



Tax Policy Center
Urban Institute and Brookings Institution

THE TAX POLICY

BRIEFING BOOK

*A Citizens' Guide for the
2008 Election and Beyond*

ECONOMIC STIMULUS

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Background: Economic Stimulus

This section looks at the tools available to the government to help reverse economic downturns and evaluates their likely effectiveness.

- What is the Economic Stimulus Act of 2008
- What does the 2008 stimulus act do for individuals?
- What does the 2008 stimulus act do for businesses?
- What is the role of monetary policy?
- How do automatic stabilizers work?
- When is fiscal stimulus appropriate?
- What characteristics make fiscal stimulus most effective?
- What fiscal stimulus options would be most effective?
- What fiscal stimulus options would have questionable effectiveness?
- What fiscal stimulus options should be avoided?

Economic Stimulus: What is the Economic Stimulus Act of 2008?

The Economic Stimulus Act of 2008 has three main parts: an individual tax rebate that the Internal Revenue Service will send out starting in mid-2008 and two business provisions that encourage investment during 2008 by increasing limits on expensing investment costs and accelerating depreciation of qualifying investments. The congressional Joint Committee on Taxation estimates that the three provisions together will reduce federal revenue by \$152 billion in fiscal 2008 and by another \$16 billion in fiscal 2009. In subsequent years, revenue will actually rise as firms will claim less depreciation for investments made in 2008 than they otherwise would have. As a result, revenue losses from 2008 through 2018 will total \$125 billion.

See Also

Economic Stimulus: What does the 2008 stimulus act do for individuals?

Economic Stimulus: What does the 2008 stimulus act do for businesses?

Economic Stimulus: When is fiscal stimulus appropriate?

Economic Stimulus: What characteristics make fiscal stimulus most effective?

Economic Stimulus: What fiscal stimulus options would be most effective?

Data Sources

U.S. Congress, Joint Committee on Taxation, "Estimated Budget Effects of the "Economic Stimulus Act of 2008," as Passed by the House of Representatives and the Senate on February 7, 2008" (Washington, February 8, 2008).

Author: Roberton Williams

Last Updated: March 13, 2008

Further Reading

U.S. Congress, Joint Committee on Taxation, "Distributional Effects of a Provision to Provide Tax Credits for Individual Taxpayers as Contained in the 'Economic Stimulus Act of 2008,' as Passed by the House of Representatives and the Senate on February 7, 2008" (Washington, February 8, 2008).

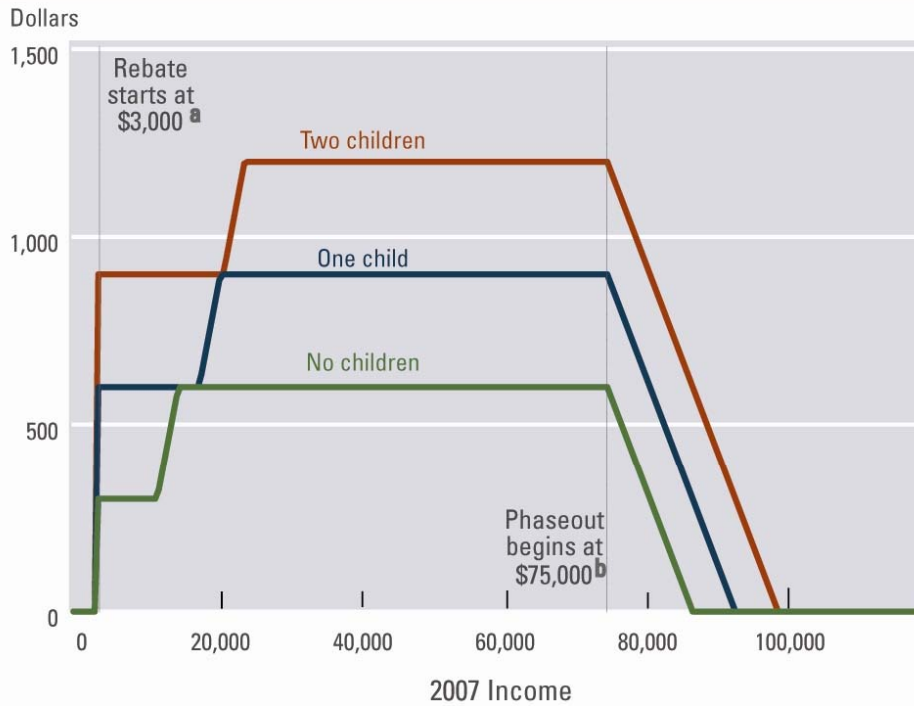
_____, "Technical Explanation of the Revenue Provisions of H.R. 5140, the 'Economic Stimulus Act of 2008,' as Passed by the House of Representatives and the Senate on February 7, 2008" (Washington, February 8, 2008)

Economic Stimulus: What does the 2008 stimulus act do for individuals?

People who file tax returns for either 2007 or 2008 may qualify to receive "recovery rebates." In total, the rebates will lower federal taxes by about 5 percent in 2008 and reduce the average effective federal tax rate (individual income, payroll, and excise taxes only) from 19.6 percent to 18.6 percent. The rebates will reduce federal revenue by an estimated \$107 billion in fiscal 2008 and by another \$10 billion in fiscal 2009.

