

The Tax Reform Act: the Expensing of Investment

The Tax Reform Act provides for a new and novel way of depreciating new capital investment: plant, equipment and buildings. For years many economists have advocated ‘expensing’ or the ability to depreciate and deduct the full value of your investment in the year it is put into operation. It is important to understand that purchase of existing assets will still follow a more traditional long term depreciation schedule.

The likely Impact of expensing new investment could be very significant. It will encourage the replacement of older less productive capital with newer capital. This of course will increase the rate of investment for the US economy as a whole, and in traditional macro-economic thinking this stimulates both the short term and long term rate of economic growth. In theory, expanding the capital stock should also boost overall worker productivity (based on capital/labor ratios). And in theory, wages rise with increases in productivity. *But* in the current context expensing raises two concerns.

a). Currently there is huge intellectual debate and much concern in the populous as a whole about automation displacing and replacing workers - rather than helping them. It is surely the case that the new plant and equipment, stimulated by expensing, will involve high levels of automation – employing robots and guided by Artificial Intelligence. This in fact may hurt job creation rather than help it. Those jobs that remain will no doubt be more productive (and as such warrant greater wages), but the impact of displaced workers may help keep a lid on such wage gains.

b). For real estate in particular the expensing of new investment is a huge incentive to build new structures: shopping centers, industrial parks, offices. Currently the property market in each of these sectors is not exactly crying out for more investment. Retail space in particular finds its demand waning as consumers shift to Internet shopping. Industrial space demand has been healthy but it is already in the midst of a building boom. Office demand is experiencing some discomforting concerns around hoteling (here called co-working) which will some believe will economize on the need for more aggregate space. In short, expensing could well generate new building construction precisely when more space is not necessarily warranted by property fundamentals.

Last time something similar occurred was 1982-1986 with the Regan Economic Recovery Tax Act. Here accelerated depreciation was applied to both new and existing assets and it did encourage new investment. In real estate this proved to be particularly troublesome for the apartment sector. It became so overbuilt (construction was 2x today’s worrisome levels) that rents sagged for a decade after.

Expensing should definitely encourage new investment, but the lesson is be careful of what you stimulate with tax policy. It may not always be what is needed and may have unintended consequences down the road.