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Small Business Expensing Allowance Under the Jobs and Growth Tax Relief Reconciliation Act of 2003: Changes and Likely Economic Effects

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Gary Guenther
Analyst in Business Taxation and Finance
Government and Finance Division

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Summary

Under current federal tax law, business taxpayers are allowed to deduct (or expense) up to \$100,000 of the total cost of qualified assets in a single tax year. In the absence of such a provision, firms would have to recover the cost over a longer period under allowable depreciation schedules. The accelerated write-off under what is known as the expensing allowance represents a significant tax benefit because it reduces the tax burden on the returns to investment in qualified assets. Certain rules governing the use of the allowance effectively confine its benefits to relatively small firms.

In early January 2003, President Bush publicly endorsed a package of measures to stimulate the economy which included a substantial expansion of the expensing allowance. On May 9, 2003, the House passed H.R. 2, which would have raised the allowance from \$25,000 to \$100,000 and the phase-out threshold from \$200,000 to \$400,000 in 2003 through 2007, indexed both amounts for inflation, and added packaged software to the depreciable assets eligible for expensing, among other things. The amended version of H.R. 2 passed by the Senate on May 15, 2003 would have made the same changes in the allowance. Under a conference agreement passed by both houses on May 23, 2003 and signed into law by President Bush on May 28, 2003 (the Jobs and Growth Tax Relief Reconciliation Act of 2003 or JGTRRA, P.L. 108-26), the allowance is set at \$100,000 and the phase-out threshold at \$400,000 in 2003 through 2005; both amounts are indexed for inflation in 2004 and 2005; and packaged software qualifies for expensing in 2003 through 2005.

Proponents of expanding the allowance in the manner of JGTRRA have maintained that such a step should impart a significant boost to small business investment. To substantiate this expectation, they note that the expansion reduces the user cost of capital for a broader pool of possible small business investment projects, is likely to increase the cash flow of many small firms in the next three years, is temporary, increases the number of firms able to benefit from expensing, and adds packaged software to the array of depreciable assets eligible for expensing.

But some analysts are convinced that the temporary expansion will have much smaller impact on small business investment. In their view, the expansion is unlikely to make much of a difference in a domestic business investment climate marked by excess capacity and widespread pessimism among business executives over future growth in sales and profits. In addition, they say that most small business owners are unlikely to speed up the timing of planned future investments to take advantage of the temporary expansion because they believe that Congress will extend the expansion before it expires. The sceptics also note that there is a lack of empirical evidence that investment tax incentives spur significant increases in business investment in the short run.

This report will not be updated.

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Small Business Expensing Allowance Under the Jobs and Growth Tax Relief Reconciliation Act of 2003: Changes and Likely Economic Effects

Under the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA: H.R. 2, P.L.108-27), firms may deduct (or expense) up to \$100,000 of the cost of qualified depreciable assets placed in service in a single tax year between 2003 and 2005. Before the enactment of JGTRRA, the maximum allowance was \$25,000 in 2003 and thereafter. In the absence of such a provision, firms would have to recover this cost over longer periods through allowable depreciation deductions. The expensing allowance represents a significant tax subsidy for business investment because it has the potential to eliminate or greatly reduce the tax burden on the returns to investment in qualified assets. Certain rules governing the use of the allowance effectively confine its benefits to relatively small firms.

This report examines the likely short-term economic effects of the large but temporary expansion of the expensing allowance enacted as part of JGTRRA. It begins with an explanation of how the allowance works and a brief description of its legislative history. The report concludes with a discussion of the allowance's likely short-term economic effects.

Current Expensing Allowance

Under section 179 of the Internal Revenue Code (IRC), business taxpayers purchasing qualified property (or assets) may deduct (or expense) some or all of its cost (depending on the amount) in the year in which it is placed into service, provided certain conditions are met. The alternative to expensing is to recover the cost over longer periods through depreciation deductions intended to approximate the rate at which these assets lose value. Between 2003 and 2005, the maximum expensing allowance is \$100,000 for firms operating outside empowerment zones. For firms conducting all their trade or business within these zones, the maximum allowance in that period is the lesser of \$35,000 or the cost of qualified property. In 2006, the maximum allowance for non-empowerment zone firms falls to \$25,000, its level before the enactment of JGTRRA.