- Tax filers who are neither dependents nor nonresident aliens receive a basic credit that is the larger of either:
 - \$600 (\$1,200 for joint filers), but not more than the tax filer's income tax liability before subtracting child and earned income credits, or
 - \$300 (\$600 for joint filers) if the tax filer has either (a) at least \$3,000 of earnings, Social Security benefits, and veteran's payments or (b) net income tax liability of at least \$1 and gross income greater than the sum of the applicable basic standard deduction and one personal exemption (two personal exemptions for a joint return). That value is \$8,750 in 2007 (\$17,500 for joint filers and \$11,250 for heads of household) and \$8,950 in 2008 (\$17,900 for joint filers and \$11,500 for heads of household).
- People who qualify for a basic credit may also receive a \$300 credit for each child eligible for the regular child credit (typically a related child under age 17 at the end of the year). This is in addition to the regular child credit.
- The sum of the basic and child credits is reduced by 5 percent of the tax filer's adjusted gross income over \$75,000 (\$150,000 for joint filers). See figures 1 and 2.
- Beginning in mid-2008, individuals who file 2007 tax returns will receive advance recovery rebates based on the information in their returns. They, along with others who receive no advance rebate, will complete a worksheet for their 2008 tax return to recalculate the rebate based on 2008 information. If that recalculation yields a larger rebate than the original calculation, the difference will be credited as a 2008 tax payment. If the recalculation yields a smaller value, the taxpayer does not have to repay the difference.

Figure 1. Stimulus Rebate for Single People by Number of Children and Income



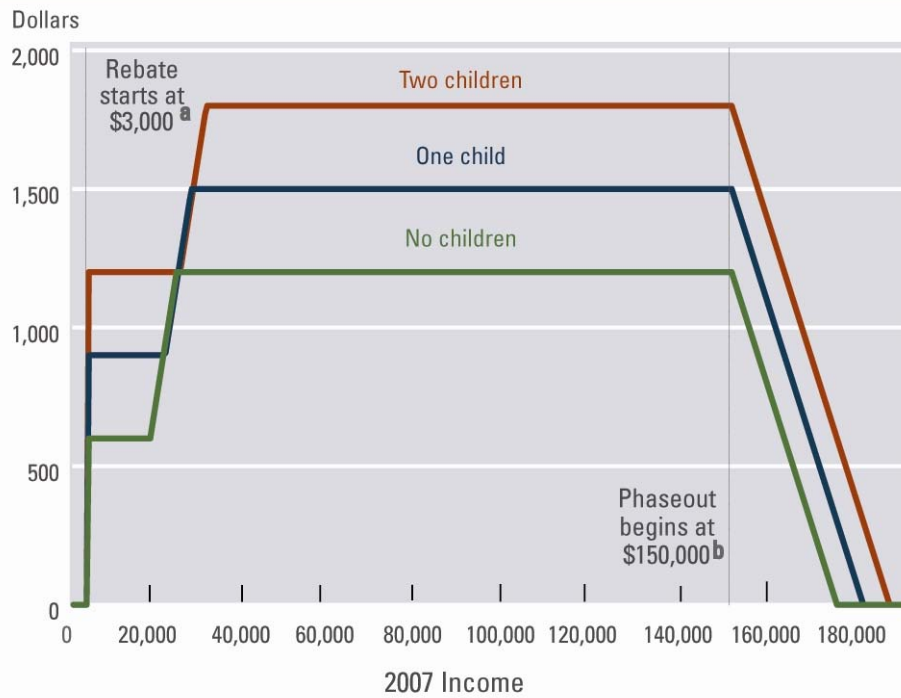
Notes:

(a) Rebate starts at \$3,000 of 2007 income from earnings, Social Security benefits, and veteran's payments *or* when total 2007 income exceeds \$8,750 (\$11,250 for heads of household) and tax unit has net income tax liability of at least \$1).

(b) Phaseout is based on adjusted gross income.

Source: Derived from information in Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of H.R. 5140, the Economic Stimulus Act of 2008, JCX-16-08, February 8, 2008, <http://www.house.gov/jct/x-16-08.pdf>.

Figure 2. Stimulus Rebate for Married Couples by Number of Children and Income



Notes:

(a) Rebate starts at \$3,000 of 2007 income from earnings, Social Security benefits, and veteran’s payments *or* when total 2007 income exceeds \$8,750 (\$11,250 for heads of household) and tax unit has net income tax liability of at least \$1).

(b) Phaseout is based on adjusted gross income.

Source: Derived from information in Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of H.R. 5140, the Economic Stimulus Act of 2008, JCX-16-08, February 8, 2008, <http://www.house.gov/jct/x-16-08.pdf>.

- [Click here for Table of Rebates for Single Individuals](#)
- [Click here for Table of Rebates for Married Couples](#)
- [Click here to see Rebate Examples for Single Individuals](#)
- [Click here to see Rebate Examples for Married Couples](#)

See Also

Economic Stimulus: What is the Economic Stimulus Act of 2008?

Economic Stimulus: What does the 2008 stimulus act do for businesses?

Economic Stimulus: When is fiscal stimulus appropriate?

Economic Stimulus: What characteristics make fiscal stimulus most effective?

Economic Stimulus: What fiscal stimulus options would be most effective?

