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TIME FOR A PRO-INVESTMENT TAX CUT

The current economic expansion, now approaching the 7½ year mark, has become the third longest on record. However, several warning lights have begun flashing the message that the expansion's continuation may be in jeopardy. It is not yet clear whether these events signal merely a brief slowdown in the pace of growth or something more serious. Nevertheless, it would be wise to take action now to reinvigorate the expansion.

The tax system is seriously biased against investment. Reducing the anti-investment bias would assist the current expansion while simultaneously fostering long-run economic growth.

There are long-standing tax and regulatory barriers to the efficient operation of the economy that should be corrected in any event. Doing so now could also serve as insurance against a dip in the growth rate.

The economic distress in Asia will have at least some negative effect on the U.S. economy. Many U.S. firms have already reported a drop in sales and profits due to lost Asian business. Difficulties originating in Asia are widely blamed for part of the slowing of real GDP growth in the United States to an annual rate of 1.6% in the second quarter. (The General Motor's strike also played a role.)

Recent volatility in the U.S. stock market may presage an economic slowdown. A stock market pullback may be only normal following the market's big gains in the last several years. However, the stock market is often a sensitive indicator of people's best guesses regarding future economic conditions.

In addition, the recovery is getting on in years. Expansions do not die of old age. However, expansions may be the result of improved circumstances—for example, better tax or monetary policies, technological advance, freer trade—that lead to a certain amount of additional growth. Once the economy has fully adapted to the improved conditions and reached a higher level of economic performance, the growth rate tends to subside to a more normal pace. No previous expansion has lasted much longer than the current one. (The record-holder did not quite reach its ninth birthday.) Perhaps this recovery will defy the calendar, but a little policy support to improve the odds would still be a good idea.

Against this backdrop, a pro-growth tax reform would be an excellent idea. The tax system is seriously biased against investment. Reducing the anti-investment bias would assist the current expansion while simultaneously fostering long-run economic growth.

Unfortunately, because investment returns are an inviting tax target, numerous tax provisions take aim at them. That causes the amount of investment to be less than it would be in a neutral tax system, with the result that the economy is smaller and less productive than if not for the tax biases. Combatting these anti-investment tax barriers would lead to higher growth as the capital stock, no longer kept so artificially small by discriminatory taxes, expands.

Investment-friendly tax reforms are also appropriate because they would help offset weaknesses that might otherwise develop in

Institute for Research on the Economics of Taxation

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1730 K Street, N.W., Suite 910, Washington, D.C. 20006
Voice 202-463-1400 • Fax 202-463-6199 • Internet www.iret.org

investment spending. One of the many consequences of the economic troubles in Asia is that some potential investors will have second thoughts about their investment plans. Investment spending may also suffer if stock prices decline: when stock prices move lower, it becomes more expensive for companies to finance projects by issuing equity, and companies may respond be scaling back their investment plans.

Another reason why investment spending should not be taken for granted involves inflation. The inflation rate has fallen in the 1990s from above 4% at the start of the decade to barely 1% over the past 4 quarters (as measured by the GDP implicit price deflator). The drop in inflation has reduced the severity of a major anti-investment tax bias. The source of the bias is that the tax system generally does not allow businesses to write off investment costs when the costs are incurred (expensing) but instead requires the businesses to stretch out the write-offs over many years (depreciation). That delay shortchanges investors by reducing the present value of the write-offs below the actual cost of the investments. Inflation worsens the problem by eroding the real value of the deferred write-offs, which are based on historic costs, unadjusted for inflation.

By understating the cost of investment, the depreciation rules overstate real profits, raising the effective tax rate on investment returns, and rendering an enormous amount of potential capital formation unattractive. Up to now in the 1990s, falling inflation has buoyed the growth of investment spending as the lessened tax bias encouraged businesses to undertake additional investment. However, much of the additional capital formation made possible by the lower inflation will soon be in place. Inflation has become so low that it has little room to decline further. Thus, the burst of investment produced by falling inflation may be fading. We must look elsewhere—to tax policy—for further improvements in the investment climate

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Growth has greatly increased federal revenues both because the economy's size is one of the main determinants of the magnitude of the tax base and because the tax system is progressive, which causes people's tax liabilities to climb more rapidly than their incomes rise. The Congressional Budget Office (CBO) assumes the economy will slow considerably in coming years but still projects federal budget surpluses totaling $1,600 billion through the year 2008.

A portion of these surpluses would provide the financing for pro-investment tax relief. (The budget surplus is sufficiently large that it could also be used to reduce other tax biases, to simplify the tax system, and to reform the Social Security system to allow for personal accounts.) Tax changes that reduce government-generated impediments to investment and capital formation would improve the odds that actual growth will be better than the CBO's slow-growth assumption. A closer-to-neutral tax system would help prolong the expansion, or, if a downturn developed, keep it milder than otherwise.

An alternative use of the surpluses would be to pay down the national debt. But debt reduction by itself would do little or nothing to stimulate growth. It cannot compare to tax reduction for boosting investment. Capital formation is driven by increases in the after-tax return on investment Federal debt reduction, per se, does nothing to enhance returns on physical capital and technical know-how (e.g., plant, equipment, structures, inventions, training and education).

For those concerned about the size of the national debt, reducing the debt in relation to the economy does not require federal budget surpluses; in a growing economy, a balanced budget will provide for rapidly falling debt relative to output. Moreover, if surpluses start to accumulate on the government's books, there is a danger that elected officials would convert them into higher government spending on less useful goods and services than would be produced by a larger private sector.

Besides giving support to the expansion, pro-investment tax relief possesses the virtue that it would lower the share of GDP that the government is taking away from people in taxes. Except for a brief period in the midst of World War II, taxes as a share of the economy have never been higher in U.S. history than they are today.

Continued economic growth is good for the federal Treasury. More important, it is good for the American people because it means greater opportunities and higher living standards. Reforms that ease tax biases against investment increase the odds the economy will remain strong.

Michael Schuyler
Senior Economist

Note: Nothing written 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 Congress.