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For Pro-Growth Tax Reform, Expensing Should be the Focus

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As Congress and the President move towards consensus on tax reform, they should work to keep three essential components at the heart of the reform.

1. Businesses should be allowed to deduct all capital expenses from their taxable income under what is known as "full expensing."

2. Corporate tax rates should be lowered significantly.

3. Only corporate income earned in the U.S. should be taxed, known as "territoriality," to put U.S.-headquartered businesses on an equal footing with their foreign counterparts.

Of these three reforms, full expensing is most important for economic growth: It is most effective at lowering the cost of capital and allowing businesses to increase investment, jobs, and wages for U.S. workers.

The Tax Foundation estimates that lowering the corporate income tax rate to 15 percent would increase total U.S. output by 4.3 percent. More impressively, full expensing of capital investments allows output to grow 5.4 percent.[1] Each reform would reduce revenues by a comparable amount before taking economic growth effects into account. Rate reductions would reduce revenue by more than expensing once the feedback effects of growth on revenue are considered.[2]

Expensing, rate reductions, and territoriality are indispensable components of tax reform. This *Issue Brief* outlines why expensing is the most important piece of an economic growth agenda aiming to achieve President Trump's 3 percent annual growth target over the next decade.

Expensing Boosts Investment

Expensing's benefits primarily apply to new investments, so it benefits businesses that are actively investing and creating jobs in the U.S. Established businesses often prefer lower tax rates over expensing because lower tax rates benefit their existing operations. While lower tax rates are an important part of tax reform, expensing provides a larger economic gain because it is forward-looking, removing the current system's bias against new investment. Compared dollar-for-dollar in reduced tax revenue, expensing lowers the cost of investment more than a rate cut, which is why it is more effective at stimulating growth. In a country suffering from a historically sluggish rate of start-ups and dynamism (the start-up rate in the U.S. is stuck 30 percent below its pre-2008 average[3]), expensing is a key part of re-energizing the economy.

Under the current tax code, businesses claim most new capital investments (e.g., equipment and buildings) as tax deductions, according to complex formulas over as many as 39 years. Expensing would

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replace that entire system. Companies could deduct the entire cost of a new investment in the year the investment is made. Tax depreciation of new investment makes investing more expensive than it would be otherwise. The value of a one-dollar investment today can be reduced to as little as 37 cents of real write-off value, if depreciated over 39 years.[4] In other words, a business must pay one dollar, but the Internal Revenue Service (IRS) only recognizes a portion of that dollar as a cost, which artificially increases profits and effective tax rates.

With U.S. corporations sitting on large uninvested cash balances,[5] expensing has enormous potential to set off a flurry of new building, equipment investment, and innovative research. This is exactly what the U.S. economy needs.

Expensing Ends Unequal Tax Treatment

The current system gives companies a partial deduction for each dollar invested in the economy. The real value of the deduction depends on the vagaries of the tax code, future inflation, and the company's cost of borrowing.

The classification of investments by type and the somewhat arbitrary assignment of the number of years over which each investment must be written off are called depreciation schedules. The imperfect design of these schedules creates unequal tax rates on investment across industries.

Chart 1 shows how the depreciation system tilts the playing field in favor of some industries at the expense of others.[6] For example, the marginal effective total tax rate on new investments in the retail trade industry is 5.6 percentage points higher than the average and 14.9 percentage points higher than investments in the mining industry. The shown variation across industry tax rates is primarily driven by the divergence between how the tax code defines depreciation schedules and estimated economic depreciation.[7]

Adopting full expensing would reduce effective tax rates everywhere, but especially in industries disfavored under the current system. The result would be more economically efficient: The tax code would no longer be steering investment to arbitrarily favored industries.

Expensing Helps Labor

Without investment in buildings, equipment, and technology, human labor would be much less efficient. One of the primary drivers of economic growth is investment that complements human labor, making production and services more efficient and better able to serve consumer needs.[8]