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Further Reading

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_____, "Technical Explanation of the Revenue Provisions of H.R. 5140, the 'Economic Stimulus Act of 2008,' as Passed by the House of Representatives and the Senate on February 7, 2008" (Washington, February 8, 2008)

Table of Rebates for Single Individuals

Parental status and income	Rebate
Childless individual	
Less than \$3,000	No rebate
\$3,000 to \$11,749	\$300
\$11,750 to \$14,749	\$300 + 10% of AGI > \$11,750
\$14,750 to \$74,999	\$600
\$75,000 to \$87,499	\$600 – 5% of AGI > \$75,000
\$87,500 or more	No rebate
Single parent with one child	
Less than \$3,000	No rebate
\$3,000 to \$17,649	\$600
\$17,650 to \$20,649	\$600 + 10% of AGI > \$17,650
\$20,650 to \$74,999	\$900
\$75,000 to \$92,999	\$900 – 5% of AGI > \$75,000
\$93,000 or more	No rebate
Single parent with two children	
Less than \$3,000	No rebate
\$3,000 to \$21,049	\$900
\$21,050 to \$24,049	\$900 + 10% of AGI > \$21,050
\$24,050 to \$74,999	\$1,200
\$75,000 to \$98,999	\$1,200 – 5% of AGI > \$75,000
\$99,000 or more	No rebate
Single parent with more than two children	
Less than \$3,000	No rebate
\$3,000 to Amount A ^b	\$300 + \$300 per child
Amount A to Amount A + \$3,000	\$300 + \$300 per child + 10% of AGI > Amount A
Amount A + \$3,000 to \$74,999	\$600 + \$300 per child
\$75,000 to Amount B ^c	\$600 + \$300 per child – 5% of AGI > \$75,000
More than Amount B	No rebate

Source: Tax Policy Center based on U.S. Congress, Joint Committee on Taxation, "Technical Explanation of the Revenue Provisions of H.R. 5140, the 'Economic Stimulus Act of 2008,' as Passed by the House of Representatives and the Senate on February 7, 2008" (Washington, February 8, 2008). www.house.gov/jct/x-16-08.pdf

a. Calculations assume that all income comes from earnings, Social Security, and veteran's payments and that all filers claim the standard deduction and only the regular personal and dependent exemptions. Income is adjusted gross income (AGI) as shown on filer's 2007 tax return.

b. Amount A = \$14,250 plus \$3,400 for each child.

c. Amount B = \$87,000 plus \$6,000 for each child.

Table of Rebates for Married Couples

Table 2. Advance Rebate Calculations for Married Taxpayers^a

Parental status and income	Rebate
Childless couple	
Less than \$3,000	No rebate
\$3,000 to \$23,499	\$600
\$23,500 to \$29,499	\$600 + 10% of AGI > \$23,500
\$29,500 to \$149,999	\$1,200
\$150,000 to \$173,999	\$1,200 – 5% of AGI > \$150,000
\$174,000 or more	No rebate
Married couple with one child	
Less than \$3,000	No rebate
\$3,000 to \$26,899	\$900
\$26,900 to \$32,899	\$900 + 10% of AGI > \$26,900
\$32,900 to \$149,999	\$1,500
\$150,000 to \$179,999	\$1,500 – 5% of AGI > \$150,000
\$180,000 or more	No rebate
Married couple with two children	
Less than \$3,000	No rebate
\$3,000 to \$30,299	\$1,200
\$30,300 to \$36,299	\$1,200 + 10% of AGI > \$30,300
\$36,300 to \$149,999	\$1,800
\$150,000 to \$185,999	\$1,800 – 5% of AGI > \$150,000
\$186,000 or more	No rebate
Married couple with more than two children	
Less than \$3,000	No rebate
\$3,000 to Amount A ^b	\$600 + \$300 per child
Amount A to Amount A + \$6,000	\$600 + \$300 per child + 10% of AGI > Amount A
Amount A + \$6,000 to \$149,999	\$1,200 + \$300 per child
\$150,000 to Amount B ^c	\$1,200 + \$300 per child – 5% of AGI > \$150,000
More than Amount B	No rebate

Source: Tax Policy Center based on U.S. Congress, Joint Committee on Taxation, "Technical Explanation of the Revenue Provisions of H.R. 5140, the 'Economic Stimulus Act of 2008,' as Passed by the House of Representatives and the Senate on February 7, 2008" (Washington, February 8, 2008). www.house.gov/jct/x-16-08.pdf

a. Calculations assume that all income comes from earnings, Social Security, and veteran's payments and that all filers claim the standard deduction and only the regular personal and dependent exemptions. Income is adjusted gross income (AGI) as shown on filer's 2007 tax return.

b. Amount A = \$23,500 plus \$3,400 for each child.

c. Amount B = \$174,000 plus \$6,000 for each child.

Examples of 2008 Recovery Rebates for Single Taxpayers

Single mother with two children and \$22,050 of earnings: rebate equals \$600 (limited to her income tax liability before child and earned income credits) plus \$300 for each child. Her taxable income equals her earnings of \$22,050 minus a standard deduction of \$7,850 minus three exemptions of \$3,400 each, or \$4,000. Her tax is 10 percent of that amount, or \$400. Her rebate is thus \$400 (the \$600 maximum reduced to her \$400 tax liability) plus \$600 (\$300 for each child), or \$1,000.

Single elderly individual whose only income is \$20,000 of Social Security benefits: rebate equals \$300 because the individual has more than \$3,000 of income from Social Security. She does not qualify for the basic \$600 benefit because she has no income tax liability.

Single individual with \$2,500 of veteran's payments and \$5,000 of investment income: the individual qualifies for no rebate. His income from earnings, Social Security, and veteran's payments is less than \$3,000 and he has no income tax liability.

