Temporary Investment Incentives

WEBINAR 6, JULY 28, 2020

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Temporary Investment Incentives

Temporary tax incentives for private investment as stimulus measures to support economic recovery from the COVID-19 pandemic.

Purpose of the note is not to advocate the use of tax incentives, but to highlight important considerations, should governments contemplate using them.

Describe features of the policy design, provide information on their effectiveness, and give examples in the COVID-19 situation.
What is the ‘Temporary’ Aspect?

Temporary investment tax incentives are set to expire after a short period, typically one to three years.

To encourage businesses to shift their investment plans forward (into the period of economic weakness) by making the incentive only temporarily available.

The incentives begin and expire for all qualifying firms on the same dates.

This fixed window of calendar time is very different from “tax holidays,” commonly seen in the investment codes of developing countries.

Focus of this presentation is on accelerated depreciation, viewed as more cost-effective than temporary tax rate cuts.
What is Accelerated Depreciation?

Spending on equipment and buildings generate tax deductions (‘depreciation’) over the useful life of the asset.

‘Accelerated depreciation’ allows a more rapid write off of the investment cost, which generates a tax saving to companies in terms of present value.

One popular form is a ‘first-year allowance’ (also known as ‘bonus depreciation’):

- Immediate write off of a portion of the capital expenditure
- Remaining cost of the asset is depreciated at the usual rate
- Sometimes the full amount can be depreciated, on top of the first-year allowance
Are there Examples in the COVID-19 Pandemic?

Australia:
- First-year allowance of 100 per cent (i.e., instant write off) of the cost of eligible new or second-hand depreciating assets, whose costs are less than AUD150,000, first used or installed for use from March 12 2020 until December 31 2020.
- First-year allowance of 50 per cent of the cost of an eligible new depreciating asset acquired from March 12 2020 and first used or installed by June 30 2021. There is no limit to the cost of a depreciating asset that can qualify for this concession.

Germany:
- Degressive depreciation with a factor of 2.5 applied to the currently applicable straight-line rates for fixed assets acquired or produced in 2020 and 2021.

Singapore:
- Depreciation for plant and machinery acquired in 2020 over two years: 75 percent of the cost in 2020 and 25 percent in 2021.
What if Companies are Loss-Making?

Evidence that firms only respond to temporary bonus depreciation if it immediately generates cash flows, even though the firms with tax losses can carry-forward unused deductions to offset future taxes (Zwick and Mahon, 2017).

For this reason tax loss carrybacks may serve as a useful complement to temporary accelerated depreciation, since they can generate a refund of tax payments for earlier years.

In the aftermath of the GFC, Canada, UK, France, and Netherlands granted a loss carryback to the preceding three tax years, and the United States to five years.

Those rules often came with restrictions, for instance to small companies or businesses not getting support through other government assistance programs. Frequently, a loss carryback is restricted in terms of the amount of losses that can be carried back with remaining amounts being carried into future years.
How Large is the Multiplier?

**Investment elasticity** = percentage increase in investment / percentage decrease in the cost of capital, due to the tax incentive

- See illustrative calculations of the cost of capital in the note


- Large impacts also found for Australia (2008-09) and Germany (1995-98) (Rodgers and Hambur, 2018, Eichfelder and Schneider, 2018)

**GDP multiplier** of the investment incentive will depend on the proportion of equipment that is imported; large capital importers will have lower multipliers.
What about the Uncertainty of the Pandemic?

Evidence suggests that investment responses weaken during periods of high uncertainty, usually associated with recessions.

Companies that consistently invest every year, typically capital-intensive firms, are found to respond to incentives during periods of economic volatility.

But companies that had not planned any investment in the absence of the policy tend to be unresponsive to the implementation of tax incentives during periods of economic uncertainty (Guceri and Albinowski, 2019).

This wait-and-see behavior is in contrast to periods of low uncertainty, when both types of firms are observed to respond to new tax incentives.
What Role for Tax Incentives in COVID-19?

Temporary investment incentive during COVID-19 are perhaps most effective in a post-lockdown period, when emphasis of stimulus measures shifts from supporting unemployed workers towards supporting business recovery.

A potential advantage of investment incentives over some other forms of stimulus is that businesses will only make investments if they expect to be profitable.

Targeted use of incentives could also facilitate economic transformation (green recovery, promote investment in selected sectors or assets, such as ‘digital assets’).
Should Temporary Tax Rate Cuts be Used?

Bonus depreciation typically yields a higher response of investment and output per dollar of tax revenue (Edge and Rudd, 2011).

Since corporate income tax applies to the income from all capital while bonus depreciation applies to expenditures on new capital only, the former represents a relatively expensive way to induce investment.
THANK YOU