Qualified property is defined as certain new and used depreciable assets – as specified in IRC section 1245(a)(3) – acquired for use in the active conduct of a trade or business. With a few exceptions, it consists of business machines and equipment used in connection with manufacturing or production, extraction, transportation, communications, electricity, gas, water, and sewage disposal. Transportation

equipment with a gross, unloaded weight of more than 6,000 pounds may be expensed, but heating and air conditioning units are not eligible for the allowance. Most buildings and their structural components are ineligible for the allowance, but research and bulk storage facilities related to these commercial activities do qualify. In addition, under JGTRRA, purchases of off-the-shelf, packaged computer software may be expensed from 2003 through 2005.

Business taxpayers may also claim a temporary 30% first-year depreciation deduction under the Job Creation and Worker Assistance Act of 2002 (P.L. 107-147) for new (but not used) property depreciable under the modified accelerated cost recovery system (MACRS) and having a recovery period of less than 20 years. Under the act, qualified property acquired between September 11, 2001 and September 11, 2004 and placed in service before January 1, 2005 is eligible for the bonus depreciation, as well as regular depreciation deductions and the expensing allowance under IRC section 179. JGTRRA extends the deadline for acquiring qualified property to December 31, 2004. For property eligible for both the expensing and the bonus depreciation allowances, a firm must claim its depreciation deductions in the following order: expensing allowance, the bonus depreciation on the remaining basis in the property (if any), and the MACRS depreciation on the remaining basis (if any). JGTRRA adds a separate 50% first-year depreciation deduction for purchases of the same property between May 6, 2003 and January 1, 2005; the property must be placed in service by January 1, 2006. Business taxpayers may claim either the 30% or 50% first-year depreciation allowance, but not both.

The amount that a business taxpayer may deduct in a single tax year under section 179 is subject to two important limitations: a dollar limitation and a taxable-income limitation. Under the dollar limitation, the maximum expensing allowance is reduced, dollar for dollar, by the amount by which the cost of all qualified property placed in service during the year exceeds \$400,000 (an amount that sometimes is referred to as the phase-out threshold) in 2003 through 2005. This limit applies to either the entire cost or a portion of the cost of one or more qualified assets. In 2006 and thereafter, the limit falls back to its pre-JGTRRA level of \$200,000. As a result, none of the cost of qualified property placed in service in a single year from 2003 through 2005 may be expensed if this cost reaches \$500,000 or more, since the cap on the allowance is \$100,000 in that period. Under the taxable-income limitation, the expensing allowance cannot exceed the taxable income a taxpayer earns from the active conduct of a trade or business. No deduction disallowed under the dollar limitation may be carried forward, but deductions disallowed under the income limitation may be carried forward.

Under JGTRRA, both the maximum expensing allowance and the phase-out threshold are indexed for inflation in 2004 and 2005.

Legislative History of the Expensing Allowance

The expensing allowance under IRC section 179 originated as an added first-year depreciation deduction enacted as part of the Small Business Tax Revision Act of 1958 (P.L. 85-866). It was intended to reduce the tax burden on small business owners, stimulate small business investment, and simplify their tax accounting. The deduction was equal to \$2,000 (\$4,000 in the case of a married couple filing a joint return) of the cost of new and used business machines and equipment with a recovery period for tax purposes of six years or more.

This allowance remained in force until the enactment of the Economic Recovery Tax Act of 1981 (ERTA, P.L. 97-34), which replaced the additional deduction with a maximum expensing allowance of \$5,000 and put in place a timetable for gradually increasing the allowance to \$10,000 by 1986. Despite the increase in the maximum deduction under ERTA, few firms took advantage of it because of a rule denying the investment tax credit established by ERTA to the portion of an asset's cost that was expensed.

