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In this article, Cole explains how eliminating the business tax deduction for interest expense would hurt all businesses, large and small.

What if a politician were campaigning on a promise to raise your personal taxes by more than 50 percent in order to offset the budgetary costs of giveaways to special interests? You would be outraged. But that is exactly what some politicians are proposing for business taxes. Specifically, they are proposing to eliminate the business tax deduction for interest expense, which has long been recognized as a legitimate business expense. In exchange, they plan to allow 100 percent expensing of specific capital expenditures, up from the current law allowance of 50 percent. The only problem? This ill-advised trade-off would end up hurting businesses — large and small — while also harming the U.S. economy.

First, let's look at the issue of interest deductibility for small businesses. A 2015 survey conducted by the Federal Reserve found that two out of three small businesses have outstanding debt; these businesses would unambiguously be harmed by this proposal. A small business uses credit to grow beyond the constraint imposed by its owners' personal wealth. For a small business with the average amount of debt, about $100,000, this proposal would raise its cost of credit by $3,500 per year. By raising the cost of credit, politicians are constraining the ability of small businesses to grow, and in some cases, forcing them to close their doors. Why is this important? According to the Small Business Administration, small businesses are responsible for two-thirds of net job growth. So proposals that would limit or eliminate interest deductibility are anti-job growth.

Now let's look at why adding 100 percent expensing does not fully mitigate the harm caused by removing interest deductibility. Small businesses do not receive any offset because they already get to expense up to $500,000 in annual capital expenditures under section 179. Only big businesses, which are currently required to amortize capital expenditures exceeding $500,000 over a period of years, would potentially benefit from this proposed offset. Even for large companies, however, this is a dubious trade-off. With one hand, we raise your taxes, while with the other hand, we lower your taxes (but not by as much as we just raised them). Consider a manufacturing company with $1 million in annual revenue that takes out a five-year loan in the amount of $2 million to finance a new machine. Expensing at 100 percent would offset the firm's taxable income in the early years but, in combination with the loss of interest deductibility, would raise the firm's taxes by $350,000 over the life of the loan (almost $200,000 on a present-value basis).[1]

Even if these proposals were revenue neutral (which they are not), some businesses would disproportionately benefit, while others, especially capital-intensive businesses of all sizes, would disproportionately be harmed.

Some critics of interest deductibility argue that the tax code is biased toward debt because of the double taxation on equity financing of corporations. Double taxation on corporate equity does exist and does distort financing choices, but creating yet another harmful distortion in the tax code through limiting interest deductibility is not the solution — two distortions don't bring clarity or equitable results. What we need is a tax structure that removes distortions to promote economic efficiencies and growth. These systems are realistic and have been enacted in other jurisdictions. Eliminating the deductibility of interest expense in favor of 100 percent expensing, however, further complicates, rather than simplifies, the tax code and would make the code less pro-growth.

So why would any politician consider these fundamental changes in the tax code? Some may want to use the additional tax revenue that this pair

[1]For details, visit my website at http://condor.depaul.edu/rcole/expensing.

of proposals could generate to offset other government spending. In a world in which the U.S. national debt has ballooned from $9 trillion in 2008 to $19 trillion today, these politicians want to "hold the line" by punishing the most important job creators in the U.S. economy. Other politicians may claim that they want to enact this ill-advised trade-off as part of larger tax reform wherein business tax rates would be reduced. Unfortunately, this type of trade-off does not help transform a bad idea into a good one from an economics perspective. Indeed, multiple studies have examined what happens when limits on interest deductibility are coupled with reductions in the corporate tax rate, and the results are sobering — the trade-off would increase the net costs of new investments and would also reduce GDP over the long term.

This is a bad proposal, it is a false choice, and it is something that all Americans should oppose.