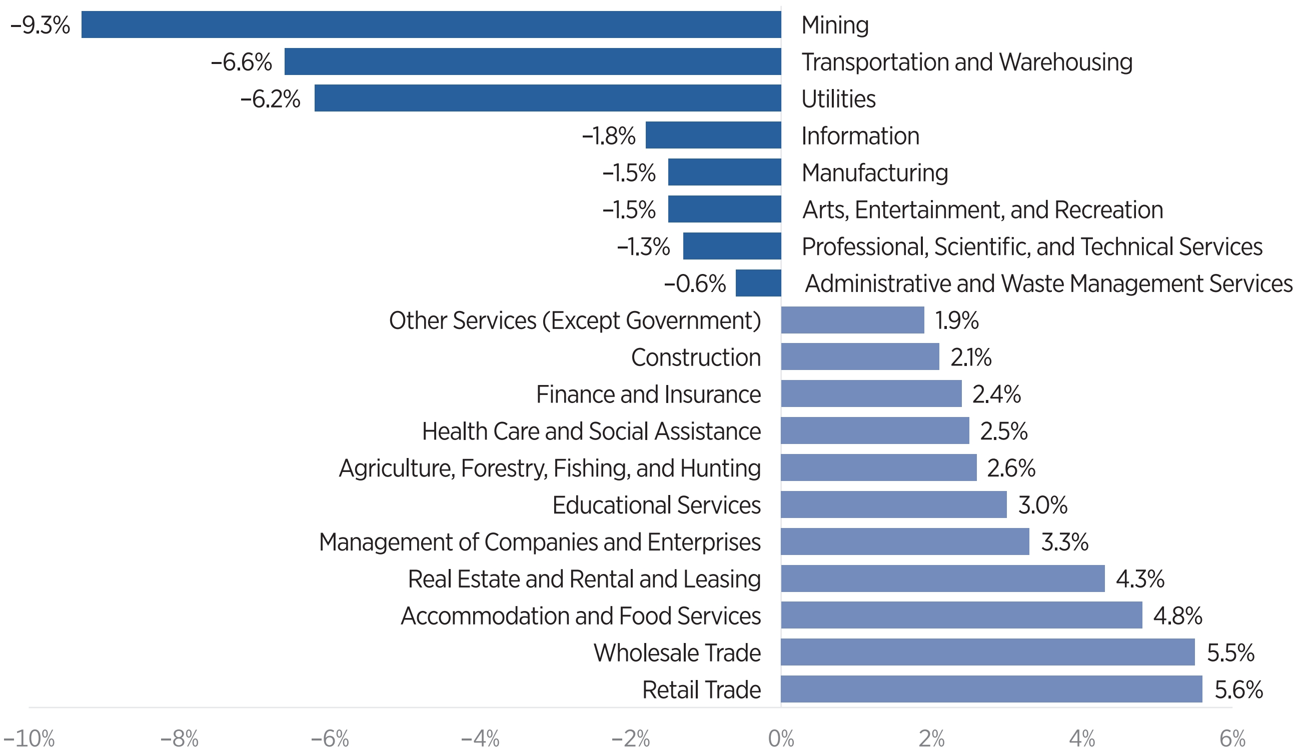
Expensing lowers the cost of capital investments. Straightforward economic models show that a lower cost of capital in the U.S. relative to the rest of the world would increase domestic investment to the point that investors earn the same rate of return as they did before

1. Tax Foundation, *Options for Reforming America's Tax Code*, June 6, 2016, https://tax foundation.org/options-reforming-americas-tax-code/ (accessed July 31, 2017).
2. A 15 percent rate would reduce revenues by $2.2 trillion ($995 billion once growth effects are considered). Expensing would reduce revenues by $2.2 trillion ($881 billion once growth effects are considered). Ibid.
3. Economic Innovation Group, "Dynamism in Retreat: Consequences for Regions, Markets, and Workers," February 2017, p. 8, http://eig.org/wp-content/uploads/2017/07/Dynamism-in-Retreat-A.pdf (accessed July 31, 2017).
4. Assuming a 3.5 percent real discount rate and a 3 percent inflation rate. Stephen J. Entin, "The Tax Treatment of Capital Assets and Its Effect on Growth: Expensing, Depreciation, and the Concept of Cost Recovery in the Tax System," Tax Foundation *Background Paper* No. 67, April 2013, http://taxfoundation.org/sites/taxfoundation.org/files/docs/bp67.pdf (accessed July 31, 2017).
5. Jeff Jeffrey, "Corporate America Is Sitting on Trillions in Cash. Here's Who Has the Most Dry Powder in Portland," *Portland Business Journal*, July 13, 2017, https://www.bizjournals.com/portland/news/2017/07/13/corporate-america-is-sitting-on-trillions-in-cash.html (accessed July 17, 2017). Expensing is not the only smart policy change for getting cash off the sidelines. Moving to a territorial tax system is also a valuable reform.
6. Authors' calculations using the Open Source Policy Center's Cost of Capital Calculator. Marginal effective total tax rate on new investment includes the impact of all levels of taxation on the incentives to invest. Calculations assume a typically financed investment by a traditional corporation using the General Depreciation System (GDS) with no bonus depreciation. Cost of Capital Calculator, "Tables of Effective Tax Rates or Their Components by Asset or Industry," https://www.ospc.org/ccc/681/ (accessed July 31, 2017).
7. Although the proper benchmark is expensing, not economic depreciation, the above variation illustrates the distortions in the current system. There are many methodological and conceptual issues with estimating true economic depreciation, thus expensing provides a more consistent baseline. Economic depreciation estimates from U.S. Bureau of Economic Analysis (BEA).
8. Matthew H. Jensen and Aparna Mathur, "Corporate Tax Burden on Labor: Theory and Empirical Evidence," American Enterprise Institute, *Tax Notes*, June 6, 2011, https://www.aei.org/wp-content/uploads/2011/06/Tax-Notes-Mathur-Jensen-June-2011.pdf (accessed July 31, 2017).