Single father with two children and adjusted gross income of \$85,000: her rebate of \$1,200 (\$600 for her plus \$300 for each child) is reduced by 5 percent of the amount by which her AGI exceeds \$75,000. That excess equals \$10,000, 5 percent of which is \$500. Her rebate is thus \$1,200 minus \$500, or \$700.

Single mother with two children and adjusted gross income of \$100,000: her rebate of \$1,200 (\$600 for her plus \$300 for each child) is reduced by 5 percent of the amount by which her AGI exceeds \$75,000. That excess equals \$25,000, 5 percent of which is \$1,250. She gets no rebate because the \$1,250 reduction exceeds her maximum benefit of \$1,200.

Source: Tax Policy Center based on U.S. Congress, Joint Committee on Taxation, "Technical Explanation of the Revenue Provisions of H.R. 5140, the 'Economic Stimulus Act of 2008,' as Passed by the House of Representatives and the Senate on February 7, 2008" (Washington, February 8, 2008).

Examples of 2008 Recovery Rebates for Married Couples

Married couple with two children and \$30,000 of earnings: rebate equals \$1,200 (limited to their income tax liability before child and earned income credits) plus \$300 for each child. Taxable income equals earnings of \$30,000 minus a standard deduction of \$10,700 minus four exemptions of \$3,400 each, or \$5,700. Their tax is 10 percent of that amount, or \$570. Their rebate is thus \$570 (the \$1,200 maximum reduced to their \$570 tax liability) plus \$600 (\$300 for each child), or \$1,170.

Married couple whose only income is \$30,000 of Social Security benefits: rebate equals \$600 because the couple has more than \$3,000 of income from Social Security. They do not qualify for the basic \$1,200 benefit because they have no income tax liability.

Married couple with \$2,500 of Social Security benefits and \$10,000 of investment income the couple qualifies for no rebate. Their income from earnings, Social Security, and veteran's payments is less than \$3,000 and they have no income tax liability.

Married couple with two children and adjusted gross income of \$175,000: their rebate of \$1,800 (\$600 for each spouse plus \$300 for each child) is reduced by 5 percent of the amount by which their AGI exceeds \$150,000. That excess equals \$25,000, 5 percent of which is \$1,250. Their rebate is thus \$1,800 minus \$1,250, or \$550.

Married couple with two children and adjusted gross income of \$200,000: their rebate of \$1,800 (\$600 for each spouse plus \$300 for each child) is reduced by 5 percent of the amount by which their AGI exceeds \$150,000. That excess equals \$50,000, 5 percent of which is \$2,500. They get no rebate because the \$2,500 reduction exceeds their maximum benefit of \$1,800.

Source: Tax Policy Center based on U.S. Congress, Joint Committee on Taxation, "Technical Explanation of the Revenue Provisions of H.R. 5140, the 'Economic Stimulus Act of 2008,' as Passed by the House of Representatives and the Senate on February 7, 2008" (Washington, February 8, 2008).

Economic Stimulus: What does the 2008 stimulus act do for businesses?

The Economic Stimulus Act of 2008 contains two provisions that help businesses by increasing limits on expensing investment costs and accelerating depreciation of some investments. The congressional Joint Committee on Taxation estimates that the two provisions will reduce federal revenue by \$51 billion in fiscal 2008 and 2009. Revenue will rise by \$43.5 billion in subsequent years as firms will claim less depreciation for investments made in 2008 than they otherwise would have. As a result, revenue losses from the investment provisions will net \$7.5 billion from 2008 through 2018.

- **Temporary Increase in Limitations on Expensing of Depreciable Business Assets.** Businesses may expense (that is, deduct the full cost of) qualifying investment undertaken in 2008, subject to limitations. The stimulus bill doubles for one year the maximum amount of investment that firms may expense. "Qualifying investment" is generally defined as "depreciable tangible personal property that is purchased for use in the active conduct of a trade or business."
 - Firms may expense up to \$250,000, but this limit is reduced by the amount by which qualifying investment exceeds \$800,000. Thus, for example, a firm that invests \$750,000 may expense \$250,000. But a firm that invests \$900,000 may expense only \$150,000, because the \$250,000 limit is reduced by the \$100,000 of investment over the \$800,000 limit. Firms that invest \$1,050,000 or more may not expense any of their investment.
 - After 2008 the limit on expensing reverts to \$125,000 (indexed from 1997), with the reduction beginning when investment exceeds \$500,000 (also indexed from 1997).
 - This provision will reduce federal revenue by an estimated \$1.5 billion in fiscal 2008 and 2009, but that cost will be offset by about \$1.4 billion of additional revenue in subsequent years, because firms will be unable to claim as much depreciation in those years on investments made in 2008. The net revenue cost from 2008 through 2018 will thus be about \$100 million.
- **Special Depreciation Allowance for Certain Property.** On top of the amount of investment that they may expense, firms may also claim an additional first-year depreciation of 50 percent of the cost of qualifying investments contracted for and placed in service during 2008. The Joint Committee on Taxation estimates that this provision will reduce federal revenue by about \$49.5 billion in fiscal 2008 and 2009, but that cost will be offset by about \$42.1 billion of additional revenue in subsequent years, because claiming the additional first year depreciation will reduce the amount firms may depreciate in the future. The net revenue cost from 2008 through 2018 will thus be about \$7.4 billion.

See Also

Economic Stimulus: What is the Economic Stimulus Act of 2008?

