# IRET Congressional Advisory

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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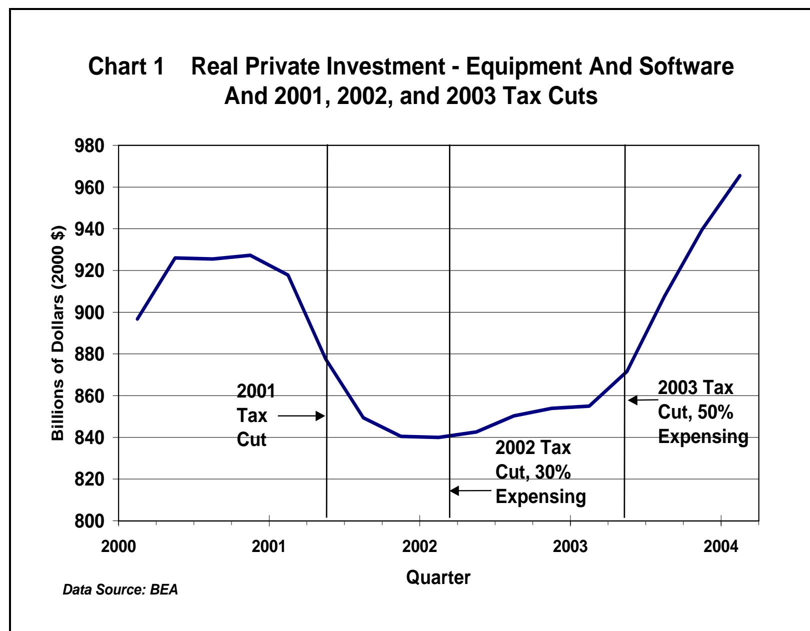
## RENEW BONUS EXPENSING TO KEEP RECOVERY STRONG

Recent swings in the economy have mirrored swings in investment. These ups and downs in investment and GDP have a lot to tell us about what kind of tax changes are effective in promoting growth and employment, and which are not.

The main cause of the 2001 recession was a sharp drop in investment. For example, the decline in spending on equipment and software is shown in Chart 1. The 2001 tax cut contained little immediate help for investment, and did not reverse the decline.




The early stages of the economic recovery, in 2002, were weak because investment remained weak. Investment in equipment and software turned up moderately in mid-2002 following the 2002 tax cut, which contained incentives for that type of investment, boosting GDP. (Chart 1.) Investment in structures, which received no help in 2001 or 2002, continued to lag. (Chart 2.)

The economic recovery really took off when investment in equipment and software surged in 2003, following the 2003 tax cut, which further boosted incentives for investment and saving, and made deferred tax rate reductions effective immediately for workers, savers, and investors. Structures got a little help from the capital gains relief in 2003; construction investment is still weak, but not in free fall. (Charts 1 and 2.)

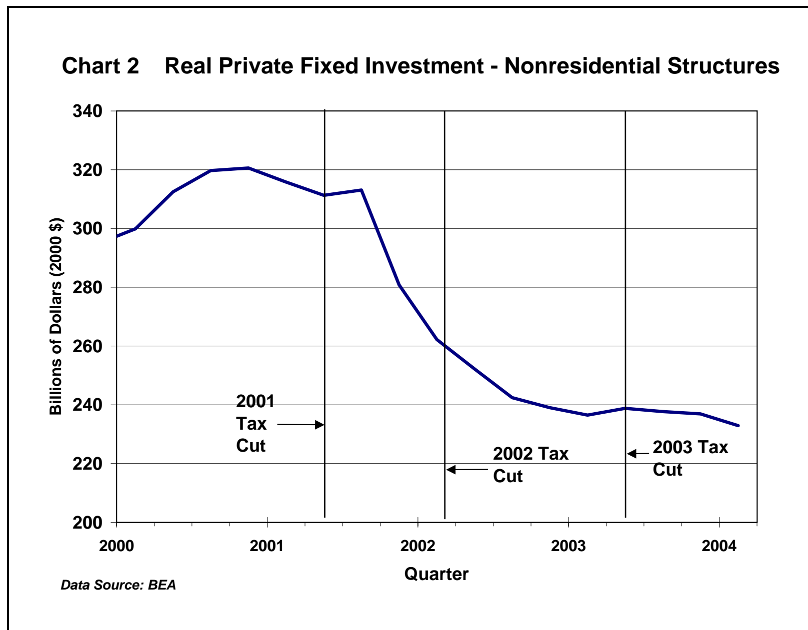
Moral: Only those tax changes that affect what ails the economy work to strengthen GDP and employment, and they do so only when they become effective.

Warning: If the investment and work incentives that boosted growth are allowed to expire, the economy will be back in the soup.

Analysis: Investment rose for ten years following the 1990 recession, buoyed by technological advances and falling inflation, which lowered effective tax rates on investment. With inflation near zero, and the end of the Y2K spending bubble, that stimulus had run its course by the end of the decade. Real private nonresidential fixed investment flattened in the last half of 2000, and then plunged, taking GDP down with it. (Chart 3.) Nonresidential investment consists of investment in equipment and software, and investment in nonresidential structures (mainly office and commercial buildings).

Equipment and software spending fell from late 2000 through 2001, recovered slowly in 2002, and then accelerated strongly beginning in the second quarter of 2003. This accelerating recovery has been the driving force behind the recent rapid growth of GDP. (Chart 1.)

