HOW TEMPORARY ARE TEMPORARY TAX BENEFITS UNDER ECONOMIC STIMULUS LEGISLATION?

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ABSTRACT

The federal government may use different types of tax-related legislation in an attempt to stimulate the economy during an economic downturn. This paper relates to the legislation which focuses on economic stimulation through individuals. It discusses the different effects of various types of tax benefits. It also shows how taxpayers may quickly develop permanent expectations for temporary tax benefits, thus making it politically difficult to allow these benefits to expire.

INTRODUCTION

During the recent economic downturn, multiple methods have been used by the federal government in attempting to stimulate the economy. Some methods involve direct federal government spending on infrastructure or on governmental programs. Other methods involve federal government transfers to state and local governments for spending. Still other methods involve income tax laws. Income tax laws in the United States are often used to effect social and economic policy, including stimulus efforts. This paper focuses on stimulus efforts targeted at individuals. One method used as an attempt to increase consumer spending is direct payments to large blocks of individual taxpayers such as the advance credit paid in 2008 legislated by the Economic Stimulus Act of 2008 [8]. Psychologically, upon receiving this money, taxpayers might treat it as a windfall from the government and use it to increase economic consumption, thus stimulating the economy. Another method used to stimulate the economy is temporary changes in targeted tax benefits related to certain expenditures or behaviors–sometimes new tax benefits, sometimes enhanced tax benefits–legislated to reduce the amount of net taxes individuals pay in the short run so they will have more money left to spend, thus simulating the economy. This paper compares the different types of tax-related legislation to stimulate the economy through individuals. The different methods that can be employed have both advantages and disadvantages. The paper discusses the different psychological effects of different types of benefits and how they lead to different taxpayer expectations for future benefits.

ONE-TIME DIRECT STIMULUS PAYMENTS

The Economic Stimulus Act of 2008 legislated a recovery rebate in the form of a tax credit for large numbers of low- and middle-income taxpayers. Although the stimulus was in the form of a tax credit, it was actually paid to most taxpayers in the form of an advance refund. These advance refunds were either directly deposited into taxpayers' accounts or mailed to them as checks. The stimulus amount was up to $600 ($1,200 for a joint return) plus $300 per qualifying child. It was phased out for taxpayers with adjusted gross income in excess of $75,000 ($150,000 for a joint return). A taxpayer's credit was phased out by 5 percent of any adjusted gross income in the phaseout range. To some extent,

the phaseout makes this credit and advance refund a targeted tax benefit. However, it was targeted at a very large set of low- and middle-income taxpayers. Because it was a one-time payment, this credit did not likely create much expectation for permanency.

On the other hand, another advance refund was legislated back in 2001 [7]. The 2001 tax legislation introduced a new, lower 10 percent tax bracket for tax years starting in 2001. However, to make the lower tax bracket even more visible, the benefit of the lower tax bracket was paid out to taxpayers as an advance refund during 2001, with a maximum credit of $600. "Although not originally conceived of as an anti-recessionary policy, by the spring of 2001 this was one of the justifications for the tax cut and for delivering part of the tax cut in this visible form" [15, p. 1]. While these 2001 tax cuts were legislated only for 10 years, taxpayers may have considered the cut to be permanent, certainly at least more permanent than the 2008 advance credit. In addition, this advance refund was a more general refund aimed at anyone who would have taxable income in the new, lower 10 percent tax bracket.

Any advance refunds of taxes or tax credits might stimulate the economy if the money is used by taxpayers for consumer spending. If used for savings/investment or to pay down debt, these payments may not have much effect in stimulating the economy in the short run. The perceived permanency of the tax benefits may have an effect on how much is used for consumer spending. While an argument can be made that taxpayers will spend a perceived one-time windfall for consumer items, it can also be argued that a one-time payment will be used for one-time savings or debt reduction since it will not provide a long-term, ongoing benefit. But if a tax benefit is seen as a permanent reduction of taxes, taxpayers may be more willing to use an advance payment of this benefit on consumer items, concluding that a permanent tax benefit will increase disposable income permanently.

