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## DEBATE OVER BUSINESS TAXES

In considering the current tax bill, there's been a lot of argument right along about the individual tax cuts--how much, how many years, what distribution, etc. More recently, some substantive questions have been raised about the Administration's proposal to reduce business taxes through the Accelerated Cost Recovery System (ACRS).\*

That system would literally revolutionize depreciation practice in the U.S. doing away with all but a small vestige of useful life determination and greatly accelerating capital recovery periods. Adoption of the ACRS would raise the U.S. to the forefront of industrialized countries with respect to liberal treatment of capital recovery and, according to its proponents, help make the U.S. economy much more competitive among those nations.

The impact of ACRS on Treasury revenues (initial impact without regard to any "feedback" effect) is large, particularly after the first two years of implementation. Critics have said that it would emasculate the corporate income tax for capital intensive industries and that corporate tax receipts as a proportion of all revenues will shrink to the vanishing point in the late 1980s. Critics also claim that ACRS distributes its tax savings in a haphazard manner giving proportionally too much benefit to such capital intensive industries as primary metals, public utilities, communications, and non-auto transportation.

According to calculations by the Joint Committee on Taxation, there is presently a wide disparity in average effective rates of tax on assumed income from investment in business equipment by industry. Such average effective rates have varied widely over the years too, being as high as 43% on all equipment in 1961 and as low as 4% in 1977. In general, according to the Joint Committee, the most generous treatment under present law goes to equipment with an ADR midpoint life between six-and-a-half and nine years. Under ACRS, it is charged that for a significant spectrum of equipment investment effective tax rates could turn "negative." A negative tax rate in this sense means that the after-tax rate of return on the particular asset exceeds the pre-tax rate. In such cases, it's said that the present value of the depreciation deductions and investment credit could result in a "subsidy" to investment but not necessarily an efficient allocation of resources.

These concerns were expressed by Professors Jorgenson and Auerbach in developing an alternative to ACRS known as the First Year Capital Recovery System

\* For purposes of this brief discussion, we will consider the original and revised (as of June 1981) ACRS proposals as one and the same. While there are differences in timing and application to particular assets, the long-term impact would not be significantly different.

(FYCRS). This system would allow as a one-time depreciation deduction the present value of economic depreciation over the life of the asset. Asset categories would be established by the Treasury and economic depreciation based on trends in used asset prices. By allowing a large upfront deduction, the system is said to remove the inflation tax penalty on investment decisions and at the same time provide tax neutrality as between asset classes. Oh yes, the investment credit would go by the boards.

The assumptions behind the First Year Capital Recovery System, in turn, have been subject to vigorous challenge. The measurement of economic depreciation is said to be far more complicated than implied by Jorgenson-Auerbach. The Treasury would be making basically arbitrary asset classifications which many in the business community would like to see done away with or at least held to a minimum of three to four as under ACRS. Obviously, the tax savings under FYCRS would depend very importantly on the discount rate used to determine present value. It's been pointed out that the assumption of a 6% discount rate, used by Jorgenson-Auerbach as the average real after-tax return, could result in a slower pace of capital recovery than under the present system for many machinery and equipment assets. The Institute for Research on the Economics of Taxation claims that under the present system there is an inherent bias against long-lived assets, and this would be perpetuated by FYCRS. Further, according to the Institute, the practical effect of ACRS would be to introduce a system close to expensing at least in the equipment end. Thus, it should tend to narrow the disparities between tax treatment of various asset classifications even if it does favor the capital intensive industries. And because of deeply embedded inflation, the aforementioned effective rate calculations are not relevant anyway.

Confronted with these challenges, particularly with respect to the speed of capital recovery under their initial proposal, Professors Jorgenson and Auerbach then proposed a corollary to FYCRS under which a variable investment credit would be offered so that the combination of the first year tax deduction and investment credit would have the same value as but not exceed expensing. This proposal would accelerate capital recovery for most equipment assets.

Congress has been exposed to the FYCRS for some time. It has been put in legislative form (H.R. 3443 and H.R. 3500) sponsored by several House Democrats. But while appealing to academicians interested in a theoretically refined and neutral depreciation reform, it hasn't exactly caught fire in Congress. The concept is quite difficult to get across. It's not surprising then that the Ways and Means Democrats, in searching for an alternative to the Reagan ACRS, took their cue from Jorgenson-Auerbach but then made the logical jump to simple expensing of equipment, phased-in and then sweetened considerably by the proposed corporate rate reduction, lowering the corporate rate down to 34% by 1987. Expensing, of course, would mean a zero effective rate of tax, providing the ultimate in neutrality and presumably simplicity as well. This package is now part of the draft Ways and Means tax bill. Although the investment credit would be repealed, the proposal would offer a significant depreciation reform and tax reductions benefiting both capital and labor intensive industries. Over the long term, it's said to yield just about the same tax savings for business as the Reagan proposal.

