



The Daily Dish

# Expensing and High-quality Tax Policy

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In the world of federal income taxation, “expensing” is the ability to deduct (write off) the full cost of an investment in the year that it is made. The 2017 Tax Cuts and Jobs Act (TCJA) provided expensing for business investment (except structures) and research and development expenses (business investment in innovation), but not permanently. The former is phasing out and the latter has lapsed. There is now tremendous interest within the business community to restore expensing.

Would doing so just be pandering to business, or is there a tax policy rationale for expensing?

Expensing is simply very sensible tax policy. When calculating a firm’s (sole-proprietor, partnership, limited liability corporation, C-corporation, or any other) income, one begins by taking revenue and subtracting costs. For workers, firms subtract all compensation, whether wages or fringe benefits. Under expensing, firms subtract physical investment and innovation investment. As a result, a \$1 investment in human capital (labor compensation), physical capital, and innovation capital has the same impact on the tax liability.

Put another way, under expensing, the tax code is neutral with respect to the types of investments firms make. Instead of tax considerations, the mix of investments is driven by the economic fundamentals that generate the greatest return. That is exactly what one should try to accomplish in tax policy.

Expensing has another advantage as well. Suppose that an investment has a rate of return,  $r$ . A firm that is making the investment is implicitly saying that getting the original  $\$I$  plus the return  $\$r$  next year is compensation for giving up the  $\$I$  this year. That is,  $\$(I+r)$  tomorrow equals  $-\$I$  today.

Suppose now that the firm is allowed to deduct a fraction of the investment,  $f$ , and then is taxed at the tax rate,  $t$ , on the future earnings. Notice that  $f=1$  is full expensing. In this case, the firm does not give up a full dollar because it gets a tax savings of  $f$  times  $t$ . In the present, it is giving up  $\$(I-ft)$ , but in the future, it is only getting the earnings after tax  $\$(I-t)(I+r)$ . That is,  $\$(I-t)(I+r)$  tomorrow equals  $-\$(I-ft)$  today. But here is the real magic. If there is expensing,  $f=1$ , then this is  $\$(I-t)(I+r)$  tomorrow equals  $-\$(I-t)$  today, which is the same as  $\$(I+r)$  tomorrow equals  $-\$I$  today.

With expensing, firm taxation does not distort firm investment decisions because the up-front tax savings are enough to compensate for the future tax payments. Tax policy does not have to fold, spindle, or mutilate growth incentives in the economy, and expensing is a straightforward way to accomplish this.

A tax code that supports the right amount of investment and the right mix of investment. What’s not to like?