Several papers make general conceptual arguments for or against the stimulus effect of tax rebates [2][5][13][15]. Other papers using different methodologies look specifically at whether the 2001 advance refund increased consumer spending. These papers reported different results, or at least different perspectives on the results presented. Shapiro and Slemrod [14] report the results of survey research that show that few households indicated that the rebate led them mostly to increase their spending. Agarwal, et. al. [1, p. 989] found that "on average, consumers initially saved some of the rebate, by increasing their credit card payments and thereby paying down debt and increasing their liquidity. But soon afterward their spending increased. . . ." These results were determined using a panel data set of credits card accounts. Johnson, et. al. [4, p. 1590] also used survey data to show that "the rebates caused an economically significant increase in household expenditure." It is possible that all of these papers are part of a larger story, even though they do not seem initially consistent. Perhaps a small percentage of households indicated that they would spend the rebate money immediately. However, they could have spent some immediately and some a little later. Even if the majority of households did not spend the money, the amount spent by those who did spend the rebates could have caused a statistically significant increase in household expenditure.

Studies on the 2008 rebate also give potentially mixed messages. Shapiro and Slemrod [16, p. 377] report that the personal saving data they examined are "consistent with most of the rebate being saved." They conclude that with "the low spending propensity, the rebates in 2008 provided low 'bang for the buck' as economic stimulus. Putting cash into the hands of the consumers who use it to save or pay off debt boosts their well-being, but it does not necessarily make them spend" (p. 379). However, by tracking weekly expenditure information of households who have received or are going to receive rebates, Broda and Parker [3] conclude "that the rebates are providing a substantial stimulus to the national economy, helping to ameliorate the ongoing 2008 downturn." These inconsistent research findings–some based on conceptual arguments, some based on survey data, some based on other empirical data–make it difficult to understand the exact success of tax rebates intended to stimulate the economy. Political arguments are also made for and against the rebates. Wilson and Beach [20] state that rebates are bad economic policy and bad tax policy. They also state that tax rate relief would be a

more appropriate method to strengthen the economy. Riedl [11, p. 1] states that "tax rebates fail because they don't encourage productivity or wealth creation. No one has to work, save, invest or create any new wealth to receive a rebate. . . .No new spending power is created. It is merely redistributed from one group of people to another." In addition, nobody has argued that the 2008 rebate was already funded. Most taxpayers recognize that the rebates came from borrowed money, thus increasing the debt burden transferred to future taxpayers. Also, it is costly to administer an advance credit [6].

TEMPORARY TARGETED TAX BENEFITS

Besides one-time direct payments, other tax benefits can be used in attempting to stimulate the economy. Targeted tax benefits, at least as identified here, refer to tax benefits, mostly credits that are targeted to a more narrow range of taxpayers rather than a broad range of taxpayers and based on certain types of expenditures or behaviors. These targeted tax benefits are often originally legislated as temporary tax provisions. In some cases, the temporary nature of the tax benefit is not an attempt to stimulate the economy, but is a trial run to see if social or economic policy objectives are met specifically so that more permanent legislation can be enacted if they are. An example of some targeted tax benefits that were originally temporary in nature but which have been extended and increased are the adoption tax credit and exclusion. Smith and Tew [19] and Smith [17][18] give some of the history of the evolution of the adoption tax credit and exclusion which show how they have been increased and made more permanent since they were first legislated. In other cases, temporary benefits may be legislated as an effort to stimulate the economy. In these cases, the benefits may really be designated as temporary and may really be expected to lapse rather than be extended. Either reason for legislating temporary benefits is strengthened by the ease of justifying funding for the tax benefits during a temporary period rather than on a permanent basis.

