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THE LEGISLATION AND POLICY ROUNDTABLE



AN ECONOMY IN CRISIS: WHAT CAN BE DONE?

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Tax Relief in the American Recovery and Reinvestment Act of 2009¹

Steven Gassert

On February 17, 2009, less than thirty days after his inauguration, President Obama signed into law the American Recovery and Reinvestment Act of 2009 (ARRA). This new law was one of many measures from the new administration designed to quickly stimulate the ailing American economy. The \$789 billion package was divided between direct government spending, tax reductions and financial relief to states and individuals.² The bill contains \$285.6 billion in tax reductions, which is about 36.3% of the legislation.³ In this article, I will analyze some of the tax provisions that were written into ARRA, and attempt to assess their effectiveness in stimulating the economy. Will these tax provisions aid in stimulating the economy or will another stimulus package have to be passed next year? The size, scope and timing of the tax provisions of ARRA may actually limit their potential value to an economic recovery.

There are numerous different causes to the current economic downturn. According to a report from the Urban-Brooking Tax Policy Center, the economy is not suffering from a lack of capacity or supply, but “rather a lack of aggregate demand that is reflected in the under-use of existing capacity: unemployment rates are high, capacity utilization rates in manufacturing are low, and consumer confidence is dismal.”⁴ The lack of aggregate demand hurts small businesses in the form of reduced sales and restricted cash flow. To best stimulate the economy, tax

¹ A special thanks to Bill Rys, Tax Counsel for the National Federation of Independent Businesses, for discussing some of the topics discussed in this article.

² Christina D. Romer, *Lessons from the Great Depression for Economic Recovery in 2009*, Brookings Institute, Mar. 9, 2009, at 4.

³ Jane G. Gravelle *et al.*, *Economic Stimulus: Issues and Policies*, Congressional Research Service, Feb. 27, 2009, at 7.

⁴ Rosanne Altshuler, *et al.*, *Tax Stimulus Report Card: Conference Bill*, Urban-Brookings Tax Policy Center, Feb. 13, 2009, at 2.

provisions should encourage spending by both businesses and consumers.⁵ Simply put, the government should boost aggregate demand by directly placing cash in the hands of consumers and businesses. The Congressional Budget Office (CBO), in a letter to Senator Charles Grassley, the ranking member of the Senate Committee on Finance, stated that in the short term, “ARRA will raise GDP and increase employment by adding to aggregate demand and thereby boosting the utilization of labor and capital that would otherwise be unused because the economy is in recession.”⁶ Tax relief for consumers allows them to spend more money in the market. Tax relief for businesses means retaining workers and increasing capital investment. In the long run, CBO estimates that output will be reduced slightly because of the increased government spending or the reduction of revenues.⁷ The CBO qualified their estimation by stating that large-scale economic stimulus through fiscal policy is rarely attempted, and it is difficult to predict how great the economic effects will be.⁸

There are a number of different tax provisions in ARRA, which target different groups of people and will have different levels of effectiveness. The tax provisions favor mostly individual taxpayers over relief for businesses. Only about 7% of the tax provisions will benefit businesses.⁹ Some of the tax provisions take effect immediately, while others will not affect taxpayers for some time.

⁵ *Id.*

⁶ Letter from Douglas W. Elmendorf, Director, Congressional Budget Office, to Senator Charles E. Grassley, Ranking Member, Committee on Finance (March 2, 2009), http://www.cbo.gov/ftpdocs/100xx/doc10008/03-02-Macro_Effects_of_ARRA.pdf.

⁷ *Id.* at 2.

⁸ *Id.* at 1.

⁹ *Congress Set to Approve Economic Stimulus Bill After Scaling Back Regressive Tax Provisions*, The Tax Justice Digest, Feb. 13, 2009, <http://www.ctj.org/taxjusticedigest/2009/02/congress-set-to-approve-econom.html>.

Making Work Pay Credit

The largest of the tax provisions is the Making Work Pay Credit (MWPC). In 2009 and 2010, individual workers will receive an income tax credit equal to 6.2% of their earned income, with a maximum credit of \$400 for individuals and \$800 for married couples filing jointly.¹⁰ The amount for each individual represents the employee's share of the Social Security payroll tax.¹¹ For self-employed taxpayers, the credit may still be taken from the income of their business.¹² The credit phases out at a rate of 2% of income over \$75,000 for individuals (\$150,000 for couples). Therefore, individuals with incomes exceeding \$95,000 (\$190,000 for couples) will not receive the credit.¹³ Unlike the 2008 individual stimulus payments, taxpayers will not receive a lump-sum check from the government. Instead, the credit will be received through a reduction in payroll taxes over the course of 2009 and then again in 2010. The reduction in withholdings from the paycheck will result in workers having about fifteen additional dollars in their paychecks in 2009 once the credit is implemented. The amount in 2010 will be less per paycheck because the \$400 credit will be spread over the entire year.¹⁴ In order to be eligible for the credit, individuals must provide a valid Social Security number on their tax returns. In addition, the credit is not available to non-resident aliens, dependents of other taxpayers, and any estate or trust.¹⁵ The Congressional Research Service estimates that the total cost of MWPC is \$116.2 billion between FY2009 and FY2011.¹⁶

