Some Ignored Costs of Bonus Depreciation

By Gene Steuerle

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As part of the recent stimulus bill, Congress and President Bush decided to try to grant businesses bonus depreciation allowances for new purchases of equipment. For each $100 spent in 2008 on equipment expected to last at least five years, businesses would be able to deduct the vast majority of costs in the first year — $600, versus $240 under the old law. At a 35 percent corporate tax rate, for instance, corporations can get checks from the IRS for $210 instead of $84 in the first year for each $1,000 invested. There is one catch: They must have $210 of taxes already due to get $210 back, or $600 of profit against which to take a $600 deduction. Otherwise they will have to delay taking the deduction — which is the world they were already in.

This article is not about whether bonus depreciation might temporarily increase investment. Instead it focuses on three longer-term negative effects that are largely ignored — the difficulty of timing when the incentive ends, the new incentive for businesses to delay their future investments in anticipation of the next round of bonus depreciation, and the anticompetitive effects of this method on new business. (See also “Can Policymakers Time the Ending of Macroeconomic Incentives?” parts 1 through 3, Tax Notes, April 1, April 15, and April 29, 2002, and Martin Sullivan, “Beyond the Conventional Wisdom: Rate Cuts Beat Expensing,” January 28, 2008.1)

The Timing

The classic case for providing fast depreciation for new assets is well established. It lowers the cost of capital or the effective tax rate on new investment, thereby inducing additional investment, and it provides additional cash flow. What better time is there to induce investment than when it is low?

Think again. If you believe it is hard to time when to send out checks to citizens, bonus depreciation has the problem in spades. The complication comes about largely on the back end. Individuals get their money, then they don’t get it. But with bonus depreciation, the firm getting $210 today instead of $84 — that is, $126 more in 2008 — then owes $126 back in future years (although without interest).

The Joint Committee on Taxation demonstrated this effect in its revenue tables. With individuals, there is a negative cash flow in fiscal 2008 and fiscal 2009 of $116.7 billion, but zero effect in the years thereafter. (Some effects carry over to the 2009 fiscal year, which starts in October 2008.) Bonus depreciation, on the other hand, is expected to result in a positive cash flow to businesses of $49.5 billion in fiscal 2008 and 2009, but a negative cash flow of $27.1 billion in the succeeding three years alone.

The stimulus will end arbitrarily at the end of 2008, one reason the Congressional Budget Office predicts slower growth in 2009 and faster growth in 2008 because of the stimulus.

Business Incentive to Delay Future Investment

Through enactments in 2002, 2003, and 2008, we’ve now provided bonus depreciation for property acquired in late 2001, 2002, 2003, 2004, and 2008. In effect, over the first eight years of this decade, Congress has announced that bonus depreciation is more likely to be available than not.

If bonus depreciation is a strong incentive for business, and you’re a business leader, how would you start planning your investments? You might be sure to move up some of your anticipated 2009 investments to 2008, then in 2009 sit back and wait for the next round of bonus depreciation. How does Congress know now that 2009 is a year in which it wants to discourage investment? If bonus depreciation is going to be around this frequently, businesses should begin planning around its availability.

As one consequence, they might contribute to an undesired slowdown in the years between bonus depreciation offerings.

Anticompetitive Effects

What types of businesses can actually use this type of allowance? Those that already have a lot of profits. Almost no investment by itself will return a cash flow of $600 in the first year for each $1,000 invested. Many businesses — both those that are new and those that are going through rough times — can’t take advantage of such a generous tax break.

Interestingly, it is during an economic slowdown or recession that businesses hardest hit will be the ones put at a further disadvantage: They will be relatively less likely than other firms to be able to take advantage of extraordinary write-offs. That is, their relative cost of capital will actually be raised. Bonus depreciation, however, favors the successful perfume manufacturer over the less successful home builder. And suppose that, like with most slowdowns, there are widespread differences
across regions and cities. For instance, among the hardest-hit areas in 2008 are those that suffer from the housing market slump. Concentrating business incentives only on the most profitable firms likely puts a disproportionate share of the money in those regions having the least problems.

Worry about putting new business at a competitive disadvantage was a significant factor in Treasury’s 1984 stance against accelerated depreciation in its study leading to the Tax Reform Act of 1986. Here is what it said then:

Accelerated cost recovery allowances are more likely to be used fully by established, profitable businesses than by new companies with substantial start-up costs or by loss companies without net income. The potential unavailability of [these] benefits may in turn lead to tax motivated acquisitions or combinations that permit the benefits to be used fully in the year incurred. [Tax Reform for Fairness, Simplicity and Economic Growth, Vol. II, p. 156.]

As economic coordinator of that project, I helped write that report. It is new business and the threat of new business that keeps existing businesses on their toes and keeps them lean and competitive. They are temporarily forgotten in this type of bill. Even if one wants temporary investment incentives, bonus depreciation is an anti-competitive way to provide them.