Faced with large and growing federal budget deficits, Congress passed the Deficit Reduction Act of 1984 (P.L. 98-369), which, among other things, postponed the scheduled increase in the allowance to \$10,000 from 1986 until 1990. Claims for the allowance rose markedly following the repeal of the investment tax credit by the Tax Reform Act of 1986.

The maximum allowance remained at \$10,000 from 1990 until the enactment of the Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66), which increased it to \$17,500 as of January 1, 1993. With the passage of the Small Business Job Protection Act of 1996 (P.L. 104-188), the allowance embarked on a path of staggered ascents. Under the Act, the maximum allowance rose to \$18,000 in 1997, \$18,500 in 1998, \$19,000 in 1999, \$20,000 in 2000, \$24,000 in 2001 and 2002, and \$25,000 in 2003 and thereafter.

Under the Jobs and Growth Tax Relief Reconciliation Act of 2003 (P.L. 108-27), the allowance jumps to \$100,000 in 2003, 2004, and 2005, before dropping back to \$25,000 in 2006 and thereafter. The Act also raises the phase-out threshold to \$400,000 in the same period, indexes both amounts for inflation in 2004 and 2005, and makes purchases of off-the-shelf software eligible for expensing in 2003 through 2005.

Main Economic Effects of the Expensing Allowance

Although many small business owners may view the expensing allowance chiefly as a vehicle for delivering what they regard as welcome tax relief, its economic effects go beyond the impact on the tax liabilities of small business owners. The allowance has implications for the allocation of business fixed investment, the distribution of the federal tax burden among income groups, and the cost of tax administration. These effects loosely correspond to the three classic

criteria for evaluating tax systems: efficiency, equity, and simplicity. Each is examined below.

Efficiency Effects

One important economic effect of the expensing allowance is that it affects (to an unknown extent) the allocation of resources in the U.S. economy by encouraging firms to invest in qualified assets at the expense of other assets. According to economists who study the forces driving business investment, the allowance does so in two ways. One is by reducing the user cost of capital for investment in these assets relative to other assets. A second channel through which the allowance encourages investment in qualified assets is by increasing the cash flow or internal funds of firms whose cost of internal funds is significantly lower than the cost of external funds. Owing to the phase-out threshold for the allowance, most of the firms taking advantage of it are likely to be relatively small in asset size.¹

The user cost of capital is a key factor in a firm's decision to invest as it embraces both the opportunity cost of forgoing other investments and the direct costs of an investment such as depreciation and income taxes. In essence, the user cost of capital specifies the after-tax rate of return an investment project must achieve in order to be profitable, and thus worth undertaking. In general, the higher the user cost of capital, the lower the number of profitable projects that might be undertaken, and the lower a firm's desired capital stock. When a change in tax policy reduces the user cost of capital, the reduction may increase the amount of capital that firms wish to hold, boosting business fixed investment in the short run.

How does expensing reduce the user cost of capital for favored assets? Basically, expensing is the most accelerated form of depreciation in that the entire cost of an asset is written off in its first year of use, regardless of the asset's actual economic or useful life. Expensing can be viewed as equivalent to the U.S. Treasury providing the investor with a tax rebate equal to the tax rate multiplied by the cost of the asset. Depreciation allowances effectively reduce the user cost of capital by decreasing the pre-tax return a firm must earn in order to attain a given after-tax return.² This cost reduction increases as the period over which the asset's cost is

¹ This point is difficult to substantiate because of a paucity of reliable data on capital spending by firm size. One way to circumvent this difficulty is to use depreciation allowances as a proxy for capital spending. Such an assumption is reasonable because of the strong correlation over time between industry asset size, capital outlays, and depreciation deductions for tax purposes. According to IRS data, in 1999, the average depreciation deduction for corporations with assets of \$250 million and over was \$4.1 million; by comparison, the average depreciation deduction for corporations with less than \$250 million in assets came to \$32.5 thousand, or 0.8% of the average for the larger corporations.

