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Beware Tax Reform That Raises Taxes on Capital
By Margo Thorning

Policy makers from the House and Senate tax-writing committees have been meeting quietly to discuss reforming the federal tax code, including far-reaching changes to the treatment of corporate income and expenses. Tax reform is a worthwhile goal, but how it is accomplished will have an important impact on future U.S. economic and job growth.

In particular, proposals that would increase the tax burden on capital-intensive industries—which are contributing to U.S. economic growth and employment—should be viewed with caution. As the saying goes, if you tax something, you'll get less of it.

Reports and studies in the past few years illustrate the potential pitfalls. The 2010 National Commission on Fiscal Responsibility and Reform (aka the Bowles-Simpson plan) and the 2012 President's Framework for Business Tax Reform include provisions that would slow the rate at which companies recover their investments in capital equipment and inventories in exchange for a lower corporate income-tax rate. Yet stretching out depreciation allowances reduces a company's annual cash flow and raises the "hurdle rate" that new investments would have to meet before they are approved.

For capital-intensive firms in sectors such as energy, manufacturing, utilities and transportation, the trade-off between delayed cash flow and lower corporate income-tax rates may result in cutbacks in capital spending. That's because the rapid payback from depreciation allowances substantially reduces the risk premium for investment in equipment. By contrast, it can take years for a tax rate cut to equal that benefit.

This is not what anyone concerned with prosperity would want. Nonresidential U.S. investment spending (after inflation) in the most recent quarter is almost $70 billion below that of the fourth quarter of 2007. Each additional $1 billion in investment is associated with 23,000 new jobs, according to data from the Department of Commerce and the Bureau of Labor Statistics.

Energy is one of the few bright spots in the economy, and so proposed changes in taxing this sector need to be scrutinized carefully for their likely effect on capital spending. During the period 2006-11, investments in fixed assets for oil and gas extraction—such as wells, gathering pipelines, trucks and bulldozers—grew by 24%. Fixed-asset investment in petroleum and coal products over the period grew by 16%. By contrast, overall U.S. fixed investment fell by 20% during that time.

And jobs? Overall U.S. employment declined by 3.4% from 2006 through 2011. During the same period, employment grew by 28% in oil and gas extraction, by 43% in industries that support activities in oil and gas, and by 3% in petroleum refining.

Given energy's key role in the economic recovery, the Bowles-Simpson plan to eliminate accelerated depreciation, bonus depreciation, last in-first out accounting (called LIFO) and other deductions is problematic. The loss of these provisions would increase the risk of making an investment. The riskier an investment, the higher the return it must earn to justify making it.

The White House's 2012 business tax reform plan would eliminate or curtail tax provisions that are called for in Bowles-Simpson, as well as deductions for interest expense. The administration also wants to eliminate or curtail tax provisions specifically applicable to the oil and gas industry, including immediate write-offs for intangible drilling costs, which are largely the labor costs of locating and drilling wells.

In addition, the president's fiscal 2013 budget calls for increasing the depreciation period for geological and geophysical costs. G&G expenses include the costs incurred for geologists, seismic surveys and the drilling of core holes. Like intangible drilling costs, but in contrast to a piece of equipment, G&G expenses have no salvage value and should not be subject to depreciation.

The direction of these changes is ill-considered. Rather than drawing out depreciation schedules, a better, pro-growth approach to corporate tax reform would be to allow all investment to be expensed—in other words, deducted from income in the first year.

Finally, the president's fiscal year 2013 budget called for repealing the Section 199 manufacturing tax deduction for oil and gas companies, leaving it in place for all other manufacturing companies. This too would move in the wrong direction: slowing the growth of a vital sector in the economy and making it harder to restore full employment. To the extent that tax changes make drilling for natural gas less attractive, U.S. businesses and households could also face higher natural-gas prices. A substantial increase in natural-gas prices could dampen the resurgence of U.S. manufacturing.

Investment, growth and job creation should be the cornerstones of any tax-reform effort. Cash flow matters to those companies that are restoring the country's economic prosperity, particularly in the capital-intensive energy sector. The preservation of tax provisions that are working, in short, is just as important as repairing those that are not.

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