Economic Stimulus: What does the 2008 stimulus act do for individuals?

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Last Updated: March 13, 2008

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U.S. Congress, Joint Committee on Taxation, "Estimated Budget Effects of the "Economic Stimulus Act of 2008," as Passed by the House of Representatives and the Senate on February 7, 2008" (Washington, February 8, 2008).

Further Reading

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Economic Stimulus: What is the role of monetary policy?

Economists view monetary policy as the first line of defense against economic slowdowns. Compared with fiscal policy, monetary policy has the advantages of the Federal Reserve's ability to act faster than the administration or Congress and to better judge the appropriate timing and magnitude of a stimulus. Further, unless well crafted, fiscal stimulus may impose long-run costs on the economy without providing much short-run gain.

- The Federal Reserve can adjust monetary policy more quickly than the administration and Congress can adjust fiscal policy. Because most contractions in economic activity last for only a few quarters, the timeliness of the policy response is crucial. Fiscal policy in practice responds to changes in economic conditions with a considerable lag: it takes time first to enact a stimulus bill and then to implement it, and time for the spending increases or tax reductions to reach the pockets of consumers. As a result, the effect of fiscal stimulus on household and business spending may come too late.
- Whether and how much stimulus is needed depends on economic conditions today, on projections of likely future conditions, and on assessments of the risks to both economic activity and inflation going forward. Forecasting economic conditions—or even determining the current state of the economy—is inherently very difficult, given limitations in the available data and in economists' understanding of the world. But the Federal Reserve's large and sophisticated team of analysts is better positioned to accomplish this task than any other agency of the federal government. In addition, the Federal Reserve staff carries out this work independent of political considerations.
- Economists worry that poorly crafted fiscal stimulus would have little short-run economic benefit and could do long-run harm. For example, permanent tax cuts unaccompanied by permanent spending reductions would increase the long-run budget deficit. And a permanent increase in the deficit—especially now, when the budget is already so far out of long-run balance—would reduce economic growth over time. Moreover, because higher expected government borrowing is likely to push up current long-term interest rates, the short-run stimulative effect would be muted as well. In fact, under plausible assumptions about economic behavior, the response of forward-looking financial markets to a sustained reduction in personal income taxes would offset about half of the incipient stimulative effect of the tax cut.

See Also

Economic Stimulus: How do automatic stabilizers work?

Economic Stimulus: When is fiscal stimulus appropriate?

Economic Stimulus: What characteristics make fiscal stimulus most effective?

Economic Stimulus: What fiscal stimulus options would be most effective?

Economic Stimulus: What fiscal stimulus options would have questionable effectiveness?

Economic Stimulus: What fiscal stimulus options should be avoided?

Author: Douglas Elmendorf

Last Updated: February 7, 2008

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Rubin, Robert E., Peter R. Orszag, and Allen Sinai, "Sustained Budget Deficits: Longer-Run US Economic Performance and the Risk of Financial and Fiscal Disarray," presented at the AEA-NAEFA Joint Session, Allied Social Science Associations Annual Meetings, The Andrew Brimmer Policy Forum, "National Economic and Financial Policies for Growth and Stability," San Diego (January 4, 2004)

Economic Stimulus: How do automatic stabilizers work?

Automatic stabilizers are features of the tax and transfer systems that tend by their design to offset fluctuations in economic activity without direct intervention by policymakers. When incomes are high, tax liabilities rise and eligibility for government benefits falls, without any change in the tax code or other legislation. Conversely, when incomes slip, tax liabilities drop and more families become eligible for government transfer programs, such as food stamps and unemployment insurance, that help buttress their income.

- Automatic stabilizers are quantitatively important at the federal level. A 2000 study estimated that reduced income and payroll tax collection offsets about 8 percent of any decline in GDP. Additional stabilization from unemployment insurance, although smaller in total magnitude than that from the tax system, is estimated to be eight times as effective per dollar of lost revenue because more of the money is spent rather than saved.
- Automatic stabilizers also arise in the tax and transfer systems of state and local governments. However, state constitutions generally require balanced budgets, which can force countervailing changes in outlays and tax rules. These requirements do not force complete balance on an annual basis: they generally focus on budget projections rather than realizations, so deficits can still occur when economic conditions are unexpectedly weak. In addition, many governments have "rainy day" funds that they can draw down during periods of budget stringency. Even so, most state and local governments respond to an economic slowdown by legislating lower spending or higher taxes. These actions are contractionary, working at cross-purposes with the automatic stabilizers.

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See Also

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Economic Stimulus: When is fiscal stimulus appropriate?

Author: Douglas Elmendorf
Last Updated February 7, 2008

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Economic Stimulus: When is fiscal stimulus appropriate?

Economists' concerns about discretionary fiscal stimulus are centered on political and administrative limitations, in particular the long lags in enacting and implementing stimulus programs and the potential for politically motivated measures that are ineffective or even counterproductive at increasing short-run economic activity. However, fiscal policy has strengths as well as weaknesses.

