

Expensing is more cost-effective, in terms of both static and dynamic government revenue effects, because it focuses on new investment. Both expensing and a reduction in the corporate tax rate reduce the cost of capital and lead to more capital formation. However, some of the corporate rate reduction applies to current income from past investment. Expensing is concentrated on reducing the cost of investment going forward. Expensing does more to increase the capital stock, sooner, than a corporate rate cut of equal “static” revenue cost to the government. Because expensing is a more powerful reduction in the cost of capital than corporate tax rate reduction, per dollar of static revenue loss, a revenue neutral trade of current expensing for a rate cut would raise the cost of capital and would lower capital formation, GDP, employment, and wages.

A switch to expensing has mainly a temporary effect on the federal budget while some old investment is being depreciated along with the outlays for new investment now being expensed. After old investment has been written off, write-offs decline to about the same amount as under a depreciation system with pieces of several years’ past investments being deducted in any given year. Even in static terms, the annual cost of expensing largely disappears over a few years. Most is gone within a decade as old 3, 5, 7, and 10 year assets complete their tax lives. Only small amounts of residual write-offs for 15 and 20 year structures linger beyond the budget window. There is a modest residual static tax reduction of about 5% or 10% of corporate tax revenue going forward because the quantity of investment is rising over time. However, in dynamic terms, expensing raises revenues in the out years due to additional growth.

One way to lower the initial cost of cutting the corporate tax rate while extending expensing would be to implement 50% expensing on a permanent basis, and phase in a ten point cut in the corporate tax rate one point per year for ten years. That would slow the GDP gains, but we would get the full benefit eventually. However, the slower rise in GDP would be lost income for the public during the transition, about ten times the amount of tax revenue saved by the government. It is not worth the budget savings.

Corporate rate cuts needed too. Many typical firms in modest-profit industries that employ a typical mix of equipment and structures would benefit greatly from expensing. Some businesses, however, would prefer a corporate tax rate reduction, for several reasons. Some businesses have few assets to depreciate. Think of engineering, software, or architectural firms. All their work involves human capital, and salaries are naturally expensed. Others do not care because they have abnormal profits that dwarf the normal return (patents, market power). Those “economic profits” are taxed even under expensing. Those firms may prefer a lower corporate tax rate on these higher profits. A lower corporate tax rate would boost the competitiveness of such firms in the world economy and increase their hiring and output in the United States.

Accounting quirks cloud the issue. Other firms may favor rate cuts over expensing for less savory reasons. Old firms growing slowly may be jealous of new firms growing fast, with more new investment to write off. Some executives may be more concerned with the appearance of the bottom lines in their financial statements than with the real tax burden on their companies. Accounting conventions do not show accelerated depreciation as a tax reduction and a profit increase, even though it is both. The convention does show a tax rate cut as a profit increase. This quirk in the accounting may cause some business managers to recommend trading a bigger real tax saving from expensing for a smaller tax saving from a rate cut because it makes their annual reports look better. Congress may be talked into making a trade that reduces investment even though it seems to boost reported profits.

- The Financial Accounting Standards Board’s Accounting Standards Codification of Generally Accepted Accounting Principles assumes a slow pattern of “economic depreciation” as the norm. Any taxes saved by more accelerated recovery allowances are reported as creating a future “deferred tax liability” of equal size, offsetting the current tax saving. The delay in the tax payment is not discounted to reflect the value of paying later, so the value to the firm is never shown.

- This is bad accounting, and contrary to what business school students are taught in deciding whether to invest or not. MBA candidates are correctly taught to ignore depreciation, and to evaluate an investment by looking at discounted cash flow.
- Similarly, stock analysts are trained in business school to back out expensing and value stocks on a cash flow basis. This is reflected in their reports, so the shareholders and the stock market are not fooled.

Lessons from past tax reforms.

Several major tax reforms in the past have altered the treatment of capital cost recovery as well as the corporate tax rate, capital gains, and dividends. After reductions in the tax on capital, the economy has done well. After increases, it has faltered. New proposals should bear these lessons in mind.