CHART 1

Large Differences Between Industry Tax Rates

VARIATION FROM AVERAGE INDUSTRY RATE OF 32 PERCENT



SOURCE: Cost of Capital Calculator, "Tables of Effective Tax Rates or Their Components by Asset or Industry," July 17, 2017, https://www.ospc.org/ccc/681/ (accessed July 25, 2017).

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the reform. Both the U.S. capital stock and the demand for labor to operate and service the new investments would be permanently larger. A larger capital stock and higher labor demand would increase the number of jobs and place upward pressure on wages.

Without expensing, the long depreciation schedules for low-tech structural investments (e.g., warehouses and retail shops) place those areas at a particular disadvantage. Under expensing, additional investment in these areas may be deflationary as capital currently locked out of the market is able to flow in. Robust economic growth of all types is known to place downward pressure on the price level, which can benefit American consumers.[9] Additional investments in low-tech capital are especially needed to create low-income and middle-income jobs. The benefits of expensing would be shared by Americans at all income levels, especially those at the bottom.

Expensing Simplifies Tax Payments

Expensing can also significantly cut compliance costs. According to IRS research, business tax compliance costs are over $100 billion per year, representing a massive waste of money and effort.[10] Other

9. Deflation can be the byproduct of a healthy, growing economy, and is more often associated with periods of growth than with depression. Norbert J. Michel, "Federal Reserve Performance: What Is the Fed's Track Record on Inflation?" Heritage Foundation *Backgrounder* No. 2968, October 27, 2014, http://www.heritage.org/debt/report/federal-reserve-performance-what-the-feds-track-record-inflation.

10. George Contos, John Guyton, Patrick Langetieg, Allen H. Lerman, and Susan Nelson, "Taxpayer Compliance Costs for Corporations and Partnerships: A New Look," paper presented at the 2012 IRS–TPC Research Conference, June 21, 2012, https://www.irs.gov/pub/irs-soi/12rescontaxpaycompliance.pdf (accessed July 31, 2017).

estimates place the cost of complying with depreciation schedules alone at over $23 billion annually, or 448 million hours each year.[11] Considering that the total compliance cost for traditional C corporations is equal to 14 percent of their taxes paid, expensing could make major inroads toward simplifying business taxpaying and lowering compliance costs.[12]

Full expensing, including the expensing of inventories, would greatly simplify tax payments. Businesses would no longer have to track investment depreciation schedules or account for the additional uncertain tax costs associated with long write-off periods. Expensing benefits small and medium-sized firms in particular by reducing compliance costs and reducing dependence on borrowing to maintain cash flow.

Expensing Is a Crucial Part of Tax Reform

To help the economy realize its growth potential, any tax reform plan must include both expensing and a lower corporate tax rate. Congress should make expensing its first priority and then permanently lower the corporate tax rate as low as possible, or ideally repeal the tax altogether.

Recent tax reform discussions have cited the $2 trillion static revenue loss from full expensing as a reason to leave expensing out of reform packages. Much of the revenue loss from expensing is front-loaded in the first years of the program as new investments are made and old capital continues to be written off. When economic growth is taken into account, the true cost shrinks to about $800 billion over 10 years.[13] The static cost continues to decrease throughout a 20-year window.[14] There are numerous ways to offset the cost of tax reform in a fiscally responsible way, but Congress should not let artificial constraints like revenue-neutrality keep important reforms from being enacted. Tax reform done right can increase output by 10 percent or more over a decade.[15]

Conclusion

Expensing is but one piece of the business tax reform puzzle. Reform without expensing will not deliver the economic growth that the President has championed and that American workers need. Holistic business tax reform should include:

- **Full expensing** to allow businesses to deduct all capital expenses from their taxable income. By lowering the cost of capital, expensing is most effective at encouraging job creation and wage growth.
- **A lower corporate tax rate** also reduces the cost of capital, making America a more attractive place to do business.
- **A territorial system** that only taxes corporate income earned in the U.S., paired with the other two reforms, would put U.S.-headquartered businesses on an equal footing with their foreign counterparts.

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11. Scott A. Hodge, "The Compliance Costs of IRS Regulations," Tax Foundation *Fiscal Fact* No. 512, June 15, 2016, https://taxfoundation.org/compliance-costs-irs-regulations/ (accessed July 31, 2017).
12. Author's calculations. Internal Revenue Service, "SOI Tax Stats—Table 17: Corporation Returns With Net Income, Form 1120," Tax Year 2009, https://www.irs.gov/uac/soi-tax-stats-table-17-corporation-returns-with-net-income-form-1120 (accessed July 31, 2017).
13. Tax Foundation, *Options for Reforming America's Tax Code*.
14. Kyle Pomerleau and Scott Greenberg, "Full Expensing Costs Less Than You'd Think," Tax Foundation, June 13, 2017, https://taxfoundation.org/full-expensing-costs-less-than-youd-think/ (accessed July 31, 2017).
15. Romina Boccia and Adam N. Michel, "Pathways for Pro-Growth, Fiscally Responsible Tax Reform," Heritage Foundation *Backgrounder* No. 3219, May 25, 2017, http://www.heritage.org/taxes/report/pathways-pro-growth-fiscally-responsible-tax-reform.