Policy option	Increase in real GDP (percent)		
	2008:Q3	2008:Q4	2009:Q1
<i>Policies costing 1 percent of GDP annually on a permanent basis^b</i>			
Proportional cut in personal income taxes	0.2	0.3	0.4
10 percent investment tax credit	0.2	0.1	0.2
Increase in federal purchases	1.0	1.0	1.0
<i>Policies costing 1 percent of GDP on a one-time basis</i>			
Temporary tax rebate (assuming 20 percent spent)	0.3	0.0	0.0
Temporary tax rebate (assuming 50 percent spent) ^c	1.0	1.2	0.2
<i>Memorandum:</i>			
One-percentage-point reduction in federal funds rate ^d	0.2	0.4	0.5

Notes:

(a) The figures for the effects of fiscal policy apply the dynamic responses reported in the Elmendorf and Reifschneider paper to a hypothetical fiscal stimulus implemented in 2008:Q3.

(b) Tax and spending changes cannot literally be permanent without offsetting changes on the other side of the government ledger or government debt would spiral upward as a share of output. Therefore, the analysis assumes that changes would be sustained for ten years before budget balance was gradually restored. The permanent 10 percent investment tax credit was not calibrated to cost exactly 1 percent of GDP, but its budget implications turned out to be very similar to those of the other policies shown.

(c) The simulations assume that half of all subsequent increases in income would be consumed as well. If instead only one-fifth of subsequent multiplier increases in pre-tax income is spent by households, the results here would require that the tax cut be targeted so that somewhat more than half of it is spent.

(d) Figures apply the dynamic responses reported in the personal communication by Reifschneider to a hypothetical monetary stimulus implemented in 2008:Q1.

Source: TPC calculations based on Elmendorf and Reifschneider (2002); David Reifschneider, Federal Reserve Board, personal communication.

- Fiscal stimulus, once implemented, can affect the economy more quickly than monetary stimulus implemented at the same time—an especially important consideration if economic conditions are deteriorating rapidly. The Federal Reserve's large-scale econometric model suggests that a 1-percentage-point drop in the federal funds rate enacted this quarter adds nothing to the level of GDP in the current quarter, 0.1 percent in the next quarter, 0.2 percent in the third quarter, and 0.4 percent in the fourth quarter. In contrast, a fiscal stimulus that distributes funds even by mid-year could have a much larger effect in the second half of the year. For example, the model finds that a temporary \$70 billion tax cut, if distributed in the third quarter to households that are likely to spend much of their extra income, would boost the level of GDP by 0.5 percent during the third quarter and 0.6 percent in the fourth quarter.

- Fiscal stimulus combined with monetary stimulus can reduce uncertainty about the total amount of thrust provided to the economy. All of the main types of stimulus—tax cuts, increases in government spending, and reductions in interest rates by the Federal Reserve—have very uncertain effects. But any surprises in the effects of these different instruments will not be perfectly correlated and will therefore cancel out to at least some extent, thus reducing the overall uncertainty.
- Fiscal stimulus could become essential in a situation where the Federal Reserve has already lowered the federal funds rate close to zero. Although adjusting the funds rate is not its only means of stimulating the economy, the Federal Reserve has scant experience with alternatives, so their effectiveness is even more uncertain. That said, the federal funds rate today is still well above zero, so this concern has little bearing currently.
- Fiscal stimulus would also become critical if monetary policy proves ineffective—if reducing the federal funds rate fails to lower other interest rates, or if wary lenders refuse to lend money, or if cautious consumers and businesses refuse to borrow. Consumer and business spending would then fail to rise in response to the monetary stimulus. None of those scenarios appears to apply now, however. Monetary expansions still appear to cause a wide range of interest rates to fall, and despite the credit crisis, banks appear able to lend money. Nor is there any evidence that households and businesses are unwilling to borrow more or that more borrowing would not spur more spending.
- Fiscal stimulus is appropriate if policymakers want to achieve full employment with higher rather than lower interest rates. Monetary policy increases output by lowering interest rates; fiscal policy increases output while increasing the budget deficit, thus resulting in higher interest rates. Policymakers may fear that lower interest rates could fuel another asset price bubble or lead investors to flee U.S. assets, causing the dollar to weaken. Although those concerns have merit, other factors may militate against them. First, some depreciation of the dollar may be necessary to correct current trade and capital imbalances. Second, lower interest rates might also help deal with the ongoing problems in housing and mortgage markets—and in financial markets more generally—by supporting housing demand, easing mortgage refinancing, and boosting asset values. Finally, lower interest rates help to spur investment and thus long-term economic growth.

See Also

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Economic Stimulus: What fiscal stimulus options are of questionable effectiveness?

Economic Stimulus: What fiscal stimulus options should be avoided?

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Economic Stimulus: What characteristics make fiscal stimulus most effective?

Fiscal stimulus can raise output and incomes in the short run when the economy is operating below its potential. To have the greatest impact with the least long-run cost, the stimulus should be timely, temporary, and targeted. It should be timely so that its effects are felt while economic activity is still below potential; when the economy has recovered, stimulus becomes counterproductive. It should be temporary to avoid raising inflation and to minimize the adverse long-term effects of a larger budget deficit. And it should be well targeted to provide resources to people who most need them and will spend them: for fiscal stimulus to work, it is essential that the funds be spent, not saved.

