Is it Time to Rationalize Depreciation Policy?

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[1] Depreciation policy seems to be back on the table for the first time since the mid-1980s. Technology, electronics, and related companies are claiming that the depreciation lives for some of their equipment are too long. Thomas Neubig and Stephen Rhody suggest that these are among a variety of distortions that have now arisen from using old depreciation class lives (Tax Notes, May 29, 2000, pp. 1267-1273). Real estate firms grumble about the lives granted for real estate. (See also Tax Notes, July 23, 2001, p. 461.) At the National Tax Association Spring Symposium this year, Jane Gravelle suggested that structures indeed may be favored relative to equipment. In the energy bill recently passed by the House of Representatives, the lives of several types of property were shortened as an incentive for energy exploration and production.

[2] What are the best depreciation policies for the nation? Will they treat businesses on an equal basis before the law?

[3] To answer those questions, we often rely on the Treasury Department to articulate a coherent approach to this policy based on principles. Its 2000 Report to the Congress on Depreciation Recovery Periods and Methods helps but does not fully articulate how policy should proceed or how the new administration views the issues. If Treasury doesn't set up the rules under which policy development is to take place, the policy is likely to evolve in dribs and drabs, lack coherence, and discriminate significantly against some businesses in the process of favoring others, and effectively reduce national income.

[4] Since World War II depreciation policy has been reconsidered several times. Accelerated depreciation, investment credits, and then the accelerated cost recovery system (ACRS) in 1981 all tended to reduce the cost of capital by accelerating when deductions would be taken or, in the case of the investment credit, by granting an immediate credit rather than deduction. Although many argued that these changes were necessary to encourage business investment, the entire period up to the adoption of ACRS was also one of continually higher inflation rates. Because the cost of property is deducted only over time, higher rates of inflation effectively reduce the real value of the deductions -- denying the full write-off of the real value of purchases made -- and thus providing partial justification for greater acceleration.

[5] Then in 1986, in exchange for lower rates of tax on capital at both the corporate and individual levels, Treasury proposed a form of depreciation that was close to economic depreciation -- the attempt to allow deductions that approximate the real economic loss associated with owning such property. Treasury also proposed that such allowances be indexed for inflation so that the real -- not the nominal value -- of such property could be depreciated. Congress did not wholly accept the Treasury position, but it did make the lives of property conform more to what were then thought to be the actual periods of time over which property was used. However, it did not allow for inflation adjustments, partly out of concern over whether these adjustments could practically be made for capital gains and interest as well.

[6] With perhaps the major exception of structures (Congress increased the period over which structures could be deducted primarily as a revenue raising measure in 1993), the 1986 compromise has held up. Indeed, corporate policy as a whole has remained relatively stable since 1986, with some small exceptions such as the corporate tax rate being raised by 1 percentage point (as a revenue raising measure) in 1993.

[7] At the same time, one important mechanism for making future adjustments -- in effect, testing the claims made by technology firms and holders of real estate today -- was abandoned. The Office of Depreciation Analysis, created as a result of the 1986 legislation, went out of business a few years later. Some businesses lobbied against it, almost surely because they feared that the lives of some of their assets would be declared too short. At the same time, the office had trouble gathering the necessary data it needed from many

businesses.

[8] One consequence of its abandonment, however, has been the lack of detailed examination of real depreciation rates on assets in any consistent manner for some period of time. Not surprisingly, such analysis is needed. The world continues to change. Not only are updates needed for tax purposes, but for national income accounting as well. Not commonly recognized is that those who estimate growth in national product and income over time must rely on limited data on actual depreciation. Moreover, businesses today put a much larger share of investment into property with shorter lives, and the dispute lies especially with this property. Much of it is technological or scientific in nature and often becomes obsolete at a fairly fast rate as new and better equipment is developed.

[9] On the political front, tax subsidies of all types are becoming increasingly popular. It is not surprising, then, that faster cost recovery allowances -- whether justified or not under some standard of economic depreciation -- would be suggested as one means of providing subsidies. The energy bill provides a primary example of these types of efforts. Almost no discussion took place over whether this or that was the right rate of depreciation and, if a subsidy was desired, whether acceleration was the efficient form in which to provide it.

[10] The danger is that changing lives one at a time is unlikely to make coherent policy. Most importantly, it does not produce an efficient economy. When one type of business activity is favored over another, there is usually waste in an economy -- effectively a loss of income to the public. For example, even if activity A is overtaxed and deserves some relief, reducing taxes on activity A relative to B on an arbitrary basis could easily create waste relative to the alternative of reducing the tax on A and B consistently. In addition, where subsidy is sought, the right way to subsidize may not be through changes in depreciation or cost recovery.

[11] The Treasury has traditionally, although not always, led the fight for the consistent treatment of different types of capital. It has articulated such principles as economic efficiency and equal treatment of equals as a means to defend its stance and deter particular interests from creating a tax code that would distort business investment decisions. Given the growth in efforts to redefine depreciation, perhaps now is the time for Treasury to take that lead once again.

Other Publications by the Authors

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