

Can Policymakers Time the Ending of Macroeconomic Incentives? Part Two: What Happens When Temporary Investment Incentives End?

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[1] The classic criticism of trying to engage in discretionary macroeconomic policy is that the necessary legislation usually can't be enacted on a timely basis. By the time that Congress gets around to acting, for instance, a recession may already have passed. With temporary business incentives such as partial write-offs for depreciable capital, a more important critique is that there is almost no chance that Congress knows in advance the correct date to end them -- yet end them it must if they are to be temporary. And if they are not temporary, then they really aren't a counter-cyclical tool that can be employed on a regular basis.

[2] To be fair to elected officials, they are led down the path toward providing write-offs for depreciable capital by a large number of my fellow economists, who love playing with this type of incentive. These economists are as likely to be Democrats as Republicans. Their shared belief is that they can use the tax code to affect behavior in ways implied by their models, usually with scant attention to matters outside the models such as tax administration. Focusing almost exclusively on the short-run and ignoring almost all long-run implications on the timing and difficulty of on-again, off- again policy, they use their mathematical tools and analysis to show how to obtain for now the greatest bang now per buck or incentive per dollar of revenue cost.

[3] The power of temporary incentives for physical capital investment derives from four different effects: (1) it provides a lot of cash flow to businesses up front, essentially in the form of an interest-free loan to be paid back later; (2) it lowers the cost of capital or the effective tax rate on returns from the capital; (3) it applies only to new capital investments; and (4) its temporary nature induces people to move planned future investments into the current eligibility period. (For some simple numerical examples of the first two effects, see the first part of this series.) But what goes around comes around. Every one of these effects works in reverse down the road. If the government is successful in spurring the economy in the initial years, then the same logic implies that it will dampen the economy in later years.

[4] First, consider the cash flow. If additional cash flow to the business encourages investment in the initial years, then the scheduled decline in cash flow could encourage a significant turnaround in investment in later years. As we showed in some examples in Part 1, moreover, the decline in cash flow once a three- year incentive is turned off in the fourth year can be greater in value than the increase in cash flow in the first year.

[5] Second, consider the incentive effect. If a 30 percent temporary write-off approximately decreases the rate of tax on physical capital investment from 35 percent to 24.5 percent, then the ending of the incentive will raise tax rates from 24.5 percent back toward 35 percent. The initial incentive wears out, thus encouraging a decline in investment once the temporary provisions have expired.

[6] The third effect is a more complex matter. Many economists like physical capital investment incentives because, so the argument goes, they apply only to new investment. In various models, the cost of capital falls and investors either get a higher rate of return or are willing to accept a lower gross return (charge lower prices for their output) to obtain the same net return. But this implies that the value of old capital falls because it must charge the same price for its output as the new capital but doesn't have the same subsidy. The effect can be likened to "zapping" old capital -- that is, imposing a one-time wealth tax on that capital. To continue the argument, past investors get trapped and are forced to bear a confiscatory tax that presumably has no effect on behavior because prices and investment patterns are determined by the new tax regime.

[7] But think about it. If the confiscatory tax effect works in the simplest way implied by many of these

models, then removal of the incentive works in reverse and provides old capital with a windfall -- a negative wealth tax or wealth subsidy. I don't want to carry this argument very far. Most of these wealth taxes and subsidies come out of systems where the government presumably engages in a series of surprise moves for which no one plans. When the removal of the incentive is already planned in advance (for example, ending after three years), then it is hard to believe that people are surprised by its ending.

[8] The real issue with any attempt to tax old capital is whether people can really be surprised, again and again, even at its beginning. If temporary investment write-offs have now become a regular tool of macro-economic policy -- and certainly in future downturns Congresses will look to what was done in 2002 -- then what is the surprise element? All investment in capital is threatened with the risk that the government will come in and favor new investment over old investment. Thus, this Congress has given businesses incentives to slow down investment when it appears that a downturn is threatened so that they can benefit from investment incentives likely to come later. Moreover, investors during an upturn now face the risk that if they invest now they won't get the lower cost of capital available to competitors who time their actions better.

[9] Finally, the fourth effect -- moving capital investment into the qualifying period -- obviously can cause a temporary capital investment slowdown after the qualifying period is over. A firm originally planning to invest \$2 million in year 3 and an additional \$2 million in 4 might now invest \$4 million in year 3 and nothing in year 4 if the incentive ends after year 3. Moreover, if a temporary incentive lasts three years, the speed-up of investment into the qualifying period is more likely to take place later in the period (for example, in years 2 and 3 rather than year 1). This implies that this incentive to shift investment forward could be most powerful, say, two years down the road, followed by a disincentive effect after three years have passed. Encouraging extra investment in two years and less investment in three years is strange timing to deal with a recession that might have ended the year before the incentive was enacted.

[10] Contrast, if you will, this cycle of incentive effects with that provided by the monetary authorities. If the Federal Reserve succeeds in cutting interest rates today, they, too, will reduce the cost of capital for new investment -- in this case through lower borrowing costs rather than tax costs. But their timing on interest rate cuts will follow more immediately the flows and ebbs of the economy itself. If the economy suddenly accelerates to the point of becoming inflationary, they will increase interest rates then. We probably wouldn't think very highly of a monetary authority that today set in place automatically a significant increase in interest rates precisely after three years had passed. We'd complain that it had unnecessarily thrown away its flexibility.

[11] In sum, the classic argument against discretionary fiscal policy is that Congress delays too long before it provides incentives. It can't get the timing right. But this criticism reflects only a lag of several months between discovery of a downturn and congressional action. With accelerated depreciation, the criticism must be applied in spades. Not only might Congress not get the incentives enacted at the right time, but almost inevitably it will remove them at the wrong time. It might be off by years, not just months, in its timing.

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