² The user cost of capital is the real rate of return an investment project must earn to be profitable. In theory, a firm will undertake an investment provided the after-tax rate of return exceeds or at least equals the user cost of capital. Rosen has expressed this cost in terms of a simple equation. Let C stand for the user cost of capital, a for the purchase price of an asset, r for the after-tax rate of return, d for the economic rate of depreciation, t for the corporate tax rate, z for the present value of depreciation deductions flowing from a \$1

(continued...)

written off contracts, and as the proportion of the cost that is written off in the beginning of that period expands. Expensing yields the largest possible reduction in the user cost of capital attributable to depreciation. The reduction can be considerable.³

How beneficial to firms is expensing? One way to illustrate the tax benefits from expensing is to assess how it affects the marginal effective tax rate on the returns to an investment. Expensing is equivalent to taxing the stream of income earned by an asset over its lifetime at a marginal effective rate of zero.⁴ In other words, under expensing, the after-tax rate of return on an investment becomes equal to its before-tax rate of return.⁵ This occurs because expensing reduces after-tax returns and costs by the same factor: namely, the investor's marginal tax rate (whether the investor is a corporation or an individual). If the tax rate is 35% and the cost of the investment is expensed, then the government bears 35% of the cost of the investment. By contrast, if the cost of the same investment were recovered at its rate of economic depreciation and no tax preferences were available, then the returns would be taxed at existing statutory rates. As a result of JGTRRA, the maximum federal corporate and individual income tax rate is 35% in 2003.

Some maintain that expensing can also stimulate business investment by augmenting the cash flow of firms that rely heavily on internal funds or retained earnings to finance new investment. Cash flow can be thought of as the difference between a firm's revenue and payments for inputs, including capital equipment. All other things being equal, expensing increases a firm's cash flow more than other allowable depreciation methods. One reason why a firm's capacity to invest could

² (...continued)

investment, and k for the investment tax credit rate. Then $C = a \times [(r+d) \times (1-(t \times z)-k)] / (1-t)$. Under expensing, z is equal to one. By plugging assumed values for each variable into the equation, it becomes clear that C increases as z gets smaller. Thus, of all possible methods of depreciation, expensing yields the lowest user cost of capital. For more details, see Harvey S. Rosen, *Public Finance*, 6th ed (New York: McGraw-Hill/Irwin, 2002), pp. 407-409.

³ In a 1995 study, Douglas Holtz-Eakin compared the cost of capital for an investment under two scenarios for cost recovery. In one, the corporation making the investment used expensing to recover the cost of the investment; and in the other, the cost was recovered under the schedules and methods permitted by the modified accelerated cost recovery system. He further assumed that the interest rate was 9%, the inflation rate 3%, and the rate of economic depreciation for the asset acquired through the investment 13.3%. Not only did expensing substantially reduce the cost of capital, its benefit was proportional to the firm's marginal tax rate. Specifically, Holtz-Eakin found that at a tax rate of 15%, expensing lowered the cost of capital by 11%; at a tax rate of 25%, the reduction was 19%; and at a tax rate of 35%, the cost of capital was 28% lower. See Douglas Holtz-Eakin, "Should Small Businesses Be Tax-Favored?," *National Tax Journal*, Sept. 1995, p. 389.

⁴ For a discussion of the economic logic behind such an outcome, see Jane G. Gravelle, "Effects of the 1981 Depreciation Revisions on the Taxation of Income from Business Capital," *National Tax Journal*, March 1982, p. 5.

⁵ For an example, see Joseph J. Cordes, "Expensing," in *The Encyclopedia of Taxation and Tax Policy*, Joseph J. Cordes, Robert D. Ebel, and Jane G. Gravelle, eds. (Washington: Urban Institute Press, 1999), p. 114.

depend critically on its cash flow is that it has limited or no access to debt and equity markets because of insufficient information on the part of lenders or investors. In this case, the cost of internal funds would be lower than the cost of external funds; so most investment would be financed out of the firm's cash flow. Some studies have found a significant positive correlation between changes in a firm's net worth or internal funds and its investment spending.⁶ In addition, this correlation is strongest for firms facing obstacles in raising funds in debt and equity markets because of information problems. But it would be incorrect to construe these findings as conclusive evidence that firms with relatively high cash flows invest more than firms with relatively low or negative cash flows. The links between cash flow and business investment are a topic of further research among economists.

