

Can Policymakers Time the Ending of Macroeconomic Incentives? Part Three: New Versus Old Business and Complexity

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[1] When policy makers decide that they are going to grant a temporary write-off for new capital investments, they essentially conclude that its macroeconomic advantages exceed other alternatives such as additional monetary stimulus, a one-time grant or tax credit to taxpayers, or a greater reduction in tax rates. Any special accounting treatment for physical capital investment in a limited time period, however, inevitably is going to have some side costs that must be weighed in assessing its overall merit.

[2] Here I deal with two of the costs not covered in the first two parts of this series. First, the incentive effects apply more powerfully to established or old business than to new business -- a potential threat to innovation. Second, new temporary allowances set in motion a set of additional accounting requirements that both increase complexity and encourage firms to play games with the timing of billing or delivery of assets near to when the incentives expire.

New Versus Old Wealth

[3] In 1986, Congress adopted a major reform proposed by the Reagan administration to replace various investment incentives with lower tax rates. The incentives that were eliminated at that time included an investment tax credit and an accelerated cost recovery system for depreciable capital. The administration was even willing to abandon its own particular cost recovery scheme first proposed and put into law in 1981. The 1981 scheme must be taken in the context of the time: It was only the latest in a long series of allowances that substantially shortened the depreciable lives for assets; its importance relative to provisions already in place was exaggerated by some friends and foes alike.

[4] Despite the switchover, the 1986 change still was consistent with the Reagan philosophy of lower rates and lower taxes. In 1981, business tax reduction was achieved indirectly; in 1986, direct rate reduction was found to be a superior method.

[5] Among the most important arguments used for the superiority of rate reduction was that the former method had favored old business over new business. Established businesses with positive tax liability might be given an incentive to invest in physical capital with accelerated write-offs, but firms with little or no tax liability generally could not make use of them. Hence, a competitive advantage was given to firm that could use the new tax breaks to offset taxes earned elsewhere. A bit of truth in labeling: I developed this argument in some earlier research and proposed its use when acting as economic coordinator of the Treasury's tax reform effort. Nonetheless, the argument was accepted and used by the administration.

[6] Who were among the losers in the old setup of accelerated allowances? Interestingly, it included many established firms that had recently gone through hard times. In the end, for instance, a number of old line, established, companies with substantial physical investment -- such as some steel companies anticipated to oppose the change because of their heavy past investment -- ended up favoring 1986-style lower rates to the prior system. Having gone through a recession in their own industry or geographic area, they realized that accelerated allowances were really working against their survival. They couldn't use them, at least for awhile, and the firms that could use them would either bid up interest rates or lower prices, all of which hurt the relative position of the firms without sufficient liability to make use of the tax breaks.

[7] Perhaps even more important, the new business is put at a competitive disadvantage by these types of incentives. Many start-up firms go for a period of time before their sales are adequate to generate positive profits. Even if they would be profitable from day one, the profits of a new firm with significant capital

investment are unlikely to be high enough to make full use of the incentives.

[8] The new allowance has some of the same problems as the old, pre-1986, law. Even new capital immediately generating a real rate of return of 10 percent could not possibly make use of this write-off provision. For instance, a 30 percent write-off of costs, along with other depreciation, requires that a typical piece of equipment (with a tax life of seven years) provide return of receipts in the first year of more than 40 cents for every dollar spent on that equipment. Few, if any, start up firms are going to be able to make use of this level of deduction -- at least if they are capital intensive. In effect, one of the consequences of these types of tax breaks is to reward past success as much as future investment -- the old "it takes money (or at least past profits) to make money (out of the tax system)." A firm has to have income from some previously successful investment before it really can generate full benefits from the new tax break. To the extent that innovation is set in motion by new firms -- or even the threat of new firms -- this type of tax break acts as a partial deterrent.

Complexity and Game Playing

[9] Needless to say, a new, one-time depreciation allowance creates yet another layer of complexity. Firms must now keep special track of assets purchased within the temporary time period set aside for a special write-off. Moreover, if this is to become standard practice every time there is a slowdown in the economy, then special write-offs could be present almost as much as they are absent (for example, if there were a slowdown every six years and the allowances were to last for three years). Note that the issue here is complexity: We questioned in a previous note the questionable extent to which this type of on-again, off-again system could continually surprise people so that it didn't have a negative effect on investment when it was temporarily turned off.

[10] No matter how one slices the law and regulations, moreover, firms will play games near to the time that the incentive is cut off. This administrative effort will be over and above the simple economic incentive to move investment forward. Cut the incentive off on the basis of billing dates, and the firm will pay in advance for capital equipment. Cut it off on the basis of some delivery date, and a flurry of activity will take place near the cut-off date to insure the firm enough delivery of parts to make a claim. Of course, if assembly is required, then another set of regulations and games will ensue, as well. Firms making and delivering equipment will be put into overdrive right before the cut-off date, to be followed by a retrenchment or slowdown. To some extent, it's simply unavoidable.

[11] In sum, this three-part series raises a series of questions about the costs of ending investment incentives on the basis of a timetable unrelated to the state of the economy. Is a series of on-again, off-again investment incentives now going to be part of the nation's macro-economic toolbox? If so, we had better think about the consequences of continually putting the tool back in the box, not simply taking it out.

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