- Making fiscal stimulus timely is especially challenging because it involves not just enacting tax cuts or spending increases but also implementing them. In the worst case, poorly timed fiscal policy adds instability to the economy, intensifying rather than damping the business cycle. If fiscal stimulus is enacted too slowly, not only might it fail to prevent a drop in output and incomes, but the stimulus might arrive after recovery has begun, leading to overexpansion and higher inflation.
- Fiscal stimulus should be temporary because, in the long run, the Federal Reserve generally keeps the economy operating close to full employment and full capacity. This means that, most of the time, fiscal stimulus would not increase output but instead simply raise inflation or induce the Federal Reserve to run tighter monetary policy in order to keep inflation down.
- Over the long run, permanent tax cuts or increases in government spending that are not matched by changes on the other side of the ledger reduce national saving, resulting in lower investment or more foreign borrowing. This, in turn, diminishes economic growth and future national income. Also, larger expected budget deficits tend to push up long-run interest rates, which restrain investment and weaken net exports by pushing up the value of the dollar—effects that will undo part or all of the direct stimulative effects of lower taxes or higher government spending. Therefore, a temporary stimulus is likely to be more effective than a permanent policy change at a much lower long-run cost. Temporary stimulus will be even more effective if it is actually paid for over five or ten years, to avoid raising the long-run path of federal debt.
- Fiscal stimulus should be well targeted in two ways. First, it should go to those households or businesses most likely to raise spending in response to the stimulus and thus increase GDP in the short run. Second, it should provide the greatest benefit to those people most adversely affected by the slowdown. These two aspects of targeting are complementary. Higher-income households can generally smooth their consumption over the business cycle by drawing down their savings or borrowing. Therefore directing resources to them will likely have little effect on consumer spending. In contrast, lower-income families are more likely to have to cut back their consumption in hard times. These families are likely to spend any additional money they receive from tax cuts or transfer payments, which thus help protect them from the downturn while also boosting the overall economy.
- Research has found that tax rebates to households rapidly increase consumer spending and hence short-run economic activity (see tables 1 and 2). An across-the-board rate reduction is much less effective than a flat tax cut per household, and capital-oriented tax cuts (such as re-

ductions in the tax rate on dividends or capital gains) provide little short-run stimulus. Policies that target the people most affected by an economic slowdown, such as the long-term unemployed, have the biggest bang for the buck—the largest increase in GDP for a given cut in taxes or increase in outlays. In contrast, few firms appear to respond to bonus depreciation for business investment, and the maximum effect on investment occurs after three years, well after fiscal stimulus would be most helpful.

Table 1. Estimates of the Effect of Alternative Fiscal Policies^a

Policy option	Increase in real GDP (percent)		
	2008:Q3	2008:Q4	2009:Q1
<i>Policies costing 1 percent of GDP annually on a permanent basis^b</i>			
Proportional cut in personal income taxes	0.2	0.3	0.4
10 percent investment tax credit	0.2	0.1	0.2
Increase in federal purchases	1.0	1.0	1.0
<i>Policies costing 1 percent of GDP on a one-time basis</i>			
Temporary tax rebate (assuming 20 percent spent)	0.3	0.0	0.0
Temporary tax rebate (assuming 50 percent spent) ^c	1.0	1.2	0.2
<i>Memorandum:</i>			
One-percentage-point reduction in federal funds rate ^d	0.2	0.4	0.5

Notes:

- (a) The figures for the effects of fiscal policy apply the dynamic responses reported in the Elmendorf and Reifschneider paper to a hypothetical fiscal stimulus implemented in 2008:Q3.
- (b) Tax and spending changes cannot literally be permanent without offsetting changes on the other side of the government ledger or government debt would spiral upward as a share of output. Therefore, the analysis assumes that changes would be sustained for ten years before budget balance was gradually restored. The permanent 10 percent investment tax credit was not calibrated to cost exactly 1 percent of GDP, but its budget implications turned out to be very similar to those of the other policies shown.
- (c) The simulations assume that half of all subsequent increases in income would be consumed as well. If instead only one-fifth of subsequent multiplier increases in pre-tax income is spent by households, the results here would require that the tax cut be targeted so that somewhat more than half of it is spent.
- (d) Figures apply the dynamic responses reported in the personal communication by Reifschneider to a hypothetical monetary stimulus implemented in 2008:Q1.

Source: TPC calculations based on Elmendorf and Reifschneider (2002); David Reifschneider, Federal Reserve Board, personal communication.

Table 2. Impact of Various Fiscal Options

Policy option	Congressional Budget Office		Moody's Economy.com	
	Cost-effectiveness	Time from enactment to impact	Cost-effectiveness ^a	Time from enactment to impact ^b
<i>Tax cuts</i>				
Nonrefundable lump-sum rebate	Large ^c	Medium	1.02	Medium
Refundable lump-sum rebate			1.26	Medium
Payroll tax holiday	Large	Medium	1.29	Medium
Temporary across-the-board cut	Small	Short	1.03	n.a.
Accelerated depreciation	Medium	Medium	0.27	Medium/long
Extend AMT patch permanently	Medium	Long	0.48	Long
Make Bush tax cuts permanent	Small	Long	0.29	Long
Make dividend and capital gains cuts permanent	n.a.	n.a.	0.37	Long
Cut corporate tax rate	Small	Long	0.30	n.a.
Extend operating loss and carryback provisions	Small	Medium	n.a.	n.a.
<i>Spending increases</i>				
Extend unemployment insurance benefits	Large	Short	1.64	Short
Increase food stamps temporarily	Large	Short	1.73	Short
Provide aid to state governments	Medium	Medium	1.36	Short/medium
Increase infrastructure spending	Small	Long	1.59	Long

Notes:

(a) One-year dollar change in real GDP for a given dollar reduction in federal tax revenue or increase in spending. Estimates are for the year the spending or tax change takes effect, which is not necessarily the year in which it is enacted.

(b) TPC's assessments are based on the discussion in Moody's Economy.com (2008).