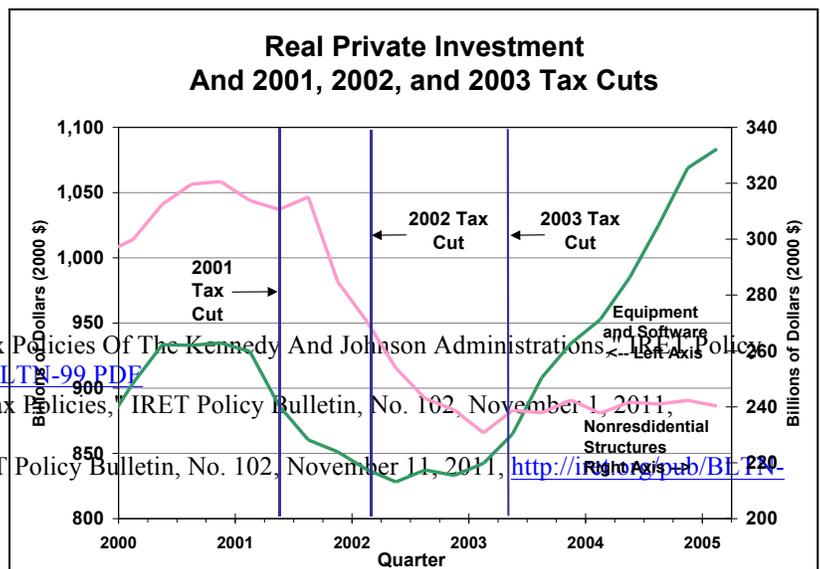
Capital taxes under Kennedy. The Kennedy tax reductions of 1962 reduced asset lives by moving from the Bulletin F lives to the Guidelines, and by introducing an investment tax credit. Combined, the effect was similar to expensing. In 1963, Kennedy and Congress also enacted a phased cut in the corporate tax rate from 52 percent to 48 percent, and reduced individual tax rates. The cuts in the business taxes provided about 55 percent of the economic kick from the Kennedy tax packages. The 1962 elements provided roughly two-thirds of the business tax cut contribution, about twice the effect of the corporate rate cuts of the 1963 Act. The Kennedy cuts spurred several years of above normal economic growth, until the Johnson Vietnam surtax reversed the effect.²

ADR. In 1971, the Treasury encouraged investment by modernizing the recovery allowances with the introduction of the asset depreciation range (ADR) and expanding the ITC. These changes had a slightly larger impact on the service price than the subsequent two point reduction in the corporate tax rate in the 1976 Act from 48% to 46%.³

The Reagan tax bills. The Economic Recovery Tax Act of 1981 (ERTA) provided a more rapid write-off of equipment and structures by moving from ADR to the Accelerated Cost Recovery System (ACRS). That, and reductions in marginal individual income tax rates, including capital gains, were responsible for the remarkable rebound from the 1981-82 recession, a rebound that puts the current miserable economic recovery to shame. Subsequent legislation in 1982 (TEFRA), 1984 (DEFRA), and the Tax Reform Act of 1986 (TRA86) reduced acceleration of depreciation or lengthened asset lives. In each case, the service price rose and investment was discouraged. TRA86 moved from ACRS to MACRS (Modified ACRS). TRA86 also raised the tax rate on capital gains, repealed the investment tax credit, and took other steps that raised the service price. Even though TRA86 cut the corporate tax rate from 46% to 34% and lowered the top tax rate on dividends, the other elements of the bill resulted in a slight rise in the service price, and the economy was weaker after its passage. The 1981 Act was good for growth, while the 1986 TRA was not. TRA86 and the percentage point increase in the payroll tax in the 1988-1990 period paved the way for the 1990 recession.⁴

The Bush tax cuts. The 2001 tax reduction (the first Bush tax cut) did almost nothing for

² Stephen J. Entin, "Economic Consequences Of The Tax Policies Of The Kennedy And Johnson Administrations," IRET Policy Bulletin, No. 99, September 6, 2011, <http://iret.org/pub/BLTN-99.PDF>
³ Stephen J. Entin, "The Nixon, Ford, And Carter Era Tax Policies," IRET Policy Bulletin, No. 102, November 1, 2011, <http://iret.org/pub/BLTN-101.PDF>
⁴ Stephen J. Entin, "The Reagan Era Tax Policies", IRET Policy Bulletin, No. 102, November 11, 2011, <http://iret.org/pub/BLTN-102.PDF>



investment, even though the slump in investment was the cause of the 2001 recession. Its individual marginal tax rate reductions were scheduled to be phased in over six years, and nothing specific was done to lower the service price of capital. Investment continued to fall throughout 2001. In 2002, Congress passed a 30 percent "bonus expensing" provision, which immediately halted the decline in equipment investment. In 2003, Congress bit the bullet. It moved to 50% expensing, lowered the tax rates on capital gains and dividends to 15%, moved forward the remaining individual marginal rate cuts, and lowered the estate tax. From that moment, equipment spending took off like a rocket, and investment in structures began to recover. (See chart.)⁵

