IRET Congressional Advisory

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# HIGH PRODUCTIVITY INVESTMENT ACT WOULD BOOST ECONOMY NOW AND PAVE WAY FOR LONG TERM GROWTH AND TAX REFORM

The High Productivity Investment Act (HPI) has been crafted by Representatives Philip English (R-PA) and Richard Neal (D-MA). The Act would let businesses claim the full cost of their investment in high tech equipment as a business expense in the year it was purchased (expensing) and would shorten the time frame over which outlays for all other equipment could be recorded for tax purposes. The new depreciation rules would apply to the AMT as well as the ordinary income tax. The effect of the faster write-offs would be to lower the cost of utilizing equipment and to increase capital formation, resulting in higher labor productivity, wages and employment. Most of the economic gains from the Act would accrue to the labor force. The HPI would rejuvenate the economic expansion and ensure a more favorable budget outlook for government at all levels.

Faster write-off of the cost of investment would give a badly needed shot in the arm to investment spending and the economy. The current economic slowdown is almost entirely due to a deceleration in the rate of real business fixed investment, primarily in equipment and software. That category of spending grew at an annual real rate of 12.7 percent from the second quarter of 1992 to the third quarter of 2000. Since then, equipment spending has fallen at a 2.8 percent annual real rate. (We warned two years ago that the investment boom triggered by the reduction in the rate of inflation in the early 1990s would soon run out of steam, and needed reinforcement in the form of faster capital cost recovery. See Stephen J. Entin, "Depreciation: The Missing Piece of the Tax Cut Plans", *IRET Congressional Advisory* No. 83, July 12, 1999.)

| Write-off periods under HPI Act and Current Law | | |
|---|---|---|
| Type of equipment | Asset life under HPI | Asset life under current law |
| New technology equipment | 1 year: full expensing in the year the asset is placed in service | 3, 5, 7, 10, 15 or 20 years depending on asset type and business category |
| Other productive equipment | 3 years | 3 years |
| | 3 years | 5 years |
| | 5 years | 7 years |
| | 5 years | 10 years |
| | 10 years | 15 years |
| | 15 years | 20 years |


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The HPI Act would turn investment spending around and lift the economy out of its current growth slump. In fact, if this Act had become law two years ago, the current growth slump might have been averted. But the HPI would do more than give the economy a short-term boost. It would raise the rate of investment for many years to come, until the trillions of dollars of additional capital formation made possible by the tax change are put into place.

***The HPI Act would turn investment spending around and lift the economy out of its current growth slump... [and] would raise the rate of investment for many years to come...***

The recently enacted tax cut provides for a very gradual reduction in the marginal tax rates on income, and some additional saving incentives, all phased in very slowly. That Act does almost nothing to boost the economy near term, and nothing for corporate investment. (The personal rate cuts will slowly encourage some additional investment by small non-corporate businesses.) It does not address the cause of the current economic slowdown and does not provide the sort of investment incentives that have the greatest potential of any tax change to spur rapid long term growth. The HPI Act would remedy that omission.

**The current write-off system is arbitrary and flawed.**

Businesses are allowed gradually to deduct the capital costs of earning additional income. The income tax allows small businesses to deduct a small amount of investment immediately (expensing). All other investment must be depreciated over many years or even decades. The assigned write-off periods are arbitrary and capricious, based very loosely on the irrelevant concept of asset life instead of on the concept of measuring the actual cost of the investment. Stretching out capital consumption (depreciation) allowances over an extended period of time reduces their value.

The current system of allowing businesses to report their expenses for equipment for tax purposes is called the modified accelerated cost recovery system (MACRS). It was adopted in the Tax Reform Act of 1986, and it significantly worsened the tax treatment of spending on plant, equipment, and structures at any given rate of inflation by

**Present Value of Current Law Capital Consumption Allowances**
**Per Dollar of Investment Compared to Expensing (First-Year Write-Off).**

| Asset lives: | | 3 yrs | 5 yrs | 7 yrs | 10 yrs | 15 yrs | 20 yrs | 39 yrs |
|---|---|---|---|---|---|---|---|---|
| Present value of expensing $1,000 of investment: | | $1.00 | $1.00 | $1.00 | $1.00 | $1.00 | $1.00 | $1.00 |
| Present value of current law write-off of $1,000 if inflation rate is: | 0% | $0.968 | $0.941 | $0.916 | $0.881 | $0.800 | $0.745 | $0.551 |
| | 3% | $0.942 | $0.895 | $0.853 | $0.796 | $0.672 | $0.597 | $0.369 |
| | 5% | $0.925 | $0.867 | $0.816 | $0.747 | $0.606 | $0.525 | $0.297 |

*Calculations assume a 3.5 percent real discount rate, 3-20 year assets placed in service in mid-year and half-year convention used, 39 year assets placed in service in June and mid-month convention used.*

lengthening write-off periods. The longer write-offs for various types of investment were chosen primarily to raise revenue in the short run to pay for other features of the 1986 Act.

The following table contrasts the present value of a dollar that is expensed with the present value of a dollar of depreciation allowance that must be stretched out over the write-off periods now in the tax code under the MACRS. As the table shows, forcing a business to delay claiming a dollar of investment spending as a current cost reduces the value of the write-off due to the loss of the time value of money and the erosion of the value of the write-off due to inflation. The longer the asset life and the higher the rate of inflation, the less of the true cost of the asset the business is allowed to claim. The result is an overstatement of the business's true earnings over the period of the investment, and an increase in the apparent tax take for the government (on a static basis). Moving toward expensing raises the write-offs to something closer to the full cost of the investments, reducing the overstatement of business income and tax liability.

