The Daily Dish

Capital Cost Recovery and Tax Reform (Spoiler Alert: Tax Nerd Moment)

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Eakinomics: Capital Cost Recovery and Tax Reform (Spoiler Alert: Tax Nerd Moment)

There is a lot of chatter about the potential for tax reform this year, and some news reports that the White House, House, and Senate are negotiating a single, compromise plan to be released after the August recess. According to Axios, “One of the toughest remaining disputes is whether to start letting businesses immediately write off the cost of equipment (known as ‘full expensing’). This would be hugely expensive, so some conservatives oppose it. But House Leadership argues it would juice short-term economic growth.”

The issue revolves around so-called depreciation allowances. These are deductions that the tax code permits firms that make capital investments. Under full expensing, if a company spends $100 dollars on a new piece of machinery, it deducts $100 (the full cost) in the year of the investment. Under traditional depreciation schemes, the deductions would be spread out over the expected lifetime of the machinery. For example, with a 2-year expected life, the firm would deduct $50 in each of the first two years. Approaches known as “accelerated” depreciation front-load the deductions, but still spread them out over the life of the investment. In this example, deducting $75 in the first year and $25 in the second year would be a form of accelerated depreciation. From this perspective, full expensing is just an extreme form of accelerated depreciation.

In a nutshell, the issue is simple. Moving from full expensing to accelerated depreciation broadens the tax base in the near term; moving to straight line depreciation does so even more. A broader base permits lower rates to raise the same revenue. The broader base, however, means that instead of having a $100 deduction to free up cash to invest, the firm has only $75 or less. That makes the tax system more costly, and diminishes incentives. (A further point is that if some investments are given accelerated treatment and others given straight line depreciation, then the tax code is non-neutral and begins to distort the choices of investment. Expensing avoids this entirely.)

You might think that is that. Tax policymakers simply have a tough choice between lower rates and better investment incentives. But not so fast. It is possible to compensate firms for the cost of having their funds tied up; that is the lost rate of return on the investment that was lost. In practice, this amounts to paying interest on future depreciation deductions. In my simple example, at current rates depreciation would be $50 in the first year, but $51.18 in the second year. (Some readers may recognize that this makes the present value of depreciation deductions exactly the same as expensing, $1.)

Voila! A broader base, lower rates, and good investment incentives.