#### Subsidizing or Removing Tax Obstacles?

Political factors obviously are looming larger than dry economics in fashioning the tax bill at this stage. Some things, however, should be kept in mind in considering the "subsidy" issue as it might apply to any capital recovery program.

(1) As long as we have had the investment credit, there has been at least the potential for a negative tax rate as applied to a particular investment or group of investments. In the mid-1960s, for example, it could be argued that the combination of the then 7% investment credit, guideline depreciation, and a basically flat inflation rate produced a negative tax rate for some equipment investment.

(2) The discount rate employed is very important. In estimating the "subsidy" element of ACRS, Jorgenson-Auerbach applied the yield of one-year government securities on the theory that depreciation deductions are an "obligation" of the U.S. Government. It's highly unlikely that any business firm would use such a calculation in its actual investment planning. If you figure a discount rate based on the real after-tax return plus an allowance for expected future inflation, you get a considerably higher discount rate and lower present value. According to the Institute for Research on the Economics of Taxation calculations, the present value of equipment investment under ACRS would average only "slightly" more than immediate expensing using a discount rate of 6% plus any of the inflation rates prevailing since 1960.

(3) Negative tax rates under ACRS may apply theoretically to selected investments, but in the marketplace firms must operate with a mix of assets regardless of tax advantage that might accrue to one class or another. Particularly when structures are included, the likelihood of a negative effective rate on the overall capital investment of any given manufacturing enterprise is much less likely even if Congress were to accept the more generous treatment of owner-occupied structures (ten years with accelerated methods) under the original ACRS proposal. Furthermore, it's questionable that a negative effective rate in this sense can be equated with an actual public subsidy unless the investment credit were made refundable or carried back so far as to be refundable in fact. For a net subsidy to occur, the whole business operation must be considered, not just its capital investment. Profitable firms would continue to pay corporate income taxes no matter how generous the combination of depreciation and investment tax credit. Nonprofitable firms would pay no taxes but would not get subsidies on their overall operations except to the extent it could be argued that excess investment credits can be marketed in mergers, acquisitions, and/or leasing arrangements. It goes back really to how you look at the investment credit. If the credit is considered a "tax expenditure" to prod firms to make investments they otherwise would not, it's easy to jump to the conclusion that depreciation acceleration and liberalization of the investment credit under ACRS is a form of public subsidy. But if you look at the investment credit as a selective rate reduction, which was instituted in the early 1960s in lieu of more generous corporate rate reduction, the subsidy issue tends to fade in the background.

(4) It's true, of course, that if the Reagan economic program is successful in bringing inflation down to the low single digits by the mid-1980s, the real value of ACRS tax savings would be proportionally greater than if inflation stays in the double-digit range. This assumes the program is enacted in roughly the same form as proposed now and the basic classifications (15-10-5-3) do not change. This increases the possibility of at least theoretically negative tax rates on equipment investment. Against this possibility must be stacked the long-term potential gains in productivity in the capital intensive sectors and the more competitive thrust to the economy that ACRS is designed to provide. The proponents of ACRS probably would admit that such depreciation reform could result in treatment more generous than expensing for some investment. They would say that's not necessarily commendable but not something to weep too loudly about either.

Except for parts of the small business community, business representatives have been reluctant to embrace the Ways and Means alternative to reduce business taxes. There are concerns that the promised future corporate rate reductions may not materialize; that the phase-in of expensing doesn't give enough current benefit; and that the phase-out of the investment credit could involve complicated transition rules and disrupt investment planning. In general, the business community still seems to look on the ACRS as a surer bet. The proposal has been around for over two years now, tested in the Congress and ready for implementation. Faster capital recovery, in this view, is the first priority.

Still, it is somewhat astounding to see under active consideration a proposal that would expense business equipment investment--an objective that, regardless of the treatment of the investment credit, was considered inconceivable only a few years ago. Now it is not only conceivable but being coupled with a program to make very significant cuts in corporate rates as well. It is not exaggerating really to say that whichever direction business tax policy takes much of the battle for significant reduction of tax obstacles to capital formation has already been won.