***The best way to encourage domestic capital investment ... is to shorten asset lives. Faster recognition of investment costs would directly increase the profitability of business fixed investment in the United States... Workers are the biggest beneficiaries of shorter asset lives.***

Depreciation is effectively an interest free loan to the government. A dollar spent on a seven-year asset gets a write-off that is only worth $0.92 in present value if inflation is zero. People who erect buildings (a 39-year write-off period) get a write-off worth only $0.55 for each dollar spent. The cost of the delay becomes even greater if there is inflation. At 5% inflation, the seven-year asset's write-off is worth only $0.82, and the building's write-off drops in value to $0.30. At modest rates of inflation, the overstatement of business income by depreciation can cut the rate of return on business investment in half. This is a huge disincentive to build up the capital stock, especially for assets with long MACRS lives. Shorter asset lives could substantially reduce this anti-investment tax bias.

Expensing is part of any tax system that seeks to measure income accurately and tries not to distort the choice between saving and investment on the one hand and consumption on the other. Consequently, every current major tax reform plan has expensing; it is inherent in all consumption-based or consumed-income-based tax systems. (Even the Treasury has pointed this out. See its *Blueprints for Basic Tax Reform* and Volume 3 of its 1984 study *Tax Reform For Fairness, Simplicity, And Growth*.) Therefore, the HPI is consistent with and a big step toward fundamental tax reform.

**There is no better way to spur growth.**

The investment booms of the mid-1980s and the mid-1990s were driven primarily by anti-inflationary monetary policy. Specifically, the Federal Reserve moved to reduce inflation in two stages, from double digits in the late 1970s to about 4 percent in the mid-1980s, and from over 5 percent during the Gulf War to about 2 to 3 percent in the mid- to late-1990s. Each reduction in inflation boosted the real value of the tax deductions for investment outlays closer to the actual costs of the assets, reducing the tax on investment and encouraging the acquisition of additional capital. The resulting increases in investment were temporary, however, lasting only until the capital stock was raised to the higher desired levels associated with the new, lower inflation rate. Continued rapid growth of investment and GDP requires further incentives to invest. With inflation as low as it has been recently, we cannot expect the Federal Reserve to deliver another significant boost in investment incentives from another downturn in inflation. Any further

investment incentives will have to come from tax policy.

The best way to encourage domestic capital investment is to enhance capital cost recovery allowances. The most direct way to do so is to shorten asset lives. Faster recognition of investment costs would directly increase the profitability of business fixed investment in the United States. Both corporate and non-corporate investment would benefit. A shortening of asset lives is a particularly effective investment stimulus because it would direct the tax relief at new investments. It would not change the tax treatment of old assets that are already in place. Moreover, enhanced capital cost recovery allowances would promote added investment that is located within the United States. In contrast, many other reforms that ease anti-saving, anti-investment tax biases would lead to more saving and investment, but much of the extra investment might be located abroad.

To wholly remove the tax bias against investment, expensing or its present-value equivalent would be needed for all assets, including structures. The HPI Act could be improved by reducing the recovery period for structures as well as equipment. Alternatively, the short-term cost of adding structures could be reduced by retaining a long write-off period similar to that in current law, but increasing the deductions each year for inflation, or for inflation plus a 3.5% real return. The latter would provide buildings with the same present value of write-offs as expensing with less near-term cost to the Treasury by "back-loading" the adjustments.

> ***Some may protest that another round of tax relief in the face of a dwindling budget surplus would be unwise, and would mean raiding the Social Security and Medicare "lock boxes"... [but the] "lock box" numbers will erode if the economy weakens. Doing nothing to rejuvenate the economy will condemn us to a prolonged period of sub-optimal economic growth. Family incomes ... [and f]ederal ... revenues would deteriorate, and the condition of the Social Security and Medicare programs would all suffer. The HPI Act would avert these problems.***

**Who gains?**

Workers are the biggest beneficiaries of shorter asset lives. Increased investment raises labor productivity, which boosts wages. After taxes, labor receives almost half of the increase in the GDP due to additional investment in the United States. Federal, state, and local governments take about 35% in taxes. After about 10% to replace capital, owners of capital net only about 5% after tax.

Tax relief for investment is also important to prepare for the retirement of the baby boom generation. Future workers must become more productive if they are to produce additional goods and services for themselves and for a larger retired population.

**We can't afford not to spur investment.**

The HPI is projected to cost between $280 billion and $320 billion over ten years, on a static basis. But because faster write-off of equipment has historically been one of the strongest growth-inducing tax changes, the dynamic result of the HPI would be little or no revenue reduction for the federal government. State and local governments would experience a revenue increase. Family income would jump.

Some may protest that another round of tax relief in the face of a dwindling budget surplus would be unwise, and would mean raiding the Social Security and Medicare "lock boxes". However, unlike a safety deposit box, which preserves intact any jewelry or papers that are placed in it, the so-called "lock

boxes" do not protect their (largely spurious) assets from outside influences. In particular, the "lock box" numbers will erode if the economy weakens. Doing nothing to rejuvenate the economy will condemn us to a prolonged period of sub-optimal economic growth. Family incomes would languish. Federal, state and local government revenues would deteriorate, and the condition of the Social Security and Medicare programs would all suffer. The HPI Act would avert these problems. It is just what the economist ordered.

Stephen J. Entin
President & Executive Director

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*Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.*