Several tax benefits for individuals were created or expanded in a stimulus effort through the American Recovery and Reinvestment Tax Act of 2009 (ARRTA) [10]. A discussion of some of these tax benefits and their temporary nature will allow further analysis. A new credit created by the ARRTA is the making work pay credit, legislated as Section 36A of the Internal Revenue Code (IRC). This credit is intended to provide tax relief for two years from a portion of the social security tax. The credit is the smaller of (1) 6.2 percent of the taxpayer's earned income, or (2) $400 ($800 for a joint return). It is phased out for those with modified adjusted gross income (AGI) above $75,000 ($150,000 for a joint return). As legislated, this new IRC section will not apply after 2010. While not paid as an advance refund through direct deposit or a check in the mail, this credit is actually received by employees throughout the year by lower withholding amounts. The ARRTA also provided for an increase in the earned income tax credit (EITC), an existing credit that has been modified and expanded many times. The EITC percentage depends on whether the taxpayer has no qualifying children (7.65%), one qualifying child (34%), or two or more qualifying children (40%). The ARRTA added an additional, increased credit percentage of 45 percent for 2009 and 2010 for taxpayers with three or more qualifying children. The EITC also phases out at a certain percentage for each of these categories when earned income reaches a certain amount. In recent years the income amount for the beginning of the phaseout has been increased for joint filers. The ARRTA increased the amount added for joint filers up to $5,000 and indexed it to increase even further for 2010. This change has the effect of increasing the range of earned income over which joint filers can get the maximum possible EITC before it starts to phase out. Section 1002 of the ARRTA is specifically labeled, "Temporary Increase in Earned Income Tax Credit." The provisions of this change state that the amendments to the EITC are special rules for 2009 and 2010. Section 1003 of the ARRTA also amends an existing tax credit and is titled, "Temporary Increase of Refundable Portion of Child Credit." The child tax credit is a $1,000 credit per qualifying child. It is a nonrefundable credit, but part or all of it can become a refundable credit to the extent of 15 percent of

earned income in excess of a certain dollar limit. This limit was $10,000 in 2001 but was indexed for inflation. Based on the inflation calculation, the dollar limit was scheduled to be $12,050 in 2008 [12]. However, the limit was reduced in 2008 to $8,500 for 2008 [9]. The ARRTA further liberalized the refundability of this credit for 2009 and 2010 by reducing the dollar limit to $3,000.

The ARRTA also created the American Opportunity Tax Credit which replaces the old Hope Scholarship Credit for 2009 and 2010. These credits are targeted to help taxpayers who are paying for college expenses. The American Opportunity Tax Credit offers a larger credit than the Hope Scholarship Credit, extends it to four years of post-secondary education from two years, adds course materials as an expenditure eligible for the credit, and increases the adjusted gross income (AGI) limits for the phaseout of the credit. All of these measures increase the possible tax benefits for taxpayers who are paying for themselves and/or their dependents to attend post-secondary educational institutions. IRC Section 529 allows a tax advantage for qualifying accounts used to save money for college. Any earnings from these accounts are not taxable as long as they are used for qualifying educational expenses. The ARRTA liberalized the definition of qualifying educational expenses for this credit to include the purchase of computer technology or equipment or Internet access or related services if they are used by the beneficiary and the beneficiary's family during a year when the beneficiary is enrolled at an eligible institution. However, the change in the definition of qualifying educational expenses is only valid for 2009 and 2010. Another change in tax law made by the ARRTA is with the first-time homebuyer tax credit. As originally legislated, this was a $7,500 refundable credit for first-time homebuyers that was, in essence, a loan from the government that was required to be repaid over 15 years as an additional tax of 6⅔ percent of the credit amount each year. As amended by ARRTA, the credit was extended to homes purchased through November 30, 2009 and was increased to $8,000, In addition and most importantly, the requirement to repay the credit was removed as long as the home is owned and used as the principal residence of the taxpayer(s) for at least three years. The targeted tax benefits mentioned above are not the only tax benefits legislated by the ARRTA. However, they do illustrate some of the tax benefits that have been legislated in an attempt to provide a stimulus to the economy by reducing taxes and thus increasing the amount of consumption taxpayers can undertake. All of these amendments to the tax code were legislated as temporary changes.