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#### SUBSIDY, INCENTIVE, AND THE EARNED INCOME CREDIT

One of the other main criticisms of the Reagan tax program is that it doesn't provide much dollar benefit for those below the \$15,000 income level. Faced with rising social security taxes and the inflation tax penalty, many workers, particularly those in the \$10,000-and-over range, would get no tax benefit from the Administration's rate reduction proposals in 1982 and only modest relief in 1983-84.

The Administration's rejoinder is that by its nature an across-the-board, even percentage rate cut can't do much for those who have little or no income tax liability. Its principle priority is to encourage savings and work incentives, and, accordingly, the best approach is marginal rate cuts reducing the burden proportionally. It concedes that the program will not have a significant dollar impact on the low-income groups but maintains that most of the major tax legislation of the late 1960s and 1970s was redistributive toward the low end, and now it's time for a change.

The argument goes beyond income tax policy. Critics claim that one effect of the Administration's budget-cutting moves in the social welfare area will be to raise the overall marginal "tax rate" on take-home pay for the working poor when the value of food stamps and other public assistance benefits are cut back more as work income rises. In this view, there will be less incentive for low-income workers to move ahead when they will receive less of the combination of after-tax earnings and benefits, at least at the margin. The marginal "tax rate" in these cases is said to be potentially as high as 95%.

In the tax-writing committees, the issue comes down primarily to the earned income credit. Chairman Rostenkowski of the Ways and Means Committee has come out in favor of a "modest" increase in the credit, and some other Democrats would like to see a substantial raise as a means of spreading more tax relief downward. The earned income credit, initiated in the Tax Reduction Act of 1975, was designed as a work incentive and as an offset to the social security tax burden on low-income workers. It was liberalized and made permanent by the Revenue Act

of 1978. It now provides a 10% refundable credit on earned income up to \$5,000, which is phased out as earnings increase over \$6,000. The benefit is phased out completely at \$10,000, and the credit is restricted to families or households with dependent children.

The earned income credit is the only significant refundable credit in the Tax Code to date. In fact, of the 5.2 million direct beneficiaries of the credit in 1978, only 18% had any income tax liability after taking the credit. This welfare aspect has caused some concern, of course, among those who believe the Tax Code is no place for public subsidies, whether corporate or individual. Ironically, it roused more concern, initially at least, because many families eligible for the credit were not aware of it or were not claiming it because they did not file income tax returns. The government was accused of not aggressively marketing the availability of the earned income credit to the target population. Presumably, under a direct grant program it would have leapt at the opportunity. In any event, the 1978 legislation contained several changes making the credit easier to obtain, including automatic refunds and advance payments to workers.

As for meeting its objectives, the earned income credit certainly does make up for social security taxes for the low end of the work scale. Up to about \$7,000 of family income, an individual employee's "contribution" to social security would be completely offset by the credit. For those earning less than \$5,000, the credit would offset most of the employer contribution as well, if you buy the theory that it's the employee who really pays both shares. This pattern will hold for awhile anyway as the social security tax rate is scheduled to rise only modestly from its present 6.65% to 7.15% in the late 1980s. But as inflation works its way through the wage structure, fewer workers will get even partial protection unless the credit terms are changed. Even now the vast bulk of the work force is not affected at all.

To what extent the credit has served as a work incentive is more debatable. Being restricted to families or households with dependent children cuts out most of the elderly poor and all singles. Probably it has encouraged some family members to take part-time or low-income jobs, sometimes in lieu of public assistance. But it's not likely to have produced many pertinent additions to the workforce. The credit has its own notch problem--just as all means-tested welfare programs. As family income rises over \$8,000, the marginal tax rate on take-home pay jumps. There is no easy solution to the notch problem within the framework of welfare programs. It's theoretically possible, of course, to stretch the phase-out of benefits over much larger income increments so that the marginal tax rate cuts in much more gradually. But then you face the distressing specter of millions of middle-income families receiving at least limited subsidies, which is a doubtful tradeoff for an uncertain work incentive.

It should be recalled that the same notch problem was one of the primary reasons for the failure of the Nixon Administration's Family Assistance Plan (FAP) to win congressional approval back in the late 1960s. The plan--a limited version of the guaranteed annual income--was not coordinated with other welfare programs. After it had been out in the open for awhile, analyses showed that potential beneficiaries, depending on their income levels and circumstances, could pyramid welfare payments well above the legislative intent but then face extremely high marginal tax rates on earned income thereafter.

Any expansion of the earned income credit now must take into account the same basic obstacle.

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