(c) The CBO table does not distinguish between refundable and nonrefundable rebates, but its text states, "Making the rebate refundable would further boost the cost effectiveness of the stimulus." n.a., not available; the source does not provide an assessment of the indicated policy option.

Source: Congressional Budget Office (CBO, 2008) and Moody's Economy.com (2008).

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Economic Stimulus: What fiscal stimulus options are most effective?

The most effective fiscal policy options to stimulate the economy are those that would increase spending quickly and be short-lived. Those criteria can be met by policies that temporarily boost the purchasing power of households who are most likely to increase their spending quickly in response. Extending unemployment insurance beyond its normal twenty-six-week limit, raising food stamp benefits, or issuing refundable tax credits, all on a temporary basis, would likely provide the greatest fiscal stimulus in the shortest time.

- *Extend unemployment insurance benefits temporarily.* Unemployment insurance protects workers against hardship due to job loss but weakens the incentive to find a new job. For that reason unemployment insurance benefits are generally limited to twenty-six weeks. But policymakers also recognize the need to extend benefits during economic slowdowns, when new jobs are harder to find. Such action could be even more important now, because the long-term unemployment rate (the share of the labor force out of work for more than six months) was nearly twice as high in the last quarter of 2007 as it was immediately before the 2001 recession. Because the funds would go to people whose income has fallen, nearly all would be spent rather than saved. Thus a policy of extending unemployment benefits offers a very high bang for the buck in terms of macroeconomic stimulus.
- *Increase food stamps temporarily.* Another option would temporarily increase food stamp benefits, for example by 20 percent for each recipient for six months. This change could be implemented quickly just by raising the value of the electronic benefit cards issued to food stamp beneficiaries. This change, too, would be well targeted to families most hurt by an economic slowdown, who would spend essentially all of the extra income.
- *Issue refundable tax credits temporarily.* Extended unemployment benefits and higher food stamp allotments would affect only a fraction of the population. Thus even the two combined would not provide adequate stimulus to offset a generalized downturn. Refundable tax credits, however, could move funds to virtually all households filing tax returns, and do so within a few months of enactment. For example, tax rebates enacted in February and based on 2007 tax returns could reach households over a five- to six-week period beginning in May or June. A refundable credit (one that can exceed taxes owed) would reach even the lowest-income households. This would maximize the share of the total outlay that would be spent rather than saved while providing assistance to those households most vulnerable to a weak economy. In contrast, a nonrefundable income tax rebate, like the one enacted in 2001, would exclude more than 25 million working households with no income tax liability; the result would not only be less fair but would also provide less stimulus bang for the buck. Making the credits temporary would ensure that they do not worsen the long-run budget outlook.

See Also

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Economic Stimulus: What fiscal stimulus options are of questionable effectiveness?

Policies that boost investment, such as direct spending on public infrastructure or tax incentives for businesses, are likely to have a smaller impact on the economy than policies designed to increase consumer spending. In particular, the available evidence suggests that the stimulus they provide would be small, not well-timed, or both.

- *Increase infrastructure investment.* Although additional investments in physical and technological infrastructure might provide an important boost to long-term growth, they are difficult to design in a manner that generates significant short-term stimulus. In the past, infrastructure projects that were launched as the economy started to weaken added little to total spending until after the economy had recovered. However, declining revenue during a downturn may force state and local governments to cut previously planned infrastructure spending (such as road repair), and such reductions can actually intensify the downturn. If policies could be designed to effectively prevent such cuts, economic stimulus could be delivered more quickly.
- *Create temporary investment tax incentives.* Temporary tax incentives for business investment, such as the bonus depreciation provision enacted in 2003, could stimulate the economy in the short run by inducing businesses to undertake investment immediately that they would otherwise have pursued in some future year. But research has found that this effect is small at best, and it appears to work more slowly than measures aimed at boosting household consumption. In addition, temporary investment tax incentives provide no direct help for families coping with a temporary downturn.

See Also

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Economic Stimulus: What fiscal stimulus options should be avoided?

Some fiscal measures would do very little to boost economic activity during a downturn, either because they would take too long to have any effect or because they would give additional spending power to households who are less likely than others to increase their spending. Such policies might even make the economy worse off in the long run if they increase the long-run government deficit, causing interest rates to rise and so reducing investment.

- *Reduce tax rates.* Permanently reducing tax rates would generate less than half as much economic stimulus as a flat, refundable tax credit of the same size. It would also give disproportionate benefits to high-income households, the least likely to be hurt by a downturn. A permanent tax reduction could also raise long-term interest rates and crowd out some of the modest direct stimulus.
- *Make the 2001 and 2003 tax cuts permanent.* The tax cuts enacted in 2001 and 2003 expire at the end of 2010. Making those cuts permanent would violate all three principles of effective fiscal stimulus—they would be neither timely, nor temporary, nor well targeted—and might even hurt the economy in the short run, for several reasons. First, a reduction in income taxes starting in 2011 would provide little boost to consumer spending in 2008. Second, the 2001 and 2003 tax reductions offered the largest dollar benefits to the highest-income families, so extending them would provide little stimulus bang for the buck even in 2011, because those families tend to save more of an unexpected increase in income. Third, a permanent tax change would increase the long-run budget deficit, likely reducing long-run economic growth. Worse, if the financial markets conclude that the policy will raise the long-run deficit, interest rates would rise today, crowding out investment and reducing GDP in the short run as well.

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