DISCUSSION

In addition to the discussion of whether or not these direct payments and temporary tax benefits have the desired effect in stimulating the economy, it is also important to consider how they are perceived by taxpayers. It is likely that the direct payment to taxpayers for the one-time 2008 credit will not lead to expectations of future direct payments, at least not on a regular, recurring basis. Since the direct payment made in 2001 was an advance of the effect of the new, lower 10 percent tax bracket, it may have been perceived as more permanent since the 10 percent bracket had been legislated for 10 years. However, the direct payment in 2001 was just a more visible, perhaps political, way to give the benefit earlier for 2001. It is possible that taxpayers understood that the 2001 payment was just a one-time advance for the first year of the new tax bracket. While taxpayers may have understood that a new, lower tax bracket would continue to benefit them, they did not expect advance payments in years beyond 2001, especially since employee withholdings could be adjusted for years beyond 2001. While taxpayers often understand the personal importance to them of receiving a direct payment, they may not understand exactly why they are receiving it, although they usually know that it is not an ongoing program. Thus, they pay attention to news of the direct payment even if they don't fully understand it.

On the other hand, when tax law changes are made that target specific tax benefits, either temporarily or permanently, taxpayers are less likely to pay close attention. They may also be less likely to understand exactly how they might benefit from targeted tax law changes. These benefits are more likely to be

buried in the tax return prepared after the year for which taxes are being calculated. Therefore, the psychological impact of these changes may not be as great. In addition, since less attention is paid to the details of these targeted tax benefits, taxpayers may have very little idea that some of them are legislated on a temporary basis. Once taxpayers become used to a tax credit or benefit for even one or two years, it may be too late to re-educate them that the benefits were temporary, perhaps aimed at stimulating the economy during an economic downturn. Thus, taxpayers very quickly build up an expectation of permanency or entitlement. Once this expectation is built, the expiration of the tax benefit may be seen as a tax increase rather than the expiration of a temporary tax benefit. This may be especially true for low- and middle-income taxpayers where the expiring tax benefit is a larger percentage of income. The permanency expectation may be psychologically different for different temporary tax benefits. For example, the ARRTA created the new making work pay credit. While it was specifically legislated on a temporary basis, once taxpayers get the benefit, they quickly forget it was supposed to be temporary (if they ever knew that in the first place). Other examples are small changes to existing tax benefits that have been in place for a number of years. The ARRTA made some small changes to the earned income tax credit and to the child tax credit refundability. Since these tax credits have already been changed several times since they were first legislated, it may be even more difficult for taxpayers to ever contemplate that the changes legislated in 2009 were intended to be temporary. When the permanency expectation exists, there is pressure on the legislative and executive branches to make the temporary tax benefits permanent so voters will not be offended, adversely affecting re-election opportunities. However, if all tax credits and other benefits created on a temporary basis, either to help stimulate the economy or to effect social policy, become permanent, the set of tax benefits will increase over time and ultimately become unsustainable. Therefore, temporary tax benefits, especially those that are intended to stimulate the economy, cannot all become permanent. For this reason, perhaps legislators should consider alternative methods of economic stimulus so taxpayers are not upset when temporary tax benefits must be allowed to expire.

CONCLUSION

The stimulus effect of one-time tax rebates and temporary tax benefits is questionable. Whether these temporary incentives stimulate consumer spending to an extent to justify them is not always clear. The evidence is mixed and can lead to multiple conclusions depending on one's political philosophy. This paper has not intended to prove whether these legislative approaches are successful or not. However, it seems quite apparent that taxpayers, either by not understanding the temporary nature of specific legislative items or by forgetting the temporary intent, can easily create a built-in expectation of permanency. The political effects of these temporary benefits toward re-election campaigns may be even more important, as taxpayers will remember the one-time payments received or the tax credits generated through these temporary benefits. However, for incumbents to keep the political momentum they have generated through this type of legislation, they may be coerced to make temporary tax stimulus measures permanent so that constituents who have psychologically made the benefits permanent do not argue that they have been subjected to a tax increase. How many temporary tax benefits are actually allowed to expire? While some may expire, it is more likely that they become permanent, perhaps even in an expanded, more costly way. The implications are that temporary tax stimulus legislation for individuals should be carefully considered before it is enacted, as it may lead to either unsatisfactory increases in consumer spending and/or because it may quickly become a permanent expectation of taxpayers. It is also costly to future generations of taxpayers when the direct payments or temporary tax reductions are funded through borrowing, as could be expected during a recession, rather than through budget surpluses.

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