To what extent has the expensing allowance contributed to shifts in the size and composition of the domestic capital stock in the twenty-two or so years it has existed in its present form? No one seems to know, largely because there appear to be no studies analyzing this impact. Nonetheless, considering expensing's impact on the cost of capital and available empirical evidence that investment in assets eligible for the allowance is somewhat sensitive to reductions in its cost of capital⁷, it is reasonable to assume that the allowance has caused domestic investment in qualified assets to be greater than it otherwise would have been. But it is also reasonable to assume that a significant proportion of investment in IRC section 179 property would have taken place without the expensing allowance.⁸ Federal tax return data made available by the Internal Revenue Service (IRS) indicate that the allowance may account for a significant share of business investment in equipment. In 2000, 5.4 million sole proprietorships, partnerships, and corporations claimed the deduction under IRC section 179, and the total cost of IRC section 179 property placed in service came to \$89.1 billion. Between 1997 and 1999, 23% of corporations filing federal tax returns claimed a deduction under section 179; the total value of section 179 deductions claimed by corporations averaged 2% of total corporate deductions for depreciation reported on those tax returns.⁹ In the same period, the total value of section 179 property placed in service averaged 14% of domestic gross investment in equipment, according to data released by the U.S. Commerce Department.

⁶ For a review of the recent literature on this topic, see R. Glenn Hubbard, "Capital Market Imperfections and Investment," *Journal of Economic Literature*, vol. 36, March 1998, pp. 193-225.

⁷ Two studies from the 1990s found that a 1% decline in the user cost of capital was associated with a rise in business equipment spending of 0.25% to 0.66%. See CRS Report RL31134, *Using Business Tax Cuts to Stimulate the Economy*, by Jane G. Gravelle, p. 4.

⁸ There is some anecdotal evidence to support this supposition. At a recent hearing held by the House Small Business Subcommittee on Tax, Finance, and Exports, Leslie Shapiro of the Padgett Business Services Foundation stated that expensing "may be an incentive in making decisions to buy new equipment, but it's not the dominant force." His firm provides tax and accounting services to over 15,000 small business owners. See Heidi Glenn, "Small Business Subcommittee Weighs Bush's Expensing Boost," *Tax Notes*, April 7, 2003, p. 17.

⁹ Data on business claims for the expensing allowance were obtained via e-mail from Nina Shumofsky of the Statistics of Income Division at IRS on March 27, 2003.

When viewed through the lens of economic theory, however, the expensing allowance takes on the appearance of a drain on economic efficiency. Assuming the amount of capital in the economy is fixed in the short run, a tax subsidy like the allowance has the potential to draw capital away from more productive uses. Theory holds that in an economy free of significant market failures and dominated by competitive markets, neutral or uniform taxation of capital income is the tax policy best suited to foster an efficient allocation of resources. The expensing allowance, however, encourages investment in specific assets by firms of a certain size. In theory, such a subsidy can prevent capital from migrating to its most economically valuable applications. Moreover, the allowance may give eligible firms an incentive to restrain their growth. This unintended incentive flows from the rise in marginal effective tax rates on the returns to investment in the allowance's phase-out range (presently, \$400,000 to \$500,000).¹⁰ Douglas Holtz-Eakin has described this perverse effect as a "tax on growth by small firms."¹¹

Equity Effects

Another important economic effect of the expensing allowance is its impact on the distribution of the federal tax burden among income groups. The current federal income tax system is built on the principle of progressivity. Under such a principle, an individual's tax burden depends on his or her taxable income, and those with higher taxable incomes bear larger shares of the overall burden. How does the allowance affect the progressivity of the federal income tax?

