IRET Congressional Advisory

July 12, 1999 No. 83

DEPRECIATION: THE MISSING PIECE OF THE TAX CUT PLANS

House and Senate Republicans are drafting tax cuts that may total nearly $1 trillion over the next decade. The rumored provisions under consideration — many of which would encourage saving — suggest that these may be very good measures for the economy. To be really great tax bills, however, the sort that can set the economy up for another decade of above-average growth, the tax reductions must add a missing piece — a spur to business investment in the United States.

To be really great tax bills, however, the sort that can set the economy up for another decade of above-average growth, the tax reductions must add a missing piece — a spur to business investment in the United States.

The tax reduction proposals will apparently focus chiefly on personal tax relief, such as offsets to the marriage penalty, expanded IRAs, elimination or reduction of the estate tax, and, perhaps, further capital gains tax rate reduction and AMT relief. Almost without exception, these proposals are good steps toward fundamental tax reform. In particular, they reduce the current income tax bias against saving, a key element of the reform movement. Business elements of the plans are expected to include a multi-year extension of the R&D credit and several other "extenders".

The best way to encourage domestic capital investment is enhancement of capital cost recovery allowances (deprecia-tion). The most direct way to do this is to shorten asset lives.

The missing piece — depreciation reform.

While promoting individual saving and research, the plans lack a significant incentive for business investment. Spurring saving is important, but it is also important to encourage businesses to use the additional saving to increase capital formation in the United States. That means incentives to add to the amount of plant, equipment, commercial and residential buildings, and inventory located here.

The best way to encourage domestic capital investment is enhancement of capital cost recovery allowances (depreciation). The most direct way to do so is to shorten 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.

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.

The table (column 1) shows the depreciation periods now in the tax code under the modified accelerated cost recovery system

Institute for Research on the Economics of Taxation

IRET is a non-profit, tax exempt 501(c)(3) economic policy research and educational organization devoted to informing the public about policies that will promote economic growth and efficient operation of the free market economy.

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

(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. The table (column 2) offers an alternative schedule of shorter asset lives to spur investment. Under this reform, for example, assets that must now be depreciated over 7 years could be written off over 4 years. The schedule would trim the asset lives by between a third and a half, with the biggest cuts in the longest assets that are currently penalized the most.

Capital Cost Recovery Periods (years)	
Current (MACRS)	Proposed
3	2
5	3
7	4
10	6
15	9
20	12
27.5	15
39	20
50	25

The reduction in asset lives could be phased in to reduce the short term budget impact (perhaps by a few months a year for 12 years). A slow phase-in would eliminate any incentive for business to defer investment to wait for the next installment. The full incentive to invest, however, would build slowly.

Earlier this year, Senator John Ashcroft (R-MO) introduced a tax package that included a more modest cut of 25% in depreciation lives. It, too, is a step in the right direction.

To wholly remove the tax bias against investment, expensing — the immediate write-off of investment in the first year — or its present-value equivalent would be needed.

To wholly remove the tax bias against investment, expensing — the immediate write-off of investment in the first year — or its present-value equivalent would be needed. Many patterns of write-offs can be devised to equal the discounted value of the full up-front price paid for an asset. For example, in a "neutral cost recovery system" (NCRS), depreciation write-offs similar to those in current law would be increased each year by a 3.5% real return. The unrecovered basis of the property would also be adjusted each year for inflation.[1] NCRS can be set up so that the near-term revenue loss to the Treasury is minimal, by "back-loading" the adjustments.[2] It would still give the deductions the full present-value of expensing, and, from the start, would encourage investment as strongly as first year write-off.

If any of these reforms were adopted, many investments that make good economic sense would no longer be blocked by the tax code. To be fully effective, the new depreciation rules should apply to the AMT as well as the ordinary income tax (as Chairman Archer arranged in 1996 for the current write-off system).

Who gains?

Workers are the biggest beneficiaries of shorter asset lives. Increased investment raises labor productivity, which boosts wages. After taxes, labor receives almost half of the increase in the GDP due to additional investment in the United States. Federal, state, and local governments take about 35% in taxes. After about 10% to replace capital, owners of capital net only about 5% after tax.

Tax relief for investment is also important to prepare for the retirement of the baby boom generation. Future workers must become more

productive if they are to produce additional goods and services for themselves and for a larger retired population.

No real alternative.

Employing depreciation instead of expensing in the calculation of income for tax purposes has the effect of deferring costs, overstating actual business income, and raising the effective tax rate on investment. Near-term income and taxes are artificially increased, while write-offs are larger in later years and future taxes are reduced. The net effect is to accelerate tax collections, and to increase their present value. The result is a higher tax rate on income used for investment than on income used for consumption, a bias that distorts economic activity and reduces investment, productivity, wages, and employment.

