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Unintended Consequences of Accelerated Depreciation (part II)

I'd gladly pay you tomorrow for a hamburger today.
-J. Wellington Wimpy, (Popeye)

Earlier this week, we discussed the importance of changes in tax rules governing Accelerated Depreciation of Capital Investment, the tax advantaged accounting change that is scheduled to expire on December 31, 2004.

From its inception, it was expected to be a temporary stimulus designed to assist industries hurting in the post-bubble environment.

It has had that effect, in varying degrees, across many industries. The rule change has been stimulating capital purchases in a variety of sectors: In particular, Semiconductors, Industrial Manufacturing, Aircraft, Heavy Trucks, Telecom, and in particular, large Enterprise-wide Software applications.

The kicker to that stimulus is that Accelerated Depreciation is scheduled to sunset this year and the governing provision is that to qualify for the tax advantage, capital purchases must be "placed into service" by December 31. That creates a possibility of a Y2K-like run up in the late 3rd and early 4th Quarters, as companies scramble to catch the last of the tax benefit before the rule's expiration.

Unintended Consequences

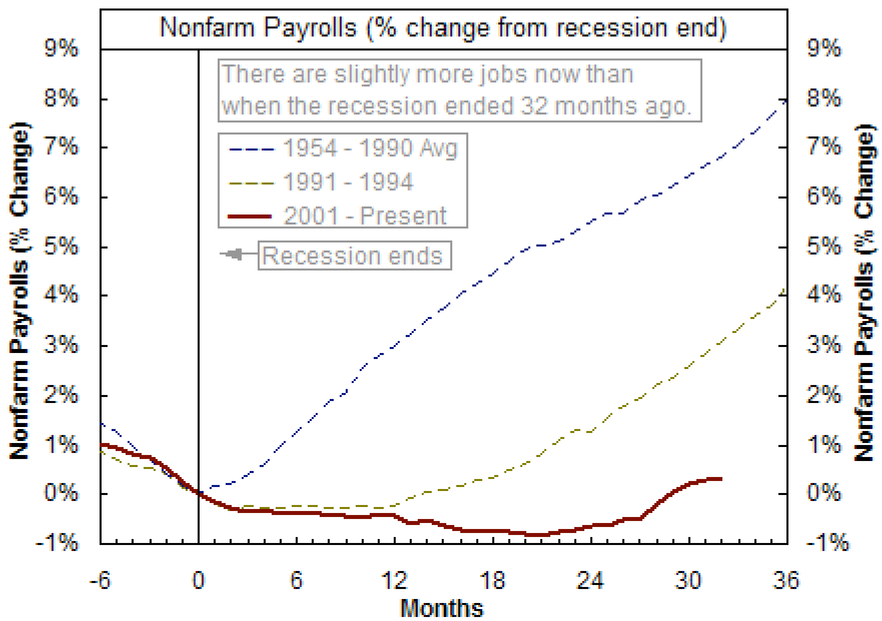
Because there's no such thing as a free lunch this fact forces the question: What are the negative, unintended consequences of the changes in the accelerated depreciation rules? We know that many sectors have benefited from the rule – but what has been the cost? In what ways has the rule been harmful to the recovery?

There are two particular dangers: deferred hiring (macroeconomic) and future purchase pull through (microeconomic). Let's briefly review each issue, to see if we can determine what, if any, the financial and/or economic impact the rule might have for the rest of this year and into 2005.

1) Deferred Hiring

The rule has had an unambiguous macro-impact on the broader economy: Large capital purchases have come at the expense of hiring.

Unlike prior economic recoveries, the post-2001 recession period has seen very unusual dynamics in expansion hiring patterns. I attribute this atypical aberration to excess post-bubble capacity, large increases in worker productivity, and cost-effective overseas outsourcing.



Source: Chart of the Day, New York Federal Reserve

But we should not overlook the impact of a subtle structural change in Corporate America: The widespread usage of business intelligence applications and enterprise resource planning software (ERP). These "efficiency and productivity' apps have had a significant impact on the economic recovery.

It has long been a staple of economic belief that corporate capital spending boosts profits, adds to the gross domestic product, and puts people to work. This held true throughout most of the 20th century. When companies purchased oil-rigs, drill presses, or large trucks, *someone* had to manufacture those goods. Companies needed workers to meet the rising demand for this capital equipment. And once that widget was manufactured, someone else was hired to operate it, drive it, or work it.

In all likelihood that was the White House's intent in accelerating the depreciation schedule for capital improvements. If companies get a larger tax benefit for making bigger purchases, then jobs *should be* the natural net result.

But this 20th century economic concept runs into some decidedly 21st century issues. Namely, labor requirements are very different in the age of intellectual property and software.

The problem seems to be that a large percentage of the capital purchases have been made in the software sector: Enterprise-wide applications make companies more efficient, productive and competitive. So efficient in fact that it reduces (or even eliminates) the need for additional hiring.

Our channel checks confirmed that suspicion: CIOs and CTOs, especially at small and medium sized firms, have been aggressively purchasing these enterprise apps over the past 2 years. Firms that design these ERPs market them as "paying for themselves" in a few years – specifically, in labor savings. The tax advantage of accelerated depreciation provided management with an incentive to install these apps sooner rather than later.

In order to stay competitive in the global marketplace, most firms would have had to install these apps eventually *anyway*. There is a global “efficiency arms race,” and if any firm garners an advantage using these tools, tools, than its inevitable that all their competitors will have to – just to stay competitive.

That’s good news for the U.S.’s competitive stance *vis-à-vis* the rest of the world. Up against cheap foreign labor, technology had better provide a cost advantage to compensate.

The bad news is that the deferred hiring comes at an economically sensitive juncture during the recovery. We have already seen the impact in slowing GDP and anemic job creation, and with the exception of continued low interest rates, most of the stimulus is behind us. The present phase of recovery should be one of organic growth where increased hiring leads to more consumer spending.

Yet that has not been happening in any appreciable way.

That’s one of the unintended consequence of the ERP and business intelligence applications: a dampening of hiring needs. Even at software firms, one of the main beneficiaries of this capital spending spree, there has not been a huge increase in headcount. That’s one of the great ironies of *accelerated depreciation*: Intellectual property doesn't require many new hires in response to an uptick in demand: How many people are needed to make another installation disc? At best, software firms see a small increase of hires in sales and support staff – but it’s relatively tiny. Compare that to the 20th century equivalent: When a steel mill or an auto factory hired in response to rising demand, they would add tens of thousands of new employees.

Thus, the *unintended consequence* of this 20th century solution to a 21st century problem: lackluster job growth.

2) **Future Purchase Pull Through**

Given the tax advantaged status of purchases made in 2004 vs. 2005, it's reasonable to expect to see accelerated buying in the second half of this year. Any firm planning on making a large capital purchase in Q1 2005 would greatly benefit from doing so in 2004 instead. Anecdotally, we have seen that.

Our working assumption is that many of the buys being made now are coming at the expense of the first half of 2005. That's the "pull through" which is the result of this rule. It's like channel stuffing – only in reverse.

Consider an analogous period: The run up to Y2K and the immediate aftermath. Prior to Dec. 31, 1999, the widely feared Y2k problem generated lots and lots of activity. Some of it, like COBOL programming and updating, were one-shot deals. We are unlikely to see another frenzy of COBOL programming activity again until the year 9,999.

Other buys, like PC purchases and software upgrades, did benefit from the flