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Business Tax Reform: Focus on Rate Reduction Now, Save Expensing for Later

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Business tax reform is essential to increasing investment and restoring robust job creation and wage growth. Reform is necessary in large part because the U.S. has the highest corporate tax rate in the developed world. This lowers business investment in the U.S. and makes U.S. businesses less competitive in the global marketplace.[1]

The current tax system also generally does not allow businesses to deduct fully what they spend on capital when they make investments (known as "expensing"). Instead, it requires them to deduct the cost of their investments gradually over a number of years, known as depreciation. This is another troublesome policy that suppresses investment.

Many past tax reform efforts prioritized establishing expensing to increase investment; reducing tax rates was secondary. However, relaxing a key assumption made in traditional analyses of tax policy shows that, given the current high corporate tax rate and accelerated depreciation schedules, reducing the business tax rate may be more beneficial for boosting investment than establishing expensing.

Constraints Force Congress into Trade-Offs. Ideally, an overhaul of the business tax system, whether as part of the fundamental tax reform of the entire tax code or a more focused effort only on business taxes, would cure all the problems of the current business system. However, certain political constraints likely prevent Congress from enacting fundamental reform of business taxes that is necessary to do so.

Those constraints are that tax reform must be revenue neutral—meaning it would not raise taxes or cut them—and that it must not shift part of the business tax burden to individuals. These are reasonable constraints, because breaking them would likely stop tax reform in its tracks.

The current tax reform effort can achieve only a limited economic benefit because of these constraints. To maximize the benefit of tax reform, Congress must make certain trade-offs. Thankfully, there is never a last tax bill, so Congress will have future opportunities to fix issues that this tax reform effort fails to address.

Lower Rate or Expensing a Key Trade-Off. The constraints on tax reform likely mean there will not be enough base-broadening or loophole closings available to both lower the corporate tax rate to get it in line with other developed nations—which would mean lowering it at least to 25 percent—and establish expensing. Congress will need to choose one or the other.

As explained below, a lower corporate tax rate is necessary because, contrary to traditional analysis, the current high rate is suppressing business investment. The high rate also makes the U.S. a less profitable place for businesses to expand than other developed countries with lower rates. Businesses invest in those other more competitive countries, and the U.S. loses out on increased jobs and wages.

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Establishing expensing would lower the cost of capital and the hurdle rate (the rate of return an investment must match or exceed for a business to undertake it) for new potential investments by removing a tax-imposed barrier to investment. This would increase investment, which would trigger subsequent benefits to job creation, wages, and economic growth.

The current system, known as accelerated depreciation, is better than traditional economic or straight-line depreciation, because it allows businesses to recover the cost of their capital sooner, but using any depreciation schedule instead of expensing diminishes investment below where it would be without tax interference.

In traditional analysis of tax policy, expensing is generally considered more important for lowering the all-important hurdle rate for investment than lower tax rates, because tax rates do not affect investment in those analyses.[2] However, real world evidence tells another story. Business leaders continually push for lower tax rates before expensing—or even lower rates *in lieu* of expensing.

Currently low inflation could be contributing to this preference. Lower inflation reduces the extra tax businesses pay because they are forced to depreciate assets instead of expense them, which makes depreciation less of a negative influence on investment. Low interest rates could also play a role: Businesses are more likely to invest when interest rates are low, because the return from investing their resources in higher-risk but potentially higher returning investments is more attractive compared to leaving those resources in low-risk savings that earn the low rates. But businesses' preference for lower rates instead of expensing predates the current environment of low inflation and low interest rates, so something else is behind the preference.

Changing Key Assumption Shows Rate Can Be More Important. The way to understand why businesses want lower rates more than expensing lies in relaxing a key assumption that traditional tax analyses make.

The long-held result that expensing is more important for lowering the cost of capital is predicated on an assumption that businesses operate in perfectly competitive markets and earn only a risk-free rate of return on their capital investments. In other words, they earn the same return on their investments (adjusted for risk and inflation) as they would if they held their resources in assets with little risk, such as U.S. Treasury bonds.

The traditional analysis assumes that businesses never earn economic profit or profits above the risk-free return. However, there are strong reasons to believe that businesses do not necessarily operate in perfectly competitive markets and do earn supranormal returns (returns above the risk-free rate). They can do so through technological advantages, market dynamics, market research, or other factors.[3] In fact, sophisticated models of the economy assume that businesses earn economic profits.[4]

Relaxing the assumption that businesses earn only risk-free rates of return on investment in perfectly competitive markets to reflect businesses earning economic profits shows that lower rates are actually more effective at lowering the cost of capital for businesses today than switching to expensing—*given current accelerated depreciation schedules and the high U.S. corporate tax rate*.[5]

Focus on Rate Reduction Now, Expensing Later. If it is assumed that businesses earn economic profit, tax reform that lowers the corporate rate at least to 25 percent and keeps accelerated depreciation in place would lower the hurdle rate for new investment more than going to full expensing and leaving the rate at its current high level.

1. See Curtis S. Dubay, "No Fooling: U.S. Now Has Highest Corporate Tax Rate in the World," The Heritage Foundation, The Foundry, March 30, 2012, http://blog.heritage.org/2012/03/30/no-fooling-u-s-now-has-highest-corporate-tax-rate-in-the-world/.
2. J. D. Foster, "The Big Choice for Jobs and Growth: Lower Tax Rates Versus Expensing," Heritage Foundation *Backgrounder* No. 2810, June 19, 2013, http://www.heritage.org/research/reports/2013/06/the-big-choice-for-jobs-and-growth-lower-tax-rates-versus-expensing.
3. Ibid.
4. Julie-Anne Cronin et al., "Distributing the Corporate Income Tax: Revised U.S. Treasury Methodology," U.S. Department of Treasury, Office of Tax Analysis, May, 2012, http://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/OTA-T2012-05-Distributing-the-Corporate-Income-Tax-Methodology-May-2012.pdf (accessed October 30, 2013).
5. Foster, "The Big Choice for Jobs and Growth."

This finding holds only if depreciation is accelerated enough, which it likely is under today's schedules.

The new finding does not change the fact that expensing is the right policy for businesses to deduct the cost of their capital investments. Instead, it shows that, given the need to make trade-offs in tax reform, the current high corporate tax rate, and current depreciation policy, Congress would do more to bolster investment by lowering rates now and coming back to establish expensing in future iterations of tax reform.

Business Tax Reform Vital for Increasing Investment. Business tax reform would boost investment, which would create jobs and raise wages for America's beleaguered workforce. Congress should take it up as soon as possible.

Given the constraints it will operate under, Congress should do everything it can to reduce the tax penalties on investment so it maximizes the benefit of tax reform to American workers. New research shows that reducing the corporate tax rate so it is on par with our foreign competitors is the best way to achieve that goal. Congress should focus on reducing the rate now and work on establishing expensing in its next reform effort.

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