By contrast, investment in nonresidential structures fell sharply until early 2003, and has continued to drift lower, at a slower rate, through the first quarter of 2004. (Chart 2.)




Why did investment spending not recover sooner? Why has equipment spending rebounded and spending on structures lagged?

The 2001 tax cut passed the Congress on May 26, 2001, but investment spending continued to slip for the rest of the year. (Charts 1 and 2.) That tax reduction did very little to encourage additional investment spending, giving out money mainly for social policies that are not related to economic growth. The bill's marginal tax rate reductions on individual business owners were largely deferred until later years, and there was nothing else in the bill that directly lowered the cost of business investment.

The 2002 tax cut was signed into law on March 9, 2002. It contained a special 30% "bonus expensing" provision for investment in equipment and software (but not structures). Investment in equipment and software (but not structures) began to recover, modestly, over the next four quarters. (Charts 1 and 2.)

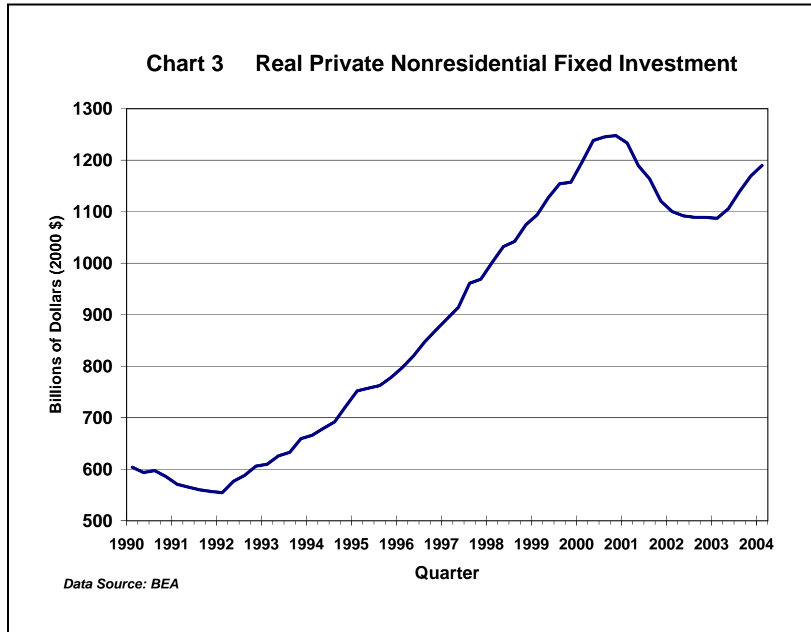
The 2003 tax cut was signed into law on May 28, 2003. It upped the special expensing provision to 50%, directly cutting the cost of equipment and software (but not structures) for corporate and non-corporate businesses. It also brought forward the deferred marginal rate cuts on individual business owners, and cut the tax on dividends and capital gains. Investment in equipment and software shot up almost at once. Investment in structures, which was helped only indirectly by the capital gains and marginal tax rate cuts, but got no depreciation relief, slowed its decline. (Charts 1 and 2.)

The slow early stages of the recovery matched the slow recovery in investment. The recent faster growth of the economy has matched the recent faster pace of investment in equipment and software. It is essential to keep investment strong, not just for 2004, but for the years ahead, if we want a strong economy, rising employment, rising wages, and falling deficits.

That can be ensured by extending the 50% bonus depreciation, permanently if possible, year by year if necessary, and amending it so that firms trapped in the alternative minimum tax can make better use of it. Year by year extension is dirt cheap from a budget scoring perspective, because it merely speeds up write-offs that would have occurred later in the budget period. (See *IRET Congressional Advisory* 145: "Enhanced Expensing Key to Boosting the Economic Recovery".) Structures should also get some relief in the form of a few years off their write-off period.

The House has recently voted to make permanent the marriage penalty relief in the 2001 Act, and plans to vote on the permanent extension of the expanded child credit and the wider 10 percent

bracket later in the year. These social policy provisions of the 2001 Tax Act give back a few hundred tax dollars to people in selected groups, and are superficially politically appealing, but they eat up a lot of revenue and do nothing to promote economic growth and the recovery. (Such tax cuts do not boost "demand" and GDP by giving people more "disposable income" to spend, because the government ends up borrowing back an equal amount to fund the deficit. Tax cuts only "work" by improving incentives, at the margin, to work, save, and invest to earn added income.) Promoting the recovery would do far more for families (and individuals) by raising their pre-tax incomes by several thousand dollars, but the parts of the 2001 and later Acts that relate to growth are not on the House's list for quick consideration.




In particular, the 50% bonus expensing provision, which did more than anything else to turn the economy around, is not even being considered for extension, because it was (foolishly) advertised as a temporary spur to investment. It is due to expire at the end of 2004. Expensing is good tax policy, and the provision should be made permanent. It legitimately applies to investment in the United States, not abroad, and will encourage domestic investment. It is far superior to the corporate tax rate penalty linked to foreign income that is included in the Senate FSC/ETI repeal, and superior to Senator Kerry's proposal to eliminate a portion of deferral of tax on active foreign source income. These latter provisions would not add to investment in the United States or boost U.S. competitiveness; rather, they would force U.S. firms to cede market share and investment opportunities to foreign rivals, and diminish U.S. exports.

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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.*