THE ADMINISTRATION'S TAX REFORM PROPOSALS AND PRIVATE CAPITAL FORMATION

Testimony Presented

to

The Committee on Finance,

United States Senate

by

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*The views here are my own and do not necessarily represent the views of IRET.

Statement of Norman B. Ture, President of IRET
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The Central Issue of Tax Reform

The broad-ranging and dramatic changes in the Federal income tax structure proposed by the Administration raise a great many issues that have been identified by the Committee and addressed by witnesses during these hearings. By far the most important of these from the point of view of the long-term progress of the U.S. economy is how these tax reform proposals are likely to affect the size and composition of the stocks of productive capital.

Every now and then it becomes fashionable to denigrate the contribution of growth in our production facilities and the efficiency of their use to the growth of our output potential. Unless the laws of production have been repealed or unless we have magically acquired a super abundant stock of capital, however, the amount and quality of the capital associated with labor services in production processes remains a critically important factor in determining how much labor is employed, and at what real wage rates. If changes in the tax structure slow the rate of addition to our stock of capital, the result will be a less productive labor force, lower levels of employment, lower real wage rates, and less total output and income than otherwise would be obtained. And if those tax changes distort the allocation of capital resources among their myriad alternative uses, the same sort of results, although much less substantial in magnitude, will occur. How tax changes affect the growth in our stock of capital and the efficiency with which we use it is, therefore, a critically important criterion of the goodness or badness of these tax changes.

There can be no question that the Administration is abundantly mindful of these concerns in tax policy. There is, however, abundant reason to be concerned that the Administration's tax reform program would enhance, rather than reduce, tax barriers to saving and capital formation and would intensify the tax distortions of the composition of the economy's stock of capital.

Regarding concerns about the effect of the tax system on how large the nation's stock of productive capital is and how rapidly it grows, the Treasury has repeatedly acknowledged the basic bias of income taxation against saving and capital formation. Notwithstanding, the Administration has chosen to disregard changes

in the income tax base that would move toward reducing, perhaps eventually eliminating, that bias: only the proposed modest increase in the limit on the deduction to spousal IRAs is an exception to this thrust of the proposed tax base changes, and this minor improvement would be more than offset by the proposed taxation of the so-called inside build-up of life insurance policies. Indeed, the only measures the Administration recommends that would be significantly pro-saving and pro-capital formation are the reductions in statutory tax rates for some individual taxpayers and for corporations. These rate reductions do not stand alone in the Administration's tax reform program; they would be financed by tax base changes, a good many of which would further bias the tax system against saving and in favor of current consumption, and raise, rather than reduce, the cost of capital. The price that the Administration asks the American economy to pay for the benefits of lower tax rates is simply excessive.

Instead of addressing the basic tax bias against saving and investment, the Administration has focused its reform efforts on reducing tax-induced distortions of the composition and allocation of capital and additions thereto. The emphasis on inter-asset tax neutrality is certainly wholesome. Regrettably, the Administration's proposals, if implemented, would accentuate, not reduce, these distortions.

In short, the Administration's tax reform program would aggravate the existing income tax bias against saving and capital formation, thereby raising the cost of capital. It would intensify tax-induced distortions of the composition and allocation of investment and of the stock of capital. The result would be a smaller amount of capital, less effectively used, than if present law were maintained.

Assessment of the Proposed Capital Cost Recovery System

Although several of the provisions of the Administration's tax reform program bear heavily on the amount and composition of private capital formation, the chief of these are the recommendations to repeal the investment tax credit (ITC) and to substitute a so-called capital cost recovery system (CCRS) for the present accelerated cost recovery system (ACRS). Adoption of these recommendations, I believe, would be a serious mistake, a major step backward, a move away from the kind of tax treatment of capital recovery called for in the interests of achieving the optimum stock of capital and its most efficient composition and use.

Capital Cost Recovery and Tax Neutrality

A tax system that is consistent with the requirements for economic efficiency and growth must be as nearly neutral as possible. Tax neutrality means that the tax system does not change the relationships among prices and among costs that would prevail in

the absence of taxation. No tax system yet devised has ever been completely neutral in this sense. Realistically, the tax neutrality objective calls for minimizing tax-induced distortions of relative prices and costs.

To conform with tax neutrality an income tax system's capital recovery provisions must pass two tests. First, they must minimize the income tax's bias against saving and capital formation and in favor of current consumption. Second, they must minimize distortions in the market's valuations of different kinds of capital or of any particular kind of capital in differing uses or in the hands of differing taxpayers. The CCRS proposal fails both of these tests.

