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WHAT SHOULD WE DO ABOUT THE ECONOMY?

The current economic slowdown is due to a plunge in business fixed investment, not a drop in consumer spending. It should be dealt with by reducing taxes at the margin on business investment, saving, and work. It can't be cured by tax rebates or other cash windfalls handed out to "consumers" or by government spending. The tax cuts that would be good for growth in the near term are the same as those that would be good for the long term — cuts that reduce tax disincentives to the production of additional goods and services. The best way to boost investment and growth is to accelerate or otherwise enhance capital consumption (depreciation) allowances and to eliminate the corporate AMT. Of lesser impact would be a cut in the corporate tax rate. On the individual side, the best change would be to accelerate the phased-in tax rate reductions in the 2001 Tax Act (and eliminate the individual AMT so everyone would gain from the lower tax rates).

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The tax code punishes investment. There are two large anti-investment biases in the tax code. One is the corporate tax, which falls more heavily on the earnings of capital and other assets (patents, other intellectual property, managerial talent, brand name recognition, etc.) used by corporations than on the earnings of similar resources used by non-corporate businesses. The other major anti-investment bias is imposed by the tax depreciation rules (capital consumption allowances) affecting all depreciable property used by corporate and non-corporate businesses. Income is revenue less expenses incurred in earning the revenue. Businesses may claim labor costs and outlays for electricity, rent, materials, interest, and state and local taxes as business expenses in the year they are paid. They get to deduct 100 cents on the dollar, the full real value of their costs. But outlays for depreciable property — plant, equipment and structures — may not be expensed when incurred. They must be strung out over many years, losing the time value of money and getting clipped by inflation. (See chart on page 2.) In present value, the deductions fall far short of the full up-front cost of the assets, overstating business income and inflating income tax liability. The after-tax income from investment is depressed, and so is capital formation. The biggest losers are workers. With less capital to work with, they are less productive, and their wages, which reflect productivity, are depressed.

Correcting the under-depreciation of capital outlays is one of the most powerful incentives Congress could give for investment spending. Consider a business that buys a machine for $100 in 2001. Suppose it expects the machine to generate an additional $120 in revenue in present value over the life of the asset after all other costs are deducted. The real profit on the investment is $20 in present value ($120-$100), and, at a 35% tax rate, the company should owe the government $7 in tax (in present value), for an after-tax return of $13 or 13%. But the government does not allow an

Institute for Research on the Economics of Taxation

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immediate deduction of $100. Suppose, strung out over several years, the write-off is worth only $80 in present value. The government makes the firm report a profit of $40 in present value ($120-$80), and takes $14 in tax over the life of the asset (in present value). The business keeps only $6 in after-tax income, a 6% return. With returns cut by more than half, there is much less capital employed, so that its scarcity drives its returns higher to pay the added tax. The owners of the remaining capital recoup some of their losses. Other savers and the work force suffer the consequences as the tax is largely shifted to labor in the form of lower wages and fewer jobs.

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The alternative minimum tax also forces businesses to defer or reduce allowable deductions for legitimate capital investment and certain other business expenses, with similar consequences. The AMT kicks in frequently when business incomes are depressed in recessions, further damaging the economy. It should be repealed.

Start-up businesses or other firms not currently profitable cannot take advantage of enhanced depreciation or a lower corporate tax rate. To ensure that all businesses experience a greater incentive to invest, the net operating loss carry back period could be increased, or losses carried forward could be increased by a market interest rate, or restrictions on leasing arrangements could be eased.

No short term consumption "stimulus" is possible. Even if the economic downturn were due to a dip in consumption, there is little that tax policy can do directly to spur consumption. Almost forty years ago, Nobel laureate Milton Friedman and other monetarist economists demonstrated that tax cuts do not work by giving people money to spend (by raising "disposable income", as the Keynesians put it). Why not? Because when taxes are cut, the government immediately borrows the money back from the public (or pays down less debt) to maintain its own outlays, wiping out the increase in private spending power. Ditto for an

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 of $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.

increase in government spending. Keynesian stimulus is a myth. Japan has tried it for 12 years and its economy is still dead in the water.

Another argument against the notion that tax cuts "stimulate" spending, and an explanation of why the public would merely buy the added government debt following the tax cut, is provided by Professor Friedman's "permanent income hypothesis". Economists have long known that temporary or unexpected tax changes are saved or used to reduce debt, not spent, even by low-income recipients. Professor Friedman won his Nobel Prize for his work on consumption behavior, not his monetary research. He showed fifty years ago that consumption habits change only after years of adjustment to changes in income. One would have expected, therefore, that the recent round of $300 to $600 rebate checks would have been saved, not spent. The recent surge in the personal saving rate corroborates the permanent income hypothesis. Advocates for additional lump sum tax rebates want to give them to low-income workers who did not qualify for the recent $300 to $600 income tax rebates on the theory that they would behave differently from the previous recipients and spend the windfall. Nonsense! These workers would behave just like other people. The Keynesians have at last given up on their "disposable income" multiplier effects, and are now reduced to divining shades of difference in behavior between the poor and the middle class as the source of their tax cut "stimulus". Their crystal ball is cracked.

The tax code punishes investment... Correcting the under-depreciation of capital outlays is one of the most powerful incentives Congress could give for investment spending.