This credit deals directly with the drop in aggregate demand and indirectly benefits small businesses struggling with cash flow. The Urban-Brookings Tax Policy Center gave this tax

¹⁰ American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, §1001, 2009 HR 1, 1, 195-198.

¹¹ Altshuler, *supra* note 4, at 3.

¹² *Stimulus Legislation Enacted; Many Tax Incentives Take Effect Immediately*, Practical Tax Bulletin, Mar. 3, 2009 (Linda O'Brien & John Buchanan eds.) at 1.

¹³ Altshuler, *supra* note 4, at 3.

¹⁴ *Id.*

¹⁵ *Stimulus Legislation Enacted*, *supra* note 13, at 1.

¹⁶ Gravelle, *supra* note 3, at 7.

provision one of the highest grades in the ARRA.¹⁷ It has the potential to have the biggest impact on the economy of all of the tax provisions because it reaches the most people and injects the most money into the economy. If the IRS implements MWPC quickly, it could have an immediate impact on aggregate demand because it puts cash directly into the hands of consumers. Since this credit comes in small increments, rather than in one lump sum, it is more likely that consumers will spend the money. Behavior studies suggest that “taxpayers view small increments to after-tax pay as income, to be spent, whereas they tend to view lump-sum payments as wealth, to be saved.”¹⁸ However, these studies have been called into question, and are far from conclusive that one rebate check is less effective than payroll withholdings in stimulating the economy.¹⁹ Furthermore, the credit is targeted at low-income workers who are more likely to spend the money immediately on everyday needs, rather than pay down debt or save it. MWPC will have an indirect impact on businesses, which will then benefit from the increased spending from consumers.

One drawback of MWPC is that the credit is only an additional fifteen dollars per paycheck, which may not translate into significant additional spending. If the credit were increased (like in previous versions of the legislation), then the impact on the economy would be greater.²⁰ Another problem with this credit is that it may lead to confusion on the part of businesses and individuals. Since the credit comes in the form of reduced payroll taxes, businesses will have to be more diligent in doing their payroll. For many businesses, the monthly payroll is a simple process that has become routine. This credit, although clear for the most part, requires businesses to take additional steps to conform. For individuals, confusion

¹⁷ Altshuler, *supra* note 4, at 4.

¹⁸ *Id.*

¹⁹ Altshuler, *supra* note 4, at 9.

²⁰ In the version that originally passed the House of Representatives, the Making Work Pay Credit was \$500 for individuals and \$1,000 for taxpayers filing jointly. See American Recovery and Reinvestment Act of 2009, H.R. 1, 111th Congress, (as passed by the House of Representatives, January 29, 2009).

may occur when filling out their 2009 tax returns. The credit is based upon Adjusted Gross Income (AGI), which is not determined until the tax return is completed. The MWPC phases out at higher income levels, meaning that a person may have received the tax credit, but then will have to pay it back come April 2010. The calculation of the credit becomes even more difficult when joint filers and people with multiple jobs are considered. It will be difficult to determine the proper amount to withhold from their paychecks in order to avoid having to repay the credit when filing their 2009 tax return.²¹

Another downside to this particular tax credit is the source of the funding for the credit. The credit is the reduction in payroll taxes, which normally pay directly into the Social Security Trust Fund. As has been well publicized, the long-term financing for Social Security is in jeopardy with the “baby boomers” heading toward retirement. This provision takes money directly from a long-term investment with an already shaky financial future.²² While the focus is right now is on short-term economic stimulus, the question becomes whether we should really be taking money from our investments for the future.

Earned Income Credit and Child Tax Credit

ARRA also includes a temporary increase in the Earned Income Tax Credit (EITC) and a temporary increase in the refundable portion of the Child Tax Credit (CTC). For 2009 and 2010, the credit percentage for the EITC will be 45% of the first \$12,570 of earned income for taxpayers with three or more qualifying children.²³ Prior to this increase, the credit percentage was 40% of the first \$12,570. ARRA also increases the phase-out range for joint filers by \$1,880

²¹ Altshuler, *supra* note 4, at 4.