To pass the first test of tax neutrality --- minimizing the tax bias against saving and capital formation in the aggregate --- taxes must not alter the cost of acquiring and holding capital relative to the cost of consuming. To satisfy this condition capital outlays must be expensed, i.e., deducted in full in the taxable year in which the costs of the capital facilities are incurred, irrespective of the nature of the capital, who uses it, or in what kind of production.[1] Interestingly, a result equivalent to expensing may be achieved even with capital recovery allowances that are spread over an extended period of years after the costs of the capital facilities are incurred, provided that the present value of these allowances equals the prices of the facilities. This means, of course, that for any facility the total amount of the undiscounted allowances must exceed its price. It is not likely that the designers of the ITC had this neutrality requirement in mind, but it is against this test of neutrality that today's tax policy makers should assess the ITC and the proposal to eliminate it. The present law ITC combined with ACRS may not insure that the present value of the combined capital recovery allowances precisely equals the prices of the facilities, but as has been shown, it does afford a reasonably close approximation thereto for most of the property for which the credit is available.[2]

There is, of course, an unlimited number of capital recovery regimes that would satisfy the test that the present value of the capital recovery allowances equals the price of the facility. For any particular facility, there is no one period of years over which recovery allowances must be spread, no one way of spreading the allowances over the period, and no one total amount of undiscounted allowances that meets this test. For example, suppose the price of a facility acquired the first day of the taxable year is $1,000, that the appropriate discount rate --- the real after-tax rate of return generally available on production facilities --- is 4 percent, and that the inflation rate is zero. A single deduction of $1,040 at the end of the first taxable year, a set of deductions of $224.62 per year for 5 years, or a single deduction of $1,216.65 at the end of the fifth year are merely three of a limitless number of combinations of write-off periods and allowances per year that would meet the tax neutrality test.

The Administration makes much of the alleged need, in the interests of tax neutrality, to conform the capital recovery system as closely as possible with "economic depreciation." Economic depreciation is the change between two points in time in the present value of the remaining gross returns an asset is expected to produce. It is impossible, as a practical matter, to determine economic depreciation for any particular asset, let alone group of assets. Apart from this difficulty, there is no relevance in principle to the concept of economic depreciation as a constraint on the design of a cost recovery system in the tax law aimed at achieving tax neutrality, as shown above. In fact, even if it were possible to determine economic depreciation for any facility or group of facilities, implementation of this concept as the cost recovery system for tax purposes would certainly result in a serious shortfall of that system from tax neutrality.[3]

To satisfy the second, inter-asset tax neutrality test --- minimizing tax-induced distortions of the relative market values of capital facilities --- capital outlays must either be expensed, or if an extended period capital recovery is to be used, afforded allowances the present values of which are the same percentages of the prices of all capital facilities. Expensing would satisfy both neutrality tests; it would impose no incremental tax on any capital, and it would, therefore, involve no difference in effective tax rates on income that is saved and invested, irrespective of the kind of capital that is acquired. If tax policy makers prefer or accept an incremental tax on capital generally, then they can assure that the same effective rate of tax is applied to all capital if the cost recovery system affords allowances the present value of which is the same fraction of the price for every kind of production facility.

The proposed CCRS meets neither of the tests of tax neutrality. The present value of the allowances it affords would fall short of the asset's price for every class of capital facility to which it would apply, and these present values would differ from class to class, systematically decreasing as the recovery period increases. As a consequence, CCRS would result in effective tax rates that systematically increase the longer the recovery period to which the facility is assigned. These findings are summarized in Table 1.

Inflation Adjustments in CCRS

One of the advantages claimed for CCRS compared with the capital recovery system in the present law is that the basis of depreciable property would be indexed for inflation in computing annual CCRS allowances. Inflation adjustments are certainly desirable to prevent inflation from eroding the real value of capital cost recovery deductions, hence imposing hidden, unlegislated increases in effective tax rates. But inflation indexing, per se, cannot overcome the fundamental deficiencies

Table 1. Present Values of CCRS Allowances* and Effective Tax Rates, at Selected Inflation Rates.**

CCRS Class	Present Value of Allowances Inflation Rates 0%	5%	10%	Effective Tax Rates Inflation Rates 0%	5%	10%
1	$0.93	$0.91	$0.89	3.2%	4.4%	5.4%
2	0.920	.90	0.88	3.9	5.0	6.0
3	0.900	.88	0.86	4.9	5.9	6.9
4	0.870	.85	0.83	6.3	7.4	8.3
5	0.840	.82	0.80	8.1	9.1	10.0
6	0.610	.60	0.601	9.5	19.7	19.8

*Per dollar of capital at a real after-tax discount rate of 4 percent. It is assumed that the facilities are acquired and placed in service at the middle of the taxable year. Dollar amounts in the first taxable year are discounted for a half year, those in the second year a year and a half, etc.

