The Center for Growth and Opportunity at Utah State University

Tax Flexibility Can Help in COVID-19 Recovery

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Reopening and rebuilding the US economy as social distancing restrictions are relaxed will pose an unprecedented challenge. Major structural adjustments will have to take place to enable safe operation in the new environment. International supply chains will have to be rethought both to assure access to critical inputs as well as to adjust to the possibility that new breakouts could occur in different parts of the world at different times.

At the same time, both businesses and households will be grappling with an enormous amount of uncertainty about the future. In this environment, it makes sense that they would be cautious about new investment and will seek safe, liquid assets such as US Treasurys in which to hold their savings. Yet, without increases in private investment and capital spending the economy will not be able to make the structural adjustments that are required to operate in the post-pandemic environment.

Making matters worse, because of the so-called Zero Lower Bound, the Federal Reserve has limited ability to lower interest rates throughout the economy to make new investment cheaper. Traditionally, the Fed has had more power to direct the short-term evolution of the economy than any other government agency.

By raising and lowering interest rates, the Fed has had the ability to stimulate or curtail both business and residential real estate investment. These are the most volatile parts of the economy and they have an outsized effect on the short-term rate of economic growth. With both a weak economy and the need for major investments to cope with the lingering effects of the pandemic, lowering interest would be the ideal tool for jump-starting the economy.

Unfortunately, the Fed has already lowered its key interest rate, the Federal Funds rate, to zero. The Federal Funds rate is the interest rate that banks charge each other for loans that last only from the close of one business day to the opening of another.

These very short-term loans between financial institutions are considered essentially risk-free. All other loans that financial institutions make are determined by adding some additional interest to compensate for the risks involved in longer-term lending to businesses and households.

With the Federal Funds rate at zero, the Fed has little ability to further reduce interest rates in the economy without distorting the lending decisions of banks. That leaves tax policy as one of the few remaining levers to stimulate the new private investment that the economy requires.

When politicians and pundits talk about economic stimulus they often are assumed to mean increased spending by the Federal Government. Through the multiplier effect it is possible for increased government spending to raise private spending. Most of this effect, however, operates through increased consumption.

Spending on new highways, for example, increases employment among construction workers who, in turn, increase their spending on other goods and services. Stimulus through spending may be appropriate especially on public investments like infrastructure that will yield benefits in the future. It, however, does very little to stimulate private investment directly.

Tax policy on the other hand can not only raise general spending through the multiplier effect, but it can target private investment directly, mimicking the function the Federal Reserve is not currently able to perform. To be effective those policies must focus on long-term reductions in the cost of capital. Temporary provisions will not provide adequate time to recoup the cost of major investment initiatives. Investments associated with shifting supply chains, in particular, may take a decade to complete even if they begin immediately.

Moreover, short-term fixes increase uncertainty, further discouraging capital spending and new investment in general. To that end, the most essential step Congress could take is to expand and make permanent the broad-based investment incentives contained in the Tax Cuts and Jobs Act.

Increasing Investment

The full expensing of new capital equipment that is set to phase out beginning in 2022 should be made permanent. Full expensing should also be extended to investments in new structures as well as equipment, and the provisions requiring the amortization of research and development should be repealed.

In addition to providing an immediate uptick in investment, these three measures together—making permanent the full-expensing of equipment, extending full expensing to structures, and repealing the requirement that R&D be amortized—would increase long-run GDP by over 5% and create more than 900,000 permanent jobs[1]. This enduring increase in economic output and employment would reduce uncertainty and give consumers the confidence to increase consumption immediately, further accelerating the recovery.

Incentives to invest will make little difference, however, if firms are unable to raise money up front to make additional expenditures. The Federal Reserve is doing all it can to ensure that liquidity remains available in US capital markets, but again in these challenging times it still may not be enough.

Subsidies and direct grants to businesses might appear to be an attractive remedy, but they put the government in the difficult position of having to pick winners and losers. Instead, Congress should allow businesses to "cash out" allowances for depreciation or net operating losses made in previous years. These are deductions companies have already earned but would normally not be able to apply to their tax liability until they returned to profitability. Allowing companies to accelerate those deductions provides them with additional cash flow to make investments today without requiring the federal government to decide which projects are worthy of aid.