²² Adam Paul, *Social Security and the Stimulus Bill*, American Enterprise Institute for Public Policy Research, http://www.aei.org/publications/pubID.29299,filter.all/pub_detail.asp.

²³ American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, §1002, 2009 HR 1, 1, 198.

to eliminate any marriage penalty. The cost of this temporary increase to the EITC will cost \$4.7 billion over the next ten years.²⁴ Under the current law, the credit equals a fixed percentage of earnings until the credit reaches its maximum. The amount of the credit is greatly influenced by the number of children in the family. The credit begins to phase out as income increases.²⁵

The CTC in 2007 distributed about \$45 billion to families, making it the largest tax code provision benefiting families.²⁶ Under the current law, the CTC allows eligible taxpayers to reduce their tax liability by up to \$1,000 per qualifying child.²⁷ The CTC is not a fully refundable credit, like the EITC. Taxpayers receive refundable tax credits even though their total credits exceed their tax liability. If a credit is not refundable, then a taxpayer loses any part of the credit that exceeds his or her tax liability. Prior to the changes in ARRA, the refundable portion of the CTC was limited to 15% of income that exceeds \$12,550.²⁸ If a taxpayer made less than \$12,550 in earned income, none of the CTC was refundable. For 2009 and 2010, ARRA lowers this phase-in amount to \$3,000.²⁹ Thus, the refundable amount of the credit will be increased and more low-income families will have access to the refundable portion of the CTC. With the increase to the refundable portion of the CTC, it is estimated that this provision in ARRA will cost about \$14.8 billion over the next ten years.³⁰

Both the EITC and the CTC are highly targeted tax benefits. They are designed to primarily benefit low-income families with children. As stated above, low-income taxpayers are more likely to spend this money quickly. Furthermore, these credits are tied directly to earned

²⁴ Altshuler, *supra* note 4, at 5.

²⁵ *Id.*

²⁶ *Id.*

²⁷ Gregg A. Esenwein, *The Child Tax Credit*, Congressional Research Service, April 6, 2006, at 1.

²⁸ Altshuler, *supra* note 4, at 7.

²⁹ American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, §1003, 2009 HR 1, 1, 199.

³⁰ *Id.*

income, meaning that recipients must be working and contributing to the economy in order to benefit.

There are downsides to the increases in these credits. As previously stated, these two credits are tied to earned income. Therefore, the availability of these credits will depend on a taxpayer's employment status. According to the Bureau of Labor Statistics, the unemployment rate in the United States rose in March 2009 to 8.5%.³¹ While the availability of these credits may incentivize people to enter the workforce, there may not be jobs available for them to fill. The high unemployment rate may limit the potential impact of these credit increases. Another downside to these two credits is that they may not have an immediate impact on the economy. The earliest that taxpayers could receive these credits is the spring of 2010 when they file their tax returns for 2009.³² Therefore, any positive impact of these provisions will not be felt until 2010.

Homeownership Tax Credit and Automobile Sales Tax Deduction

As a way to help the presently struggling housing market, Congress modified the First-Time Homebuyer Credit into a cash grant in the form of a refundable tax credit. Before ARRA, people who purchased a home received a credit in the form of an interest-free loan that had to be repaid within 15 years.³³ For homes purchased in 2009, the revised credit only needs to be repaid if the house ceases to be the taxpayer's primary residence within three years of the

³¹ Bureau of Labor Statistics, *Employment Situation Summary*, April 3, 2009, <http://www.bls.gov/news.release/empstat.nr0.htm>.

³² Altshuler, *supra* note 4, at 8.

³³ *Stimulus Legislation Enacted*, *supra* note 13, at 6.

purchase of the home.³⁴ The value of the credit is 10% of the value of the home, up to \$8,000 for first-time homebuyers.³⁵

Congress also attempted to aid the automobile industry through a tax provision in ARRA. A new tax deduction was created for sales tax paid on the purchase of new cars or light trucks within one year of the enactment of ARRA.³⁶ The automobile sales tax deduction phases out for single taxpayers with incomes between \$125,000 and \$135,000 and for couples between \$250,000 and \$260,000.³⁷ The deduction can be claimed regardless of whether or not a taxpayer itemizes his or her tax return.³⁸

These two credits have the potential to boost aggregate demand in their respective industries. Both are designed to incentivize behavior and are targeted to two areas of the economy that are in need of significant financial assistance. The homebuyer's credit ideally will increase demand for housing, and may thereby increase home values.³⁹ The timeliness of the homebuyer's credit is another important feature. Taxpayers who purchase a home in 2009 may take the credit on their 2008 tax return.⁴⁰ This provides a quick stimulus to the housing market by providing immediate incentives to enter the housing market. Similarly, the automobile sales tax deduction may incentivize consumers to purchase a new car in the next year.

