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How Tax Uncertainty Harms Economic Growth

Agricultural Investment and Section 179

by Tom Giovanetti

At the very last moment at the end of 2014, Congress once again passed a bundle of retroactive tax provisions in an attempt to mitigate the harmful effects of high corporate tax rates and thus stimulate increased investment. And while retroactive, last-minute tax reductions are better than no reductions at all, they won't achieve their desired aim.

If Congress wants to encourage businesses to invest based on tax incentives, Congress must make those policies clear at the beginning of the tax year, not the very end. This paper explains how 2014's tax uncertainty caused economic harm, specifically in the agricultural sector.

What Is Economic Growth?

With a growing population and Americans' general expectation of ever-increasing standards of living, the U.S. economy must grow between 3 and 4 percent above the inflation rate each year just to keep from falling behind. Economic growth means not just economic activity but actually growing the overall size of the economy.

There is broad agreement that the key factor in economic growth is investment; the political disputes tend to be about whether the private sector or government spending is the best source of this investment.

Investment, of course, is not simply spending, but rather spending on inputs that increase productive capacity, such as buildings, equipment, technology and human capital. The goal of investment is to increase productive capacity—in essence, making 2 + 2 = 5. To the degree that businesses small and large throughout the economy make these investments successfully, the economy grows.

Tax Policy and Economic Growth

Tax policy has a clear and direct impact on private sector investment. Because taxes come off businesses' bottom line, they reduce the amount of available investment capital.

Many CEOs claim that tax policy is often the major factor in deciding whether to buy new plant or equipment, where to site a new investment, or, indeed, whether to remain domiciled within the United States.

Policymakers have long recognized this connection and have tried to spur investment through the tax code by making investment expenditures tax deductible or by otherwise reducing taxes on investment.

These tax preferences are necessary because of the U.S.'s high corporate tax rate—the highest among all the developed economies—which is why the current focus of tax reform efforts is to lower the corporate tax rate and thus reduce or eliminate the need for so many off-setting tax breaks.

But businesses can only make decisions based on the tax rules at the time, not on what the rules might be in the future. An investment decision made in March of 2015 has to be made based on the law at the time of the decision, not upon guesses about what Congress might do retroactively in the last week of the year.

Because of the vagaries of the U.S. budget process, many tax preferences designed to stimulate investment are not a permanent part of the tax code, but rather require annual reauthorization. Some of these provisions are narrow and affect a single industry, while others, such as the R&D tax credit, affect a large number of industries key to American competitiveness and economic growth.

The fact that so many of these tax preferences are subject to annual reauthorization has eroded tax stability. Businesses are hesitant to make long-term investments when they cannot predict from one year to the next the details of the tax regime under which they operate.

Section 179

One key tax preference, Section 179, is designed to encourage small and medium-sized business investment by allowing them to deduct the full purchase price of most common equipment, software and tangible goods used in that business in the year in which the purchase is made. In other words, these purchases may be immediately expensed and do not have to be depreciated over a number of years.

It should be obvious that, by allowing full expensing, Section 179 encourages small business investment, thus contributing to economic growth. In fact, many tax reformers believe most if not all business investment should be expensed rather than depreciated, and that such a change would result in significant increased economic growth. Section 179, therefore, is an example of how the tax code should treat most business investment.

Except for one small detail: Like many tax preferences, Section 179 is subject to annual renewal, which means uncertainty and thus of limited value to the small and medium-sized businesses it is intended to help.

Case Study: Section 179 Uncertainty and Agriculture in 2014

Every industry has its share of uncertainty, but the nature of agriculture exposes it to more than most. Rain or drought, heat or cold, and even their timing can conspire against agriculture to depress crop yields, complicate harvests, and otherwise impact productivity. Additionally, U.S. farmers have to compete globally against countries that heavily subsidize their domestic producers and erect barriers to U.S. imports.

Yet American agriculture remains globally competitive, mostly because of mechanization and technology. But advanced technology and equipment requires ongoing heavy investment by farmers.

What American farmers have in common with all other U.S. businesses is that they are brutalized by the high corporate tax rate. What they have in common with other small businesses is that they depend on specific tax provisions such as Section 179 to mitigate the harm of the high tax rate. But in 2014, uncertainty about Section 179 depressed investment by farmers in equipment and technology. Here is how it happened.

At the close of 2013, the Section 179 limit was at the last minute raised to $500,000 retroactive for 2013. But on January 1, 2014, the Section 179 limit dropped back down to $25,000, and stayed there during the entirety of 2014, until again being raised to $500,000 and made retroactive at the close of 2014. Today, in early 2015, the Section 179 allowance has again dropped all the way back down to $25,000.

How did this tax uncertainty affect agricultural investment during 2014? According to the Federal Reserve Bank of Kansas City:

> "... 2014 combine and four-wheel drive tractor sales in the U.S. began on par with 2013 levels but slowed steadily and ended the year down 26 percent. Although the existing Section 179 tax incentives for the purchase of machinery and equipment were reinstated the last week of December, the reinstatement seemed too late to significantly boost 2014 sales."[1]

So a first-level effect of Section 179 uncertainty is that farmers themselves did not invest in increasing productive capacity as much as they likely would have. But the effects don't stop there.

What happens when farmers don't buy as much equipment as they would have? According to the Des Moines Register, the John Deere Company had three rounds of layoffs in five months, eliminating the jobs of 800 Iowa plant workers.

> "Deere blamed the layoffs on decreasing demand for its farming equipment. . . . 'Other machinery manufacturers likely will follow Deere's lead with similar job cuts,' said Chad Hart, an agricultural economist with Iowa State University."[2]

It is reasonable to link the drop in agricultural investment and the resultant job cuts to the failure of Congress to renew the higher Section 179 allowance early enough in 2014 to have its intended incentive effect.

While this pattern of last minute renewal of Section 179 has gone on for several years, there is evidence that the new Congress recognizes the problem. In February the House of Representatives passed HR 636, which would make the Section 179 expensing allowance permanent at $500,000. The bill passed 272-142, just shy of a veto-proof majority.[3]

The bad news is that President Obama has threatened to veto the bill.[4] And his budget also contains provisions that would subject farmland inheritance to capital gains taxes, imposing an even higher tax burden on struggling farmers.

Conclusion

Instability, uncertainty and last minute extensions are no way to run a tax policy. There must be certainty about tax provisions designed to encourage investment, or the investment won't take place. Fundamental tax reform that lowers the corporate tax rate to something below 25 percent and eliminates the need for many of these tax preferences is long overdue.

In the meantime, Congress should pass temporary tax preferences within the first quarter of the year in order to provide certainty and to encourage investment. Agriculture is just one example of the harms to economic growth and employment that result from the combination of high tax rates and tax uncertainty.

Tom Giovanetti is the president of the Institute for Policy Innovation.

Endnotes

1. http://kansascityfed.org/research/indicatorsdata/agfinance/index.cfm#/articles/research/afd/2015/first-quarter/ag-finance-dbk-1Q-2015.cfm
2. http://www.desmoinesregister.com/story/money/agriculture/2015/01/23/john-deere-iowa-layoffs/22210349/
3. http://www.agri-pulse.com/House-OKs-permanent-Section-179-extension-02132015.asp
4. http://agri-pulse.com/Obama-threatens-veto-tax-extenders-02102015.asp

Institute for Policy Innovation: 1320 Greenway Drive, Suite 820 Irving, TX 75038

www.ipi.org phone: 972-874-5139 email: ipi@ipi.org