IRET Congressional Advisory

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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ENHANCED EXPENSING KEY TO BOOSTING THE ECONOMIC RECOVERY

The most effective pro-growth feature of either the 2001 or the 2002 tax cuts was the 30% first year expensing provision in the spring 2002 "stimulus" package. That provision allows businesses to write off 30% of eligible investment immediately in the year it is placed in service, while depreciating the remaining 70% over time in the usual manner. Equipment and special structures with a life of 20 years or less (virtually all investment except buildings) ordered before September 11, 2004 and placed in service before January 1, 2005 is eligible for the faster cost recovery.

Expansion of the 2002 30% expensing provision would be a great way to give investment spending a shot in the arm both for the near term and as a means of moving toward fundamental tax reform for the long haul. It would cost the Treasury very little, because it merely involves moving forward a portion of the write-off of the cost of investment that businesses would be allowed to take anyway a few years later. But letting businesses deduct more of the cost of machinery nearer to the time they actually buy it makes a big difference in the rate of return on the asset, and can push hundreds of billions of dollars of investment from the "unaffordable" to the "affordable" category.

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In fact, expensing has added advantages, especially for smaller corporate or non-corporate businesses. It improves their cash flow, which both enables them to fund more of their investment in house and to present a better picture to the bank or other creditors should they need to borrow to finance their expansion. Less debt finance greatly reduces the risk of having to meet fixed repayment schedules. Many mid-sized companies that are not well known to the credit markets are constrained by the availability of financing, and would make substantial investments as soon as they could afford them. Such businesses have the potential to grow very rapidly, and have been an important source of new job creation over the last two decades.

The following table shows the pattern of revenue changes under the 30% provision. The Joint Tax Committee estimates that the 30% expensing rule costs about $29 to $35 billion in each of the first three years (2002-2004, when eligible investment gets the added write-offs), but increases revenue thereafter as there is less cost remaining to be depreciated in the outyears. Over the ten year budget window, the net cost is about $16 billion. In fact, that loss figure is misleading, because revenues would continue higher in later years as 10, 15, and 20 year assets continue to show lower outyear write-offs after getting more up front. The net effect over a twenty-year write-off period for any given level of investment is a wash for the Treasury even without counting the added investment, jobs, wages, and income taxes that the better treatment of investment would generate.

To provide some additional short term impetus to the recovery, as well as strengthening investment over time, it would be good to raise the expensed amount from 30% to 60% or even 100%, and extend the provision for an added year. The extra static budget cost would not be large, and it would give a badly needed lift to investment spending. A rough pass at the costs of going to 60% and 100% expensing for equipment and special structures placed in service by the end of 2005 is shown in the table. Over the ten-year federal budget period, the added cost of 60% expensing for three years is only $22 billion, and the cost of full expensing for three years is only $44 billion (and much less if one looked out twenty years).

Ideally, the provision should be made permanent. That would show annual losses forever (under static scoring, not counting growth effects), but these would taper off to much lower numbers in the outyears than at the start. The losses taper off because of the "moving forward" phenomenon, and as old assets still being written off under old depreciation schedules exit the calculations and only the new assets' costs are in the system. For any given amount of investment, the losses would go to zero after twenty years, but the amount of investment normally rises over time, and this results in a small annual loss on the incremental amounts in each year. For example, permanently expensing all investment except buildings would eventually reduce revenues by just over $70 billion a year (and by only $50 billion a year if only equipment is included). In reality, the added economic growth and capital formation due to the provision would turn the provision into a net revenue raiser sometime between years ten and fifteen.

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An alternative to showing these (ultimately illusory) budget losses, which could provoke points of order under the budget rules, would be to extend the provision by a year, or two, or three at a time, a "perpetual temporary expensing". Most of the cost of the additional years' expensing would be recovered within the budget window. Since the real cost of moving the write-offs forward is minimal if the whole investment cycle is shown, this is not "cheating", but is merely a means of getting around a misleading fluke in the way tax changes are scored.

If the extension is to be adopted by a simple majority of 51 votes, without the need for 60 votes in the Senate to overcome a point of order under the budget rules, it has to be done within the framework of the Budget Resolution and its associated reconciliation bill. That means that any negative revenue consequences must fall entirely within the budget resolution period time; they cannot spill over into later years, specifically, years 11 and beyond. Positive revenue consequences can spill into later years, however.

Extending the expensing provision one, two, or three years at a time would meet the requirement. The cost of the additional years of expensing would fall entirely within the extension period, and all subsequent years would show gains. For example, suppose the Congress were to adopt a five-year budget resolution in April, for fiscal years 2004-2008. The 30% (or 60%, or 100%) expensing provision could be extended to cover any investment placed in service before October 1, 2008. There would be up front revenue losses for the Treasury for each new asset put in service through that date, followed by lower levels of write-off and higher revenues than under current law each fiscal year thereafter.

The recent recession and the current merely moderate rebound can be traced chiefly to a slowdown in investment spending. That was partly a reaction to overcapacity in the telecommunications and high tech sectors, including some of the aftermath of the Y2K computer buying spree. For the manufacturing sector in general, however, the long investment boom over the past twenty years had finally run its course. The only way to get it restarted is to lower tax rates on additional capital formation.

(The boom was kept going by the Fed's efforts at bringing inflation under control. The drop in inflation acted like a tax cut on capital by reducing the erosion, by inflation, of the value of the capital consumption allowances. The allowances more nearly reflected the full cost of the investment, producing a lower real tax burden and a higher real return. With inflation near zero, another round of disinflation and Fed-generated tax reduction is not in the cards.)

The manufacturing sector could easily find good use for hundreds of billions of dollars of new equipment to expand and modernize capacity if it could overcome some of the tax hurdles that make the projects too risky in the current environment. If the economy is to grow at 4 or 5 percent a year (instead of 2 or 3 percent) and return quickly to a period of rising budget surpluses and 4 percent unemployment (instead of deficits and 5 to 6 percent unemployment), then investment spending must recover and reach new heights. That can best be achieved by enhancing the 2002 expensing provision. It is not expensive, and the rewards for workers and savers would be enormous. It would even save the government money in the long run.

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Revenue Effect of Additional Capital Expensing ($ billions)
Augmenting the Current Law Three-year 30% Expensing Provision for Equipment and Special Structures (Other than Buildings)

Fiscal Year	2002 30% Expensing Provision*	Raise to 60% Expensing and Extend 1 Year	Raise to 100% Expensing and Extend 1 Year	Permanently Expense All Investment Except Bldgs	Permanently Expense All Equipment Investment
2002	-35			0	0
2003	-32	-79	-185	-185	-153
2004	-29	-57	-133	-133	-107
2005	0	-87	-144	-144	-115
2006	19	3	19	-135	-106
2007	18	24	65	-127	-97
2008	15	66	128	-100	-74
2009	12	45	87	-86	-62
2010	8	30	56	-77	-54
2011	5	18	34	-73	-51
2012	3	10	19	-71	-50
2013	2	5	11	-72	-50
2002-2012	-16				
2003-2013		-22	-44	-1204	-918

** 2002 provision revenue estimates for expensing 30% of equipment and special structures (effectively, all investment not buildings) from Joint Committee on Taxation, Estimated Revenue Effects of the "Job Creation and Worker Assistance Act of 2002", March 6, 2002. Other columns extrapolated from the Joint Committee figures by Fiscal Associates.*