The allowance reduces the tax burden on a portion of capital income: namely, the returns on investment earned by firms able to claim the allowance. Most studies of the taxation of capital income leave the impression that any such tax is likely to be borne by all owners of capital in the short run, given reasonable and defensible behavioral assumptions. Research shows that capital income is heavily concentrated in upper-income groups: in a 1998 report, the Congressional Budget Office estimated that in 1999, 40% of capital income would be received by the top 1% of households ranked by cash income, 60% would be received by the top 5%, and 67% would be received by the top 10%.¹² Available data indicate that the typical small business owner has a relatively high income and net worth.¹³ These findings suggest

¹⁰ Jane Gravelle estimated that, assuming a corporate tax rate of 28% and a rate of inflation of 3%, in the phase-out range for the expensing allowance the marginal effective tax rate on the returns to favored assets is 36%, compared to a rate of 0% for each dollar of investment up to \$200,000 and a rate of 22% for all corporations.

¹¹ U.S. Congress, Senate Committee on Finance, *Small Business Tax Incentives*, hearings on S. 105, S. 161, S. 628, S. 692, S. 867, and H.R. 1215, 104th Cong., 1st sess., June 7, 1995 (Washington: GPO, 1995), pp. 11-12.

¹² U.S. Congressional Budget Office, *Estimates of Federal Tax Liabilities for Individuals and Families by Income Category and Family Type for 1995 and 1999*, memorandum (Washington: May 1998), p. 30.

¹³ Surprisingly few studies examine the incomes and wealth of small business owners. A recent study, funded in part by the Small Business Administration (SBA), compared the mean and median income and wealth of families with and without small business owners

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(but do not prove) that relatively high-income households capture most of the tax benefits generated by the allowance, and that the allowance lessens (to an unknown but probably minor extent) the progressivity of the federal income tax system.

Tax Administration

Another notable economic effect of the expensing allowance is that it simplifies tax accounting for firms able to claim it. Less time and paperwork are involved in writing off the entire cost of a depreciable asset in its first year of use than in recovering the cost over a longer period. Tax simplification has long been an important policy objective for most small business owners, largely because of the relatively high costs they must bear in complying with federal tax laws. According to a 2001 study prepared for the Office of Advocacy of the Small Business Administration, in 2000, the cost per employee for tax compliance was an estimated \$665 for all firms, \$1,202 for firms with fewer than 20 employees, \$625 for firms with 20 to 499 employees, and \$562 for firms with 500 or more employees.¹⁴

Proposals in the 108th Congress to Expand the Expensing Allowance

Recent actions by the 108th Congress indicate there is bipartisan support for bolstering the expensing allowance in order to both stimulate the economy and aid small business owners. In early January 2003, President Bush endorsed a package of measures designed in part to accelerate the pace of short-term economic growth. One of the measures called for a permanent expansion of the expensing allowance. Specifically, the President proposed that, effective January 1, 2003, the allowance be increased from \$25,000 to \$75,000, the phase-out threshold be raised from \$200,000 to \$325,000, and purchases of off-the-shelf computer software qualify for the allowance; he also recommended that the allowance and threshold be indexed for inflation as of January 1, 2004.

Since the start of the 108th Congress, at least 11 bills to enhance the allowance have been introduced.¹⁵ Two played critical roles in the enactment of JGTRRA:

¹³ (...continued)

from 1989 to 1998, using data on consumer finances obtained from the Federal Reserve Board. It found that in 1998, households with no business owners had a mean income of \$43,999; by contrast, households with small business owners had a mean income that was \$101,563, or 2.3 times greater. Similarly, in 1998, the mean net worth of households without business owners was \$171,904, or about one-fifth the mean net worth of households with small business owners, which came to \$832,514. See George W. Haynes, *Wealth and Income: How Did Small Businesses Fare from 1989 to 1998?*, May 16, 2001, pp. 24 and 27, available from the SBA's Office of Advocacy website: www.sba.gov/advo.

¹⁴ W. Mark Crain and Thomas D. Hopkins, *The Impact of Regulatory Costs on Small Firms* (Washington: Office of Advocacy, Small Business Administration, 2001), p. 32.

¹⁵ The bills are H.R. 2, H.R. 22, H.R. 179, H.R. 224, H.R. 1079, H.R. 1126, S. 2 (identical (continued...))

