

US Daily: Corporate Tax Reform: Trading Interest Deductibility for Full Capex Expensing (Mericle/Struyven)

- Both the House Republicans and the incoming Trump administration have called for significant corporate tax reform. In today's note, we discuss two specific proposals: eliminating or capping net interest deductibility and shifting to full expensing of capital investment.
- We estimate the impact of these policies on investment spending both through the impact on firms' cash flows and using a traditional "user cost of capital" model. Relative to our pre-election assumption that bonus depreciation would remain in place, we find that trading net interest deductibility for full expensing provides only a slight positive boost to investment spending over the next year.
- We expect these policies would be accompanied by an offsetting reduction in the statutory corporate tax rate. A tax reform package consisting of these policies plus a cut in the statutory rate to the 20% figure proposed in the House plan would have a positive effect on investment in the long run, though we expect that budgetary constraints will push the statutory rate higher than that, resulting in a more neutral impact on investment.

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Both the House Republicans and the incoming Trump administration have called for significant and complex packages of corporate tax reform. In an earlier [note](#) we considered the prospects for a shift to a "destination-basis cash flow tax," which would affect the deductibility of imported goods. Here we tackle two other proposals: eliminating or capping net interest deductibility and shifting to full immediate expensing of capital investment. While we do not address the impact of a reduction in the statutory corporate tax rate here, we think it is highly likely such a cut would accompany the elimination of interest deductibility.

Under the House Republican plan, the deductibility of corporate net interest expense would be repealed. In return, companies would gain the ability to immediately deduct the cost of capex from their income instead of depreciating it over time. Full expensing of capex is intended to incentivize investment spending by reducing its cost, while repealing the deductibility of net interest is intended to eliminate the preferential tax treatment of debt financing over equity financing under current law, which incentivizes firms to increase leverage.

Under existing law, companies can only deduct a fraction of the depreciation cost of an investment good in a given year, with the exact share depending on the depreciation schedule and the life of the asset. However, there is already a 50% bonus to the depreciation allowance in place that we had assumed would continue



regardless of the election outcome. For a 7-year property, which roughly corresponds to the average asset life of the capital stock, current policy allows companies to deduct about 70% of the cost of investment in the first year and a half. As a result, the shift to full expensing would front-load an additional 30% of the deduction.

We consider the impact of these policies on investment spending both through the impact on firms' cash flows and using a traditional "user cost of capital" model. The after-tax "user cost" is the cost to a firm of using capital for its business activities over a period of time, after taking into account not only interest and depreciation but also the tax rate and any tax incentives. The net impact of the two policies would boost firms' cash flows over the next year because the savings from pulling forward depreciation would outweigh the loss of the interest deduction. After the first year, however, the impact on cash flow would begin to decline and eventually turn negative.

To estimate the impact of increased cash flow on near-term investment spending, we survey econometric studies. Most such studies analyze the capex response of firms that have benefited from cash windfalls that were not reflective of greater profitability, such as a favorable outcome in a lawsuit. Looking across a number of studies, summarized in Exhibit 1, we estimate that an additional \$1 of cash flow raises investment spending by roughly 15 cents. This implies that \$114bn worth of corporate tax cuts would boost investment by \$17bn, or about 0.7% of private nonresidential investment.

Exhibit 1: Estimates of the Impact of Cash Flow on Investment Spending

Study	Method	Investment Spending Per Additional \$1 (¢)	Change in Investment Per 100bn Tax Cuts
Chaney, Sraer, Thesmar (2012)	Studies capex of firms with shocks to local collateral land values	6¢	0.3%
Lamont (1997)	Studies capex of nonoil subsidiaries of oil firms around 1986 oil price decrease	8¢	0.3%
Blanchard, Lopez-de-Silanes, Shleifer (1997)	Studies capex of firms around windfalls from lawsuits	6¢	0.3%
Rauh (2006)	Studies capex of firms with nonlinear defined benefit pension plan funding rules	60¢	2.6%
GS Estimates		15¢	0.7%

Source: Goldman Sachs Global Investment Research

In the medium to longer run, the impact of these policies on investment is better gauged through the user cost model. Completely eliminating net interest deductibility in isolation would raise the after-tax user cost by about 23%.¹ Using an average estimate of the impact of the user cost on the capital stock implies that this would reduce investment spending by a bit over 4% per year if the adjustment were to occur over a five-year period, as shown in Exhibit 2.² Full expensing would cut

¹ We estimate the increase in the user cost from the increase in the effective corporate tax rate implied by eliminating the net interest deduction.

² Specifically, our calculation assumes that the elasticity of the capital stock with respect to the user cost is -0.1.



the other way, lowering the user cost of new investment somewhat. The reason is that although companies are eventually able to expense the full value of investment under existing law, the net present value of the depreciation allowance would rise under a shift to full immediate expensing.

Using these two approaches, we can estimate the net impact of the two policies on investment spending both over the next year and in the longer run.³ As Exhibit 2 shows, our estimates imply that the two policies would roughly offset over the first year, boosting investment by less than 1%. In the longer run, the net effect of the two policies alone on investment spending via the user cost would be negative, unless offset by a corresponding reduction in statutory corporate tax rates. We note that our estimates of the boost from full expensing are calculated relative to our prior assumption that the current 50% bonus depreciation provision would remain in place permanently, and would of course be larger if the baseline instead assumed that bonus depreciation would expire.

Exhibit 2: Impact on Investment of Repealing Net Interest Deductibility and Full Capex Expensing

Policy	Cash-Flow Approach		User-Cost Approach	
	Impact on Cash Flows in Year 1 (\$bn)	Investment Impact	Impact on User Cost	Investment Impact
Repealing Net Interest Deduction	-231	-1.5%	23.0%	-4.4%
Switch from Bonus Depreciation to Full Expensing	345	2.2%	-2.0%	0.4%
Total	114	0.7%	21.0%	-4.0%

Source: Goldman Sachs Global Investment Research

Beyond the impact on investment spending, the proposed policy changes also have implications for leverage and tax revenues. Based on a similar survey of economic research on the impact of policy changes in the tax treatment of debt on corporate leverage, we estimate that repealing net interest deductibility would reduce economy-wide corporate leverage (the debt-to-asset ratio) by about 2pp. With respect to the revenue effects, the Tax Policy Center [estimates](#) that the two reforms would reduce revenues by \$447bn over the next 10 years, but raise revenues by \$636bn over the following 10 years—consistent with the notion that the package would be positive for private investment over the near-term, but negative over the longer-term.

The proposals to repeal net interest deductibility and replace it with full expensing of capex are just two parts of the corporate tax reform package proposed by House Republicans. In combination, these two policies alone would likely provide a small boost to investment spending over the next year relative to our current projections, but would raise the user cost of capital and reduce investment in the longer run.

However, we think it is highly likely that an offsetting cut to the statutory corporate tax rate would accompany these proposals. A tax reform package consisting of these policies plus a cut in the statutory rate to the 20% figure proposed in the House plan would have a positive effect on investment in the long run as well. But we expect that budgetary constraints will push the statutory rate higher than that,

³ We assume that the funding mix of capital spending between debt and equity remains unchanged.



resulting in an impact on investment that is more neutral in the long run and that could be slightly negative if the statutory rate does not decline sufficiently.

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Disclosure Appendix

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We, Jan Hatzius, Zach Pandl, Alec Phillips, David Mericle, Daan Struyven, Karen Reichgott and Avisha Thakkar, hereby certify that all of the views expressed in this report accurately reflect our personal views, which have not been influenced by considerations of the firm's business or client relationships.

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