Effective rates computed at a statutory corporate income tax of 33 percent. Effective rate is defined as the percentage difference between the present value of the pretax gross returns required under the system of tax rules to warrant investment in the facility and the present value of the required gross returns in the absence of the tax. See **IRET Economic Report No. 29, pp., 6-7, for a discussion of the concept of effective tax rates. Note that these effective tax rates are the rates of the incremental taxes on the returns to capital, because in the ordinary case the income which is saved and invested in the facility will itself have borne tax liability.

of CCRS. There is no question that the proposed basis adjustment would moderate the adverse effects of inflation, but as Table 1 clearly shows, it would not prevent effective tax rates from being boosted by inflation nor would it significantly moderate inflation-induced differences in effective rates among asset classes.

The failure of the inflation adjustments of CCRS allowances to prevent inflation from increasing effective tax rates results from the fact that the indexing would not apply in the taxable year in which the property is placed in service. The Administration offers no reason for not allowing the adjustment of the first year's depreciation for any inflation occurring during that first year. The consequence of this constraint is that inflation would be allowed to increase effective tax rates significantly.

The proposed inflation adjustments, moreover, would also be incomplete in that the accumulated inflation-adjusted allowances would fall short of the inflation-adjusted price of an identical replacement property. The reason for this shortfall is that only

the current year's recovery allowance would be adjusted for the current year's inflation; prior years' allowances would not be adjusted upward to offset their erosion by inflation in subsequent years. For example, with an inflation rate of 5 percent a year, the inflation-adjusted price of a property that sold for $1,000 would be $1,276 five years later; the CCRS inflation-adjusted allowances, however, would aggregate only $1,065 for a CCRS class 1 facility written-off over the five years.

The Administration claims that with the reduced statutory tax rate and the inflation adjustments, the proposed CCRS would result in lower effective rates on virtually all depreciable property than result under the present ACRS-ITC system. The claim is correct providing inflation occurs at rates substantially higher than those that have prevailed in the last few years and are projected over the next several years. In fact, at a five percent inflation rate, the statutory corporate tax rates that would be needed with CCRS to prevent effective rates from exceeding those under present law would have to be much lower than the proposed 33 percent, except in the case of class 5 and class 6 property. At very low inflation rates, negative statutory tax rates would be needed if substituting CCRS for ACRS-ITC were to avert increases in effective tax rates for all equipment. Only in the case of structures would CCRS result in lower effective tax rates than those resulting under the present law's ACRS-ITC. These findings are presented in Table 2.

Another way of looking at this is to ask how high an inflation rate would be needed if the effective tax rates under CCRS with its proposed 33 percent statutory tax rate were not to exceed those under present law. Table 3 shows that except for property in CCRS classes 5 and 6, inflation would have to be much more acute than at present and, indeed, much higher than generally projected, to keep the proposed tax changes from increasing effective tax rates.

I certainly do not mean to belittle the desirability of adjusting the basis of depreciable property with respect to inflation for purposes of computing capital recovery allowances. This indexing, however, should not be regarded as overcoming deficiencies in an inadequate cost recovery system. Indexing is not a substitute for a correctly designed cost recovery system.

How to Improve CCRS

The deficiencies in the CCRS proposal can be substantially overcome, resulting in a cost recovery system that would more nearly satisfy the requirements of tax neutrality. The objective to be sought by CCRS modifications is to achieve effective tax rates as close to zero as possible for every class of property and to insulate these effective tax rates as much as possible from the effects of inflation.

One simple way of achieving this objective would be to provide an investment tax credit for the property in each CCRS class.

The rate of the credit would increase as the recovery period increases, and the basis of the property for purposes of computing CCRS allowances would be reduced by the full amount of the ITC. The adjusted basis of the property would be indexed for inflation, beginning at the time at which the property is placed in service.

If inflation were 5 percent a year, tax neutrality as defined in this discussion would be achieved with ITC rates shown in Table 4. Except in the case of structures (CCRS class 6), all of these ITC rates are lower than those that now apply to ACRS 5-year property.

Table 2. **Statutory Tax Rates at Which CCRS Would Result in Effective Tax Rates Identical to Those Under ACRS-ITC***

CCRS Class	ACRS Recovery Period (Years)	Inflation Rates (Percent) 0%	5%
1	3	-99.0%	23.5%
2	5	-340.0	21.0
3	5	-160.0	18.5
4	5	-90.0	15.5
5	10	-3.0	40.7
6	18	35.4	49.2

*CCRS effective tax rates were computed with a 33 percent statutory tax rate. ACRS-ITC effective tax rates were computed with a 46 percent statutory tax rate.

