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TIME FOR SOME TAX INCENTIVES FOR INVESTMENT

Economic troubles in Asia, Russia, and Latin America have depressed the stock market and threaten to spill over into the real U.S. economy. Reduced exports and investment spending could lead to a slowdown in the U.S. economic expansion, or even to recession.

This is not the time for policy makers to be timid. Postponing needed tax relief and reform because of market uncertainty will only spook the markets further, and worsen the outlook for profits and employment. It would resemble, on a smaller scale, the reaction of the Hoover Administration to the crash of 1929.

The current tax system taxes investment more heavily than consumption....Shorter asset lives could substantially reduce this anti-investment tax bias.

There is no sound reason to postpone worthwhile tax changes. Tax reforms that are good long term economic policy would also strengthen the economy near term. The key is to recognize and adopt those tax changes that reduce the cost of capital and the cost of labor, spurring investment and employment.

Most tax bills enacted in recent years have raised taxes on capital investment to cut taxes for individuals. The individual tax reductions have contained some modest saving incentives, but, on the whole, they have not focused primarily on encouraging work, investment, and growth. On balance, tax policy in this decade has been modestly anti-growth.

More recent tax proposals mentioned by Speaker Newt Gingrich (R-GA) and Representatives Nancy Johnson (R-CT) and Sam Johnson (R-TX) have focused mainly on politically popular cuts that deal with social issues, such as marriage penalty relief and expanding health care deductions for the self-employed. Whatever their merits on other grounds, the limited marriage penalty relief (increasing the standard deduction for couples to twice the amount for individuals) and the health insurance provision would do very little to lower marginal tax rates on labor, and would have little effect on employment.

The Speaker's plan would also reduce the capital gains tax rate, ease the Social Security earnings penalty, eliminate the upper tier of tax on Social Security benefits, and phase out the estate tax. The Johnson and Johnson plan would also ease the Social Security earnings test. These latter provisions would give some modest encouragement to employment or saving, but cannot be considered "big guns" in the battle for growth.

A bold exception to this pattern is the proposal put forward by Senator John Ashcroft (R-MO). While addressing the social concerns, the Ashcroft plan contains significant incentives for business investment.

The biggest tax gun in the growth arsenal is enhancement of capital cost recovery (depreciation). This could best be accomplished by shorting 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.

Institute for Research on the Economics of Taxation

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The current tax system taxes investment more heavily than consumption. An unbiased system would allow businesses to write off investment costs as soon as they make the expenditures (expensing). (Equivalently, write-offs could be delayed but their nominal amounts increased sufficiently so that they have the same present value as the investment expenditures.) When businesses are forced to defer write-offs for their investment expenses for years, the write-offs have a lower present (discounted) value than the actual expenses. That causes business expenses to be understated for tax purposes and business income to be overstated. The effective tax rate on the returns from investment becomes higher than the statutory rate, and much economically sound investment is never undertaken.

The table shows the depreciation periods now in the tax code under the modified accelerated cost recovery system (MACRS). The stretched-out write-off periods seriously inhibit investment, especially in assets with long MACRS lives. Shorter asset lives could substantially reduce this anti-investment tax bias.

Capital Cost Recovery Periods (years)

Current (MACRS)	Proposed
3	2
5	4
7	5
10	7
15	11
20	15
27.5	20
39	30
50	35

The table offers proposed schedules of shorter asset lives to spur investment longer term and to strengthen current economic activity. Under this reform, for example, assets that must now be depreciated over 7 years could be written off over 5 years. If the proposed schedules were adopted, many investments that make good economic sense would no longer be blocked by the tax code. (To wholly remove the bias, expensing or its present-value equivalent would be needed.)

This proposal is very similar to one element of the Ashcroft plan. Senator Ashcroft would reduce asset lives by 25%.

The importance of shorter asset lives was recognized by the Congress in the 1996 tax act. At the behest of Chairman Bill Archer (R-TX) of the Ways and Means Committee, the 1996 act eased the anti-investment sting of the Alternative Minimum Tax by substituting the asset lives of the regular income tax for the even longer lives formerly used in AMT calculations. Shortening the regular income tax lives for all businesses is the next logical step.

Businesses are not the only beneficiaries of short asset lives. Increased investment raises labor productivity, which boosts wages. Labor receives between two-thirds and three-quarters of the increase in the GDP due to additional investment in plant, equipment, structures and inventory in the United States.

It is long past time to reduce the tax barriers against business fixed investment. The Federal Reserve under Alan Greenspan laid the groundwork for the current economic expansion by reducing inflation since 1990. The lower inflation reduced the erosion of the value of the capital recovery allowances and increased the profitability of plant, equipment, and structures. With inflation near zero, however, there can be little additional support for the economic recovery from further improvement in monetary policy. Further encouragement of investment must come from tax relief.

Tax relief for investment is also important longer term, both for raising living standards in general and, in particular, as part of the preparation for the retirement of the baby boom generation. Unless future workers are more productive, they will be unable to produce additional goods and services for themselves and for a larger retired population.

Current workers, who will be the future retirees, should be encouraged to own shares to provide themselves with retirement income and to provide themselves and future workers with additional capital equipment to generate higher real output.

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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.

In addition to encouraging business to add to their physical plant through shorter asset lives, other steps should be taken to combat anti-investment tax biases. The individual and business AMT should be eliminated. Corporate capital gains should be given the same relief recently enacted for individuals' gains. Lower corporate tax rates would also be helpful. Ideally, fundamental tax reform would eradicate the corporate tax and the double taxation of corporate income, and provide expensing of all business outlays. Until fundamental reform is achieved, smaller steps in that direction would benefit the current economic expansion and the long-term health of the economy.

Some Members of Congress have been quoted as saying the stock market downturn and the potentially weaker economy might reduce projected budget surpluses, and, therefore, tax relief should be delayed. On the contrary, it is more urgent than ever that some portion of the revenue gains due to the strong economy of recent years be "reinvested" in appropriate tax relief to keep the economy healthy. If nothing is done, and the economy falters, then the surpluses will surely disappear anyway, and we will have a downturn to boot. On the other hand, appropriate pro-growth tax relief could strengthen the economy and reinforce the good budget outlook.

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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.