investment incentives such as accelerated depreciation or an investment tax credit because they allow money-losing firms to receive the full benefit of those incentives.

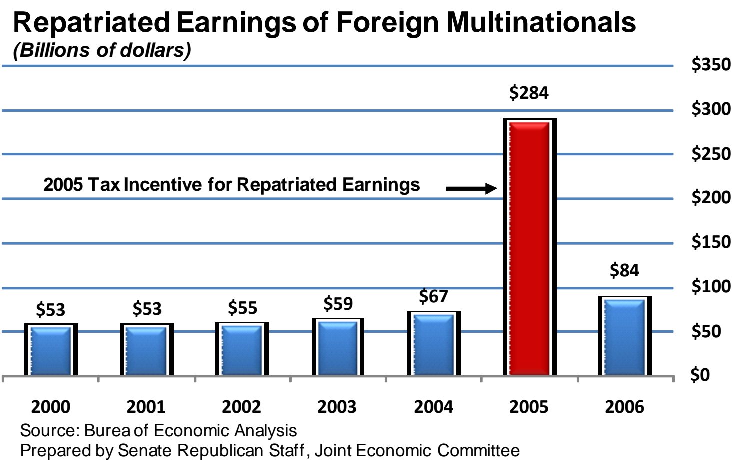
Taxes on Repatriated Foreign Earnings

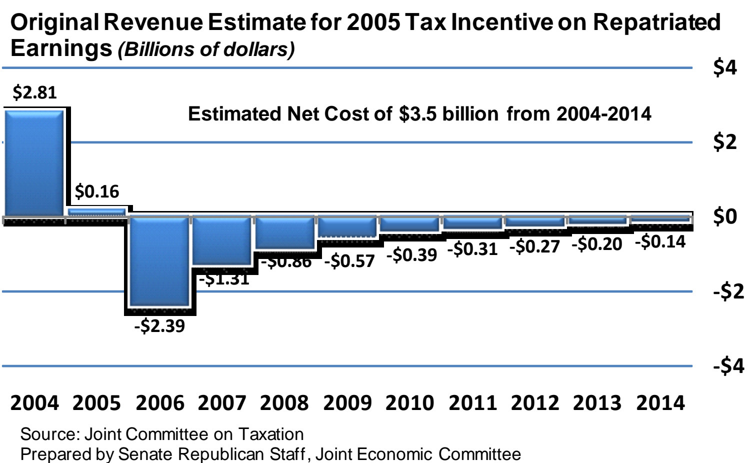
An additional possible way to stimulate U.S. business spending is to cut taxes on repatriated foreign earnings of multinational corporations. The United States employs a "worldwide" tax system, under which domestic corporations generally are taxed on all income, whether derived in the U.S. or abroad. Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income generally is deferred. Provisions of the American Jobs Creation Act (AJCA) of 2004 provided a significant temporary reduction on taxes applied to repatriated earnings of multinationals. That tax cut led to substantial increases in earnings repatriations. In principle, a significant boost in repatriated earnings can stimulate U.S. business investment.

Recent Temporary Provision to Cut Taxes on Repatriated Earnings

The American Jobs Creation Act (AJCA) of 2004 provided U.S. multi-national corporations with a tax incentive to boost dividends from their foreign subsidiaries and to use those funds for certain domestic activities.

- The AJCA allowed U.S. companies that received dividends from foreign subsidiaries during a specified period[2] to exclude a large portion of the dividends from U.S. taxable income. The result was an effective tax rate on extraordinary dividends of 5.25% if the company was subject to the highest corporate tax rate (35%).
- To increase the effectiveness of the incentive and prevent windfall benefits on earnings that would have been repatriated absent the additional tax incentive, companies claiming the incentive were required to develop a domestic reinvestment plan to show how the repatriated earnings would be used to increase hiring, investment, research and development, or financial stability.
- During the year that the tax incentive was in effect, direct investment dividends of U.S. multinationals soared. While the Joint Committee on Taxation (JCT) estimated that the measure would generate about $150 billion of inflows, the difference in inflows between 2004 and 2005 was $217 billion.
- The JCT estimated that the measure would result in a 10 year revenue loss to the government of $3.5 billion.
- A few very large foreign affiliates, primarily holding companies, accounted for a substantial majority of the increase in direct investment dividends in 2005. These large affiliates encompassed a variety of industries, including pharmaceuticals, petroleum manufacturing, electronic components, and beverages. Affiliates in the manufacturing, finance and insurance, and wholesale trade industries also paid large dividends in 2005.
- By geographic area, the large dividends were concentrated in Europe, particularly the Netherlands, Luxembourg, Switzerland, and Austria. There were also substantial dividends from the United Kingdom Islands-Caribbean and Bermuda.





---

[2] Companies could choose calendar year 2004 or 2005, but because of the timing of the legislation, most companies choose to use the incentive in 2005.

Critics of a Temporary Tax Cut on Repatriated Earnings: Critics argue that even if repatriations are stimulated, it is not clear that a tax cut for repatriations would lead to a stimulus to U.S. economic growth. According to critics, the regular tax on repatriated earnings should not weaken domestic investment spending because businesses wanting to fund domestic projects can simply borrow against their overseas cash. In addition, critics argue that even if U.S. multinationals are required to submit a plan earmarking repatriated earnings to domestic investment or hiring projects, companies could merely declare that repatriated funds are being used for a particular listed purpose, without necessarily altering the overall allocation of repatriated funds.

Proponents of a Temporary Tax Cut on Repatriated Earnings: Proponents of a temporary tax cut for repatriations argue that the provisions will result in increased repatriations of funds that U.S. firms would otherwise reinvest abroad, thus boosting U.S. domestic investment and hiring of workers in the U.S., and in turn boosting GDP growth and employment growth. Although there have not been, to date, any serious economic analyses of possible effects on U.S. GDP growth or employment due to the temporary tax cut on repatriated earnings in the AJCA, the chart on repatriated earnings provides fairly clear evidence that the Act lead to a significant boost in repatriated foreign earnings.