H.R. 2 and S. 2. H.R. 2, as passed by the House on May 9, 2003, would have raised the expensing allowance to \$100,000 and the phase-out threshold to \$400,000 and index both for inflation from 2003 through 2007. It would also have made purchases of off-the-shelf computer software eligible for expensing in the same period. By contrast, S. 2, as reported by the Senate Finance Committee on May 8, 2003, would have implemented the President's proposal in the period from 2003 through 2012. During floor consideration of S. 2, the Senate incorporated the language of S. 1054 into H.R. 2 as an amendment and approved the amended version on May 15, 2003. The Senate amendment would have made the same changes in the expensing allowance as the House-passed version of H.R. 2. Under the conference agreement for H.R. 2 (H.Rept. 108-26) approved by the House and Senate on May 23, 2003, the allowance rises to \$100,000 and the phase-out threshold to \$400,000 in 2003 to 2005; off-the-shelf computer software becomes eligible for expensing in 2003 to 2005; and the amounts of the allowance and phase-out threshold are indexed for inflation in 2004 and 2005. Starting in 2006, the allowance is to return to its status before the enactment of JGTRRA.

Likely Short-Term Economic Effects of the Temporary Expansion of the Expensing Allowance

In the debate preceding the enactment of JGTRRA, those favoring a substantial increase in the IRC section 179 expensing allowance pointed to the potential economic benefits as the primary reason for taking such a step. Two such benefits were paramount, in their view. First, they said that a more generous allowance would generate greater rates of capital formation and employment growth among small firms in the short run by lowering their cost of capital for investment in qualified assets and by increasing their cash flow. Second, they maintained that an enhanced allowance would reduce their compliance burden by simplifying their tax accounting for depreciation. Public comments in support of President Bush's proposal to expand the expensing allowance made by Chad Moutray, the chief economist at the Small Business Administration's Office of Advocacy, and Gregory F. Jenner, the Deputy Assistant Secretary for Tax Policy at the Treasury Department, exemplified this line of reasoning.¹⁵ Such an argument raises the question of how much of new investment and how many new jobs are likely to arise from the large but temporary expansion of the allowance under JGTRRA.

In light of what is known about the main economic effects of the allowance, this much seems clear. First, there are reasons to believe that the temporary expansion

¹⁵ (...continued)

to H.R. 2), S. 106, S. 158 (identical to H.R. 179), S. 414, and S. 513.

¹⁶ See Chad Moutray, "President's Plan Means Jobs and Growth for Small Business," *The Small Business Advocate* (Washington: Small Business Administration, Feb. 2002), p. 5; and statement by Gregory F. Jenner before a hearing of the House Small Business Subcommittee on Tax, Finance, and Exports held on April 3, 2003 and entitled "Small Business Expensing: Increasing Incentives for Small Companies to Grow and Invest in Their Businesses," available from www.nexis.com.

could trigger a significant increase in small business investment in the short run. It reduces the user cost of capital for investment in qualified assets; the reduction is proportional to the share of an asset's cost that is expensed. The expansion also adds computer software to the pool of assets eligible for the allowance for three consecutive years. In addition, it would increase the number of firms able to take advantage of expensing. And by reducing a small business taxpayer's current tax liability relative to what it otherwise would be, the expansion increases the amount of internal funds available for investment (or other purposes, including paying dividends or retiring outstanding debt) by small firms claiming the allowance in the next three years. Finally, because the expansion is temporary, it increases a firm's incentive to invest in qualified assets in the next three years relative to future periods. Rising investment in turn would create some new employment opportunities.

Second, the temporary expansion of the expensing allowance would also lessen to an unknown (but probably minor) extent the progressivity of the federal income tax system by increasing the number of small business owners who benefit from expensing.

And third, expanding the allowance as provided in JGTRRA should also have the benefit of simplifying tax accounting for an increased number of small firms.

Nonetheless, some seriously doubt that the expansion of the expensing allowance will impart as strong a boost to small business investment and employment in the short run as proponents have maintained. They cite several reasons for this scepticism.

