Allow Expensing of All Investment Outlays and Dividend Payments

By Arthur W. Wright

President Obama’s tax reform task force should consider two proposals related to the corporate income tax: allowing firms to expense all investment outlays, including research and development, and allowing firms to expense dividend payments.

Both of those proposals would promote at least one of the three goals in the mandate of the task force. Both would improve economic efficiency, thereby increasing national output and the associated incomes that make up the base of the federal income tax. Expensing investment outlays would also permit simplification of the code, make enforcement easier, reduce firms’ incentives to pursue loopholes, and end the breaks on depreciation deductions that I take to be the meaning of corporate welfare.

Politically, under the “Nixon goes to China” theory, a Democratic government (executive and legislative branches) could more readily enact the proposed measures than a Republican one. The GOP would likely come under partisan attack for cronyism were it to attempt such changes to the nation’s tax laws. On a good day, one can even imagine either change attracting bipartisan support in Congress.

Expensing of All Investment Outlays

A standard result in financial theory, encountered early in all undergraduate finance textbooks, is that profit-maximizing business firms subject to an income tax are able to attain the greatest possible economic efficiency if they are allowed to expense all outlays during the tax period (for example, a year) in which they are made. Thus, the existing mare’s nest of deductions and incentives for depreciation is economically less efficient than a
policy of allowing firms to expense their investment outlays, just as they may expense outlays on labor and material inputs. (I ignore the question whether alternatives to a federal tax on corporate income might be more efficient.)

The current U.S. tax treatment of investment expenditures raises firms’ costs of capital, compared with allowing firms to expense them. That same treatment gives firms an incentive to try to lower their costs of capital by lobbying for more generous depreciation deductions. But that adds insult to injury: Put through the legislative sausage grinder, the outcome is a tax law that is not only inefficient, but also expensive both to enforce and to comply with.

The efficiency-enhancing effects of reducing the drag from current depreciation provisions can be seen from the substantial empirical evidence that accelerated depreciation and investment tax credits boost corporate investment.

Note that interpreting our current anti-capital-depreciation policy as pro-labor is false, to the (considerable) extent that workers’ productivity is increased by having more and better capital to work with. Reducing firms’ costs of capital by allowing the expensing of investment outlays would actually benefit their employees.

**Expensing of Dividend Payments**

Taxing corporate income before dividends are paid, and then taxing it again on the individual returns of dividend recipients, is taxing dividends twice. (I refer here to what are called “ordinary dividends” and ignore “qualified dividends,” which are taxed at capital gains rates.) As with the requirement to depreciate investment outlays over time, the effect of the double taxation of dividends is to raise the cost of capital to corporations, thereby reducing investment and both the quantity and quality of business firms’ capital stocks.

Why do companies pay dividends? One suggested reason is as a signal to financial investors about their financial situations. In that sense, dividends are no different a form of business expense than, for example, the costs of debt financing. But even if a firm
pays dividends for want of profitable internal investment opportunities, taxing the dividends twice impedes the reallocation of capital from less productive to more productive uses in the broader economy.

Supposing we were to agree to end the double taxation of corporate dividends, how should it be done? Allowing firms to deduct dividends from their taxable incomes would parallel the tax treatment of wages and salaries paid to employees. The alternative — to exclude dividends from individuals’ taxable incomes — would tax dividend income at corporate rates but wages and salaries at individual rates. My own preference would be for the former, pending a thorough reexamination of the relative rate structures applied to the two types of income.