While these tax provisions may stimulate the market, the design, scope and timing of the tax relief hinder their overall effectiveness. While the timing of the homebuyer's credit will provide quick stimulus to the market, the automobile sales tax deduction will not be available until tax year 2009. Also, the relative size of these credits may not be sufficient to bring people

³⁴ American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, §1006, 2009 HR 1, 1, 202.

³⁵ *Id.*

³⁶ American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, §1008, 2009 HR 1, 1, 203.

³⁷ *Id.*

³⁸ *Stimulus Legislation Enacted*, *supra* note 13, at 2.

³⁹ Altshuler, *supra* note 4, at 13.

⁴⁰ *Id.*

into the market. They may have an effect on people who are currently considering purchasing a home or a new car, but they may not be large enough to force people to reconsider a decision to put off such purchases.

A larger homebuyer's credit, as recommended in the Senate version of the bill, might have been more effective at bringing new people into the housing market.⁴¹ The people who will most benefit from these two credits are people who can afford to be in either of these markets right now. The deduction for sales tax will most benefit taxpayers in the highest tax brackets because it is a deduction and not a credit. Therefore, those who can use the deduction to lower their taxable income into a lower tax bracket will benefit the most.⁴² Furthermore, first-time homebuyers make up a small percentage of the housing market, and any increase in sales for first-time homebuyers may not have a significant effect on the entire market.⁴³

American Opportunity Education Tax Credit

ARRA renames the HOPE Education Credit the "American Opportunity Tax Credit" and increases the amount of the existing education tax credit. ARRA made several substantive changes to the education credit. First, it increased the maximum amount of the credit from \$1,800 to \$2,500. Second, it extended the availability of the credit from the first two years of college to all four years. Third, ARRA increased the phase-out levels to \$80,000 for single filers and \$160,000 for joint filers. Finally, ARRA made 40% of the credit refundable.⁴⁴ The new

⁴¹ The Senate version of ARRA contained a First-Time Homebuyer's Credit of \$15,000. See Rosanne Ashuler et al., *Tax Stimulus Report Card: Senate Bill*, Urban-Brookings Tax Policy Center, Feb. 10, 2009, at 12.

⁴² Altshuler, *supra* note 4, at 17.

⁴³ *Id.*

⁴⁴ American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, §1004, 2009 HR 1, 1, 199.

credit is retroactive to January 1, 2009, but it does not apply to tuition paid in 2008 for the spring semester of 2009.⁴⁵

This credit, unlike the others in ARRA, has multiple effects. It can help stimulate the economy and help students obtain post-secondary education. Since part of the tax credit is refundable, qualifying taxpayers will receive larger refunds to spend in the economy. However, unless taxpayers adjust their withholdings in anticipation of receiving this credit, the benefits of the new credit will only be received when tax returns are filed.⁴⁶ Another benefit of this credit is that it encourages people to begin and complete post-secondary education. At a time when the unemployment rate is high, the availability of additional education provides an alternative to seeking new employment. However, ARRA only enhances the credit for 2009 and 2010, and the expiration of the changes will limit the incentive to pursue post-graduate education to only these two years.

Extension of Enhanced Small Business Expensing and Five-year Carry-back for Losses

The two major tax provisions targeted at businesses are an extension of enhanced small business expensing and a five-year carry-back for losses for small businesses. Under §179 of the Internal Revenue Code, businesses can take immediate expense deductions for a portion of certain capital investments.⁴⁷ Congress temporarily increased the amount of the deduction and the phase-out limits in 2003. Before ARRA, businesses could expense up to \$100,000 and the amount of the deduction began to phase out for capital investments at \$400,000. ARRA has extended these limits, which were set to expire, through 2009.⁴⁸ Allowing businesses to take an

⁴⁵ *Id.*

⁴⁶ Altshuler, *supra* note 4, at 10.

⁴⁷ I.R.C. § 179 (2006).

⁴⁸ Altshuler, *supra* note 4, at 21.

expense deduction for capital investments is intended to promote immediate capital investments by businesses.

Additionally, ARRA allows for a five-year carry-back of losses for small businesses. Prior to ARRA, businesses were permitted to carry-back losses for two years to offset past years' taxable income. ARRA extends the carry-back an additional three years. This would improve the cash flow of small businesses that were profitable in previous years but now face significant losses in the economic downturn.⁴⁹ In order to take advantage of the additional carry-back, businesses will have to file amended returns for previous years.