First, sceptics note that economic context and timing are critical to the efficacy of fiscal policy as a tool for stimulating the economy. In their view, investment tax incentives like an investment tax credit or expensing are likely to be most effective when an economy is growing, most industries are operating at relatively high rates of capacity utilization, and the vast share of business executives are optimistic about future growth in sales and profits. Yet U.S. business investment and industrial operating rates remain significantly below the levels they reached when the economy was growing robustly in the late 1990s, despite relatively low interest and inflation rates in the past two years and the enactment of a temporary 30% first-year depreciation deduction in 2002.¹⁷ Some argue that the temporary expansion of the

¹⁷ According to figures released by the Commerce Department, real domestic investment in non-residential fixed investment (seasonally adjusted at annual rates) fell steadily from its most recent peak of \$1,340.7 billion (1996 dollars) in the third quarter of 2000 to \$1,178.7 billion in the third quarter of 2002, before rising to \$1,185.3 billion in the fourth quarter of 2002. This investment accounted for 12.5% of real gross domestic product (GDP) in 2002 and was the primary reason that real GDP declined in each of the first three quarters of 2001. And according to figures released by the Federal Reserve Board, the capacity utilization rate for all U.S. industries dropped from 84.2% in the fourth quarter of 1997 to 75.1% in the fourth quarter of 2001 and the first quarter of 2002, before rising to 75.4 percent in the fourth quarter of 2002.

allowance under JGTRRA is likely to exert little stimulus in the current domestic climate for business investment.¹⁸

Second, sceptics contend that it would lead to the creation of fewer jobs than proponents of the expansion of the allowance under JGTRRA have argued. They point out that such a measure would lower the cost of a unit of eligible capital relative to a unit of labor among small firms able to claim the allowance, all other things being equal. According to mainstream economic theory, such a shift in relative costs would give those firms an incentive to substitute capital for labor in their operations, where feasible. Assuming constant levels of output, the net result would be an increase in labor productivity and perhaps profits, but a decline in total employment, among those firms. Many economists attribute the weak rebound in employment from the economic downturn in 2001 largely to robust gains in productivity in recent years.¹⁹

Third, sceptics note that temporary investment incentives typically pack a stronger stimulative punch in periods of sluggish or negative economic growth than permanent ones.²⁰ Although the expansion of the allowance under JGTRRA is temporary in that it will be effective from 2003 to 2005, they argue that its short-term impact on small business investment depends in part on how many business executives expect that Congress will allow the expansion to expire at the end of 2005. Some believe that so many executives and small business owners will come to expect Congress to extend (and perhaps even further increase) the expansion before 2006 that it may induce relatively few firms to move forward planned future investments.

Finally, sceptics say that the existing literature on the efficacy of investment tax incentives offers little empirical support for the belief that the expansion of the allowance under JGTRRA will spur a significant increase in small business investment. They point to recent studies that found a very low response of investment in equipment to declines in the user cost of capital and no correlation between the internal funds of firms and their investment spending.²¹

¹⁸ See William G. Gale, "The President's Tax Proposal: First Impressions," *Tax Notes*, Jan. 13, 2003, p. 269; and Joseph E. Stiglitz, "Bush's Tax Plan – The Dangers," *New York Review of Books*, March 13, 2003, p. 13.

¹⁹ See James C. Cooper and Kathleen Madigan, "Why Cutting Unemployment Will Be One Tough Job," *Business Week*, Dec. 23, 2002, p. 25.

²⁰ Gravelle, *Using Business Tax Cuts to Stimulate the Economy*, pp. 6-7.

²¹ See Robert S. Chirinko, Steven M. Fazzarri, and Andrew P. Meyer, "How Responsive is Business Capital Formation to Its User Cost? An Exploration With Micro Data?," *Journal of Public Economics*, vol. 74, 1999, pp. 53-80; and Jason G. Cummins, Kevin A. Hassett, and Stephen D. Oliner, "Investment Behavior, Observable Expectations, and Internal Funds," working paper, Board of Governors of the Federal Reserve, Sept. 2002, available through [<http://www.federalreserve.gov>].