Wyden-Coats. The Wyden-Coats bill (formerly Wyden-Gregg) and the Bowles-Simpson Commission emulate TRA86. They would cut tax rates on businesses in exchange for higher tax rates on capital gains and dividends, and provide much slower tax depreciation of plant, equipment, and structures. The Wyden-Coats bill would revert to the Guidelines with straight line depreciation, which would be worse treatment than under the pre-Kennedy Bulletin F lives in the Eisenhower Administration. Capital gains and dividends would be taxed at rates up to 22.75%. In spite of retaining the top business tax rates of 35% for individuals, and cutting the top corporate tax rate to 24% for corporations, Wyden-Coats would raise the service price of capital and depress the growth of GDP. I estimate that Wyden-Coats would reduce GDP over time by 4.3%, with 3.2% due to the change in depreciation alone. The adverse shift in the tax treatment of dividends and capital gains would more than cancel out the benefits of the proposed cut in the corporate tax rate. Although the bill is scored to be about revenue neutral, it would lose substantial revenue due to the drop in GDP.⁶

Tax treatment of interest.

Another tax change sometimes mentioned as a partial "pay-for" for a corporate tax rate reduction is the restriction of the interest deduction. (For example, the Wyden Coats bill curbs interest deductions for corporations by disallowing a deduction of the inflation portion of the interest rate, while continuing to tax lenders on the inflation portion.) Restricting the deduction of interest by borrowers, while continuing to tax lenders, is horrible tax policy. It exaggerates the tax base. It is not a fit response to the higher taxation of equity compared to debt finance. That problem arises from the double taxation of corporations and shareholders on the same income. That should be ended by one of the many methods of integrating the corporate and individual tax, or making all corporations pass-through entities. The double taxation should not be extended to debt finance to even out the differential. (Nor should pass-through entities be attacked in the process of tax reform. They are being taxed in a more nearly correct, more saving-consumption neutral manner than C-corporations.)

Financing a purchase is not additional GDP over and above the production of the machine or building or consumption item or service (except for the small amount of intermediation services provided by the bank or broker) that is part of national output and income. Taxes on financing flows should be a wash to the Treasury, as when you deduct the interest you owe me and I pay tax on it. Not allowing the deduction is wrong. Either interest should be deductible by the borrower and taxable to the lender, or non-deductible and non-taxable.

But aren't some savers/lenders tax exempt? Yes, but that is because Congress created a tax break for charities, presumably because it furthers important public policy goals. It is senseless to create an incentive at one end of a transaction only to take it back at the other end. In particular, it is wrong to punish all borrowers if some lenders are tax exempt. Note that tax exempt entities are not the marginal sources of lending, because they are limited as suppliers of funds by the amount of their grants and contributions, and by the distributions they are required by law to make. At the

⁵ Stephen J. Entin, "The Economic Consequences Of George W. Bush's Tax Policies," IRET Policy Bulletin, No. 104, December 5, 2011, <http://iret.org/pub/BLTN-104.PDF>

⁶ Stephen J. Entin and Michael Schuyler, "Economic Consequences Of The Wyden-Coats Tax Plan," IRET Policy Bulletin, No. 100, October 28, 2011, <http://iret.org/pub/BLTN-100.PDF>

margin (where it matters), when people want to expand the capital stock, the lenders who provide the saving are taxable.

Conclusion. Expensing and corporate rate reductions are both powerful spurs to investment. Expensing is less costly in a static revenue sense, and its cost diminishes with time. In a dynamic sense, both would eventually return their costs to the Treasury by increasing revenues from other taxes due to added growth of GDP. Both should be part of a pro-growth tax reform.

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