The Tax Treatment of Capital Assets and Its Effect on Growth: Expensing, Depreciation, and the Concept of Cost Recovery in the Tax System

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Congress is debating reforms of the corporate and individual income taxes. One expressed goal is to promote economic growth while lowering the deficit. Growth is key. Without it, employment and incomes will suffer, and the hoped-for tax revenue will not appear. Proper tax treatment of the cost of plant, equipment, and buildings is an important prerequisite for a pro-growth tax system.

How capital assets are accounted for in the tax code dramatically affects what is defined as taxable income and, thereby, directly influences the cost of capital. The higher the cost, the less capital is formed, and the slower the economy will grow. The lower the cost, the bigger the economy will be, and with it the number of jobs and the level of wages. Getting cost recovery right is immensely important for the well-being of the population. Economic growth, not budgetary convenience, should be the determining factor in crafting cost recovery in tax reform.

Costs must be subtracted to get profit. Tax deductions for costs should not be eliminated or watered down for the sake of base broadening. Doing so would (further) overstate income and raise the effective tax rate, counteracting the statutory rate cut supposedly being funded by the base change.

In business school, students are taught to ignore depreciation and to evaluate projects based on discounted cash flow (including expensing of all outlays). Stock analysts are trained to do the same when evaluating a company. This is in line with basic concepts such as the opportunity cost of an investment and the time value of money.

Accountants prefer straight line depreciation, which seeks to match outlays to receipts over the life of the asset. This avoids swings in annual income when big investments are made, and tells a simpler story to shareholders. But it hides the cash flow, and, while easier to follow, distorts the picture. Some businesses find it makes a rate cut look better than expensing because the rate cut shows up on the bottome line, while the faster depreciation is offset by an artificial "deferred tax liability".

Tax collectors prefer long asset lives to front-load taxes. Tax theorists believe in "economic depreciation" (the decline in value of an asset over time) as the ideal measure of depreciation. This is in line with the Haig-Simons idea that income equals change in net worth in a year. That idea was based on the concept of over-taxing capital to redistribute income. Economic depreciation taxes the time value of money, and results in a uniform double taxation of capital relative to consumption. It is also unmeasurable, as assets lose value differently in different uses. Economic depreciation is part of the bias in the income tax. The tax community talks of making this bias more uniform as a great achievement of the 1986 Tax Reform Act, and they would like to go further. But fixing the income tax by making this bias more uniform, by ending accelerated depreciation for equipment so as not to advantage it so much compared to structures, will not generate growth.

Expensing remains a key component of any neutral tax base and any pro-growth tax reform.