These two provisions probably will have little effect on improving the financial condition of businesses in the current economy because neither deals with the problem of aggregate demand. Both provisions infuse some small businesses with cash, which may lead to new investment when credit is not available. However, only certain small businesses will benefit. Those businesses that are currently capable of making a capital investment will benefit from the extension of the expensing for capital investment. These expensing rules have been in place for several years, and the extension of the rules likely will have little new effect on the economy.⁵⁰ The addition of three years to the carry-back for operating losses similarly will have little effect on stimulating the economy. The carry-back may give some businesses an infusion of cash, but the businesses must have income from previous years in order to benefit. In addition, previous years of profitability may be insufficient to offset current losses. Adding three years to the carry-back rules may not change a business's plans going forward, meaning that it will probably not lead to new investments by businesses.⁵¹

⁴⁹ Altshuler, *supra* note 4, at 25.

⁵⁰ Altshuler, *supra* note 4, at 22.

⁵¹ Dean Baker, *Spending Versus Tax Cuts: Who Pays the Cost of Political Compromise?*, Center for Economic and Policy Research, Jan. 2009, 1-2.

Alternatives to ARRA Tax Provisions – Payroll Tax Holiday

One alternative proposed by a number of organizations is a Payroll Tax Holiday. This would provide relief for both consumers and producers. Currently, payroll taxes are split between employers and employees, with each paying half. Therefore, suspending the tax for a short period of time would provide immediate cash to both. This would significantly reduce the cost of labor for employers, allowing them to use the money to invest in capital or hire/retain workers. Employees would benefit from the additional money in their paychecks. Such a provision would essentially expand the MWPC to include employers. John Makin of the American Enterprise Institute believes that relief from the payroll tax may be the best fiscal policy measure available to stimulate the economy. A payroll tax holiday, according Makin, would provide an immediate increase of 3.5% in disposable income per household.⁵² That amounts to about \$127 per week into the hands of every worker.⁵³ The payroll tax is a regressive tax because it is a flat rate on all employees regardless of income, and relief from this tax would most benefit low-income households. In addition, the tax relief would be distributed incrementally, increasing the likelihood that money would be spent immediately.⁵⁴ One of the best aspects of the Payroll Tax Holiday is that it would take effect immediately because payroll withholdings are a part of every paycheck.

There are two potential downsides to a Payroll Tax Holiday. First, payroll taxes are used to finance Social Security benefits. A suspension of the tax would remove money from the system. However, Makin suggests that since the federal government is obligated to pay the benefits anyway, the funds could come from other sources, such as income tax or borrowed


⁵² John H. Makin, *Print Money and Cut the Payroll Tax*, American Enterprise Institute for Public Policy Research, Nov. 25, 2008, http://www.aei.org/publications/pubID.28990/pub_detail.asp.

⁵³ David Frum, *The Wrong War at the Wrong Time*, American Enterprise Institute for Public Policy Research, Feb. 10, 2009, http://www.aei.org/publications/filter.all,pubID.29378/pub_detail.asp.

⁵⁴ Makin, *supra* note 49.

assets.⁵⁵ The other downside to this remedy is that since it is only temporary, businesses are unlikely to alter their view on the cost of labor.⁵⁶ If that is the case, then it is unlikely that a temporary break from the tax will lead to additional employee hiring or capital investment.

Conclusion

It is hard to conclude that the tax provisions in ARRA will have an immediate and significant effect on the ailing economy. There may be some positive effects on the economy from these provisions. Generally, ARRA will place more money into the hands of businesses and individuals. However, there are three main problems with the ARRA tax provisions that limit the potential effect of the legislation. First, in order to benefit from some of the changes, taxpayers will have to file tax returns, meaning that relief will not come until the spring of 2010. The only tax reduction for individuals that will have an immediate effect is the MWPC. Secondly, the size of the provisions may not be large enough to incentivize new consumption and investment. Larger tax credits could have enticed more consumers to invest in housing and automobiles. Instead, ARRA attempts to target many different people all at once. The effect is that the size of each provision is reduced, lessening the impact of the tax reduction. To maximize the immediate effect of ARRA, Congress should have removed the less effective tax provisions, increased the size of the remaining ones, and drafted tax provisions that would have a more immediate effect. 

⁵⁵ *Id.*

⁵⁶ Arnold King, *How to Get Profitable Again*, FORBES, Jan. 29, 2009, http://www.forbes.com/2009/01/28/payroll-tax-stimulus-opinions-contributors_0129_arnold_kling.html.