> ***A shortening of asset lives ... [or] enhanced capital cost recovery allowances would promote added investment that is located within the United States.***

Inflation makes the problem of deferred costs even worse by reducing the real value of the write-offs. Inflation magnifies the understatement of real business costs, the overstatement of real business income, and further boosts the effective tax rate on the earnings of the capital assets.

> ***Workers are the biggest beneficiaries of shorter asset lives... After taxes, labor receives almost half of the increase in the GDP due to additional investment..., governments take about 35% in taxes..., owners of capital net only about 5% after tax.***

Monetary policy has been extraordinarily conducive to economic growth by slowing 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. The resulting increase in the rate of investment is temporary, however; it will last only until the capital stock is raised to the higher desired level associated with the new, lower inflation rate. Continued rapid growth of investment and GDP requires further incentives to invest. With inflation near zero, there can be little added support for the economic recovery from an improvement in monetary policy. Further encouragement of investment must come from tax relief.

Depreciation reform on hold.

Ways and Means Chairman Bill Archer (R-TX) reportedly will not include any speed-up or enhancement of depreciation write-offs in his forthcoming tax cut proposal. Last year, he asked Treasury for a thorough review of the depreciation issue. The Chairman may want Treasury guidance to come up with a more rational assignment of asset lives. Alternatively, the Chairman may be pressing Treasury to acknowledge that it is a hopeless task and come out in favor of expensing (first-year write-off).

No good can come of a Treasury review of depreciation. Treasury is wedded to the illegitimate concept of "economic depreciation" as a basis for accounting for investment costs for tax purposes. It is an integral feature of the biased "broad-based income tax" system, which deliberately overtaxes saving and investment to aid income redistribution. Juggling the asset life assignments can't set the system right, because its premise is nonsense. As long as Treasury remains in the income tax camp, it will not change its view of depreciation.

In an unbiased tax system — neutral as between consumption and investment uses of income — investment would be expensed in the first year. Every current major tax reform plan has expensing; it is inherent in all consumption-based or consumed-income-based tax systems. (Even the Treasury has

special help for the particular assets it uses most. pointed this out. See its *Blueprints for Basic Tax Reform* and Volume 3 of its 1984 study *Tax Reform For Fairness, Simplicity, And Growth*.) Since we know this to be the right answer, why wait for Treasury to come around? It is time to take at least some small step in the direction of expensing.

> ***The business community should unite on a plan to shorten all asset lives, or to enhance write-offs across-the-board.***

But what step? To help the Congress make it happen, business has to get its collective act together. Each industry should stop asking for The business community should unite on a plan to
shorten all asset lives, or to enhance write-offs across the board.

> ***Now that there is money in the budget forecast, it is time to think clearly and think big about depreciation reform... Some step toward shorter asset lives or ... enhancement of capital consumption allowances should be part of the tax bill.***

The arbitrary asset lives assigned to various types of machines and structures can place one industry at a disadvantage to another, distort investment choices, and generally retard investment. The Congress has been confronted with frequent requests from various businesses to move this or that asset to a shorter asset life category (e.g., the widget-machine tool industry wants its widget-makers shifted from the 5 year category to the 3 year category because the whatzit-makers industry get the faster write-off, so why shouldn't they?).

The plaintiffs may justify the requests by claiming that the actual "useful lives" of their type of assets has been reduced by rapid technological advances and is less today than when the asset-life assignments were laid down. They may claim that the assignments were illogical to begin with (and why not, when the asset lives for structures were originally based on a handy study of how long telephone poles last in the wild!). But this piecemeal approach creates confusion and clouds the prospect for reform.

Now that there is money in the budget forecast, it is time to think clearly and think big about depreciation reform. It is long past time to reduce the tax barriers against business fixed investment. Some step toward shorter asset lives or a neutral cost recovery enhancement of capital consumption allowances should be part of the tax bill.

Stephen J. Entin
Executive Director & Chief Economist

. . . .

Endnotes

1. The current rate of inflation is about 1.5%. Assuming 3.5% as a normal real return, a reasonable nominal discount rate would then be about 5%. (More precisely, it would be 5.0525%, with compounding, since 1.015 x 1.035 = 1.050525.) The write-off schedule for a 5-year asset with a present value of $100 might work as follows: $20 in year 1, $21.02 in year 2, $22.08 in year 3, $23.18 in year 4, and $24.36 in year 5. Each year's write-off is 5.0525% higher than that of the year before. Although the nominal write-offs would exceed $100, they would be just equal in present value to the $100 outlay for the machine.

2. For example, the write-off for the 5 year asset illustrated in note 1 could be $20 a year for 5 years, with an added $9.16 write-off in year 6 to make up the present value shortfall in years 1 through 5.

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.