Lawmakers should also strongly consider prospectively removing both the deductibility and the taxability of interest. This would mean that the interest payments from all new loans and bond issuances would not be taxed, but business and households would not be able to deduct such payments from their taxable income either. This would make it more attractive for investors to lend to businesses today, but would increase the liability of those same taxpayers in the future.

This switch, however, is precisely what it needed. Businesses require funding now to reopen. Once, they do and the economy is on a stronger footing they will be able to afford the greater tax liability they face in the future. Removing both the taxability and the deductibility of interest would contribute to a stronger tax system over the long-term by removing the incentive for companies to use debt over equity financing during normal times and by making it more difficult for them to game international tax rules.

The recent tariffs should also be suspended. The US will have to think critically about how it provides essential goods and services and maintains its supply chains in the new environment. It is difficult for anyone to say what an ideal solution will look like. The goals of national security have to be balanced by the enormous benefits of global trade and integration.

What we can say, however, is that as policymakers think through these complex issues, businesses should not be hampered by trade policy that was designed in the pre-pandemic era. The slate should be wiped clean and Congress should begin anew with a holistic approach to securing America's supply chains while maintaining the efficiency and productivity of US industry.

Supporting a Flexible Economy

It is crucial that tax policy not stand in the way of the expansion of New Economy businesses that have proven invaluable during the pandemic. The gig economy, for example, was hit hard by social distancing requirements, but it also provided essential delivery services that made those requirements practicable.

In general, New Economy firms have provided enormous flexibility for US workers and businesses during the pandemic. As we look for ways to adjust to open up the economy they have the potential to provide even more support, not only in terms of flexibility, but in developing the kinds of health and public safety services the economy will need to reach its potential.

To that end, Congress should ease the tax compliance process for gig economy workers through streamlined deduction rules, modifications to quarterly estimated payments, and safe harbor provisions for gig economy firms to help their workers on tax issues.

A simplified expense deduction—modeled on other simplified deductions like the home office deduction or the vehicle miles traveled deduction—should be created to give gig economy workers an option not to itemize expenses in situations where that may complicate tax compliance.

Gig economy platforms should be permitted to voluntarily withhold income and self-employment tax on behalf of their workers in addition to providing tax guidance where appropriate under a safe harbor provision of existing labor law.

At the state level, discriminatory excise taxes on New Economy services should be repealed, and instead, states should focus on ensuring that the services are incorporated into state sales tax codes in a streamlined fashion.

In addition, lawmakers should reform the treatment of R&D tax credits for startups and entrepreneurs, with a focus on simplification and equal treatment of R&D expenses across firms. This could be done by expanding the use of the Alternative Simplified Credit and by allowing more startups to offset payroll tax liability with R&D credits. The latter policy contributed to tax neutrality by offsetting the penalty imposed on losses under current law.

Providing reforms that increase the flexibility of the economy together with tax provisions that lower the cost of capital more generally will spur the very types of private investment that the US needs to open safely. At the same time, it will substitute for the Federal Reserve's inability to jumpstart the broader economy through lower interest rates. To be sure, this alone will not be

enough to solve our problems. It will, however, go a long way towards ensuring that the US is not mired in deep and prolonged recession.

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The Center for Growth and Opportunity at Utah State University is a university-based academic research center that explores the scientific foundations of the interaction between individuals, business, and government.

The COVID Recovery Symposium explores public policy changes needed in the wake of the COVID-19 crisis to encourage economic growth and opportunity over the next decade.

The views expressed in this paper are those of the authors and do not necessarily reflect the views of the Center for Growth and Opportunity at Utah State University or the views of Utah State University.

Endnotes

1. Erica York and Huaqun Li, "Reviewing the Economic and Revenue Implications of Cost Recovery Options" (Tax Foundation, April 28, 2020), https://taxfoundation.org/full-immediate-expensing/.