Insight

Expensing, Interest and the Economic Report of the President

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The president's Council of Economic Advisers released its *Economic Report of the President* (Report) last week, an annual undertaking that produces a massive tome of charts, tables, and selective history and analysis. Understood as such, it often comes and goes with little serious scrutiny. However, this report is notable for some worthwhile and balanced analysis with respect to certain, select elements of tax policy.

Notwithstanding serious deficiencies in its overall approach, the administration has been devoting more effort to advancing business tax reform in the coming year, and the *Report* devotes a chapter to this policy goal. As part of this discussion, the *Report* attempts to discredit some policy alternatives, such as pairing corporate rate reduction with an equivalent individual rate reduction and moving the international tax regime to a territorial system that more closely resembles those of our major trading partners.

In its critiques of alternatives, the *Report* also addresses expensing of new investment, which would allow businesses to write-off in a single year investments that are depreciated over time under current law. In its discussion of this policy approach, the *Report* identifies a problem that exists in the current code: negative tax rates for debt-financed investment. Under current law corporate interest expenses is deductible, while dividends and returns to equity are not. This introduces a significant disparity between the tax treatment of debt and equity financing. Indeed, debt financing exposes firms to a marginal effective tax rate of -2.2 percent, compared to 39.7 percent on equity financing, according to a study from the Department of the Treasury. This disparity considerably distorts corporate finance decisions and firm capital structure, with a fairly clear bias towards debt.

The *Report's* discourse on investment expensing notes that expensing reduces the effective marginal tax rate on new business investment and would therefore "boost investment, the capital stock, and productivity." All good things. But the *Report* notes that adopting this approach without addressing interest deductibility would exacerbate the existing disparity between the tax treatment of debt and equity-financed investment. Also a good point. Pairing a repeal of the deductibility of interest with expensing, would solve this challenge, and would reflect, as the *Report* notes: "a well designed tax system."