Think "incentives", not "stimulus". Tax cuts work only by changing incentives. About thirty years ago, Nobel laureate Robert Mundell and other neoclassical economists such as Norman Ture revived the classical view that tax cuts work by changing price signals in the economy. As the Kennedy business and individual tax cuts demonstrated, tax reduction spurs activity by increasing the reward to incremental hours worked, or to incremental purchases of plant, equipment, buildings, etc. Cuts in marginal income tax rates — such as the 15%, 28%, 31%, 36%, and 39.6% rates effective before the recent tax reduction — encourage additional work and saving. Enhancement of tax allowances for the cost of new investment in depreciable property to more nearly equal the full cost of such investment boosts capital formation. Cutting the corporate tax rate boosts investment, but is a bit less focused. All these would spur production and the capacity to produce. The wages and profits earned from that additional production would become income to the labor and capital suppliers, who would then increase their spending on the additional output. Supply activates demand. There is no added real demand without real supply. This sort of growth is not inflationary, because demand rises only in line with output. (The Federal Reserve cannot help by boosting nominal spending. That does not raise real output, just prices.)

What then should we do with tax policy to spur the economy and also improve the tax system for the long haul? Shorten the tax lives of depreciable assets. Alternatively, permit a percentage of each investment to be expensed while the rest is depreciated. (To be effective "at the margin" the expensing must be a percentage, such as 30%, of all new capital outlays, not a capped dollar amount). This will benefit directly all businesses, corporate and non-corporate, that use physical capital. It will do the most for capital intensive businesses; these are the firms, mainly in manufacturing and transportation, that are discriminated against by the current tax depreciation rules. But all businesses will benefit. "Human capital" intensive businesses such as software will gain as their business customers resume expanding. Service sectors such as tourism and retail sales will gain as their customers are re-employed and their incomes and spending pick up. Even "over-built" sectors such as telecommunications will perk up as marginal projects are reconsidered and their customers revive. Workers will be the chief beneficiaries as their productivity and wages resume the uptrend of the last 18 years.

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Don't sweat the debt. The heads of the House and Senate Budget Committees have urged that any short term tax "stimulus" be offset in later years to put debt reduction back on track. They fear an increase in interest rates that would depress investment and GDP. More nonsense! It makes no difference to global interest rates whether the last trillion dollars of U.S. national debt is paid off in 2011 or 2015, or if we keep one or two trillion dollars of debt outstanding indefinitely. The world's stock of outstanding financial instruments (stocks, bonds, notes, bills, mortgages, commercial paper, etc.) is rapidly nearing $100 trillion and will double in a generation. An additional trillion dollars of U.S. government debt would scarcely affect the price of this huge stock of assets, which means it would have almost no effect on world interest rates. If a slower-than-forecast paydown of the U.S. national debt were to add less than a percent to the stock of world debt instruments, it would raise interest rates by at most a few basis points (e.g. from 5% to 5.05%). Better tax treatment of capital investment would boost investment by far more than any increase in federal borrowing would retard it. It is not even a close call.

Faster depreciation has no long term budget cost, even on a static basis. Accelerating depreciation write-offs only reduces revenue for a short time, even under static scoring. On any given investment, businesses would get to write off more in the first years, but less in later years. There is some initial revenue dip as new investment gets more write-off than before while old assets are still being depreciated. But once the old investments have moved through the system, and all investment outlays are receiving the new treatment, the annual level of deductions for capital outlays would go back to about the level they were at before the tax cut, for any given rate of investment. That is, for any given amount of capital stock, the revenue dip would be temporary. The added incentive to invest would be permanent, however. As a result, businesses would want to employ more capital, and there would be an increase in total investment spending and write-offs, but in that case, the businesses would also be reporting additional production and taxable income. They would also be employing more people, who would be paying more tax. Dynamic scoring would show a long term revenue increase.

Make the incentive tax cut permanent to make it truly effective.

Make the incentive tax cut permanent to make it truly effective. A temporary investment credit will do little or no good. It might cause some investment spending to be moved forward a few months, but it would be "borrowed" spending from the future, building in a subsequent decline in investment outlays. It would not cause businesses to want to expand their productive capacity. Why not? Suppose you were a businessman thinking of adding a fifth assembly line to your factory. You examine the cost and compare it to the added sales you could generate by having the added capacity. It won't quite break even, and you do not proceed. Four lines is your optimal size. Now the tax on the investment is reduced. Going to a five line plant will now do better than break even. You are about to go forward. Then you notice that the tax cut is temporary. In two years, having a fifth assembly line will again be a losing proposition, and you would have to shut one line down. Why bother? The most you might wish to do is to replace an old existing line a few months ahead of its normal replacement schedule, or accelerate the purchase of something else you were intending to buy anyway. But there would be no net expansion of the business.

We have the means and the knowledge to make changes in the tax code that would actually do some economic good. That is, they would be effective at boosting capital formation and work incentives, thereby raising economic output and incomes for all citizens. Such changes should be viewed as the means to lift the economy to a permanently higher level of efficiency and productivity, not as "counter-cyclical" quick fixes. Enacting growth-generating tax reforms for the long term makes sense at any time. If the current economic slump provides additional motivation, that is just one more reason to go ahead. It is not a reason, however, for enacting foolish and ineffective alternatives, such as otherwise unjustified public works or tax rebates. Let’s get it right this time!

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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.