Table 3. **Inflation Rates at Which CCRS Would Result in Effective Tax Rates No Higher Than Those with ACRS-ITC**

CCRS Class	ACRS Recovery Period (Years)	Inflation Rate (Percent)
1	3	6.9
2	5	6.8
3	5	7.5
4	5	8.6
5	10	3.3
6	18	*

*CCRS would result in lower effective tax rates at any positive inflation rate.

Table 4. **Effective Tax Rates with CCRS and Multiple-Rate ITCs, at Selected Inflation Rates***

CCRS Class	ITC Rate	Inflation Rates 0%	5%	10%	20%
1	4.5	-1.3	0.0	1.1	3.1
2	5.1	-1.2	0.0	1.1	3.2
3	6.0	-1.2	0.0	1.1	3.2
4	7.3	-1.2	0.0	1.1	3.2
5	8.8	-0.8	0.0	1.2	3.2
6	17.4	-0.8	0.0	.7	1.5

*Calculated at a 33% tax rate with basis adjusted for the full amount of the ITC. A 4 percent real after-tax rate of return was used to compute present values of recovery allowances and effective tax rates.

Combining these modest ITCs with CCRS would not only fully achieve the goal of tax neutrality with respect to the consumption vs. investment uses of current income, it would also very substantially satisfy the test of inter-asset tax neutrality. Moreover, with this system, effective tax rates would be only moderately altered for any given class of property even with enormous inflation rates. Differences in inflation rates would have only the most modest impact in changing effective tax rates among the different property classes.

A very large ITC would be required for CCRS class 6 property (structures) if the goal of inter-asset neutrality were to be fully served. It is difficult to identify any reason why the principles and criteria for neutral capital recovery should not apply to structures of all sorts, particularly if the revisions in the tax treatment of gains and losses on the disposition of depreciable property in the **President's Tax Proposals** were to be adopted. Changes in capital recovery provisions in the last several tax revisions have tended to widen the effective tax rate differential between machinery and equipment and other personal property, on the one hand, and real property, on the other. If the proposed tax reforms are thought to be efficient in eliminating or at least severely restricting the availability of real property tax shelters, there is little obvious reason to continue to bias capital recovery provisions against structures.

Conclusions

Much remains to be done if the federal income tax is to be purged of its bias against saving and capital formation and its distortion of the allocation of saving among the virtually countless types of capital and capital uses. The conditions that must be met to achieve these two tax neutrality goals are readily

specified: the effective tax rates---properly defined---on the income produced by all depreciable property should be as close to zero as possible and should be as fully insulated from the effects of inflation as possible, and the differences in effective tax rates among different classes of property should be as small as possible. These conditions are not only readily stated, they may also be readily attained.

The inflation adjustments of the basis of production facilities for depreciation purposes proposed in the **President's Tax Proposals** is a step in the right direction, but in itself is not adequate to remedy the deficiencies in the proposed CCRS. These deficiencies could be very substantially overcome and a very nearly tax-neutral capital recovery system could be achieved by adding to the CCRS a multiple-rate ITC with full basis adjustment.

Without these modifications, the CCRS proposed by the Administration would be a seriously retrograde change in the tax law. In time, it would result in a significantly smaller stock of capital than would be attained if present law were continued, and contrary to the Administration's claims, that capital would be less efficient in terms of its composition and its production uses.

The modifications to CCRS that I have proposed would, I believe, avoid these unfortunate results. The principles these proposals embody, moreover, should be applied widely with respect to all productive capital, not only depreciable property. These principles should be used in the case of natural resources and mineral properties, and a wide range of intangible assets. The more broadly applied, the more effectively will the private sector's saving be allocated among the countless capital uses to which saving is put in our economy.

With these modifications, substantial progress could be made towards the inter-asset tax neutrality which is emphasized by the Administration. No less important, these modifications would fortify the thrust, established by ERTA in 1981, toward restoring the growth in our economy's industrial base and our international competitiveness. The benefits in doing so would be found not only in a larger, more technically advanced and more efficiently used stock of business capital, but also in higher levels of employment, higher real wage rates, and higher levels of output and real income than we are likely to realize if the Administration's proposals in their present form are enacted.

FOOTNOTES

1 See **IRET Economic Report No. 25,** "ACRS, ITC and Tax Neutrality," January 4, 1985.

2 See **IRET Economic Report No. 29,** "Pluses and Minuses (Mostly) in the President's Capital Cost Recovery System," July 8, 1985.

3 See Norman B. Ture, "The Accelerated Cost Recovery System: An Evaluation of the 1981 and 1982 Cost Recovery Provisions," in Charles E. Walker and Mark A. Bloomfield, Editors, **New Directions in Federal Tax Policy for the 1980s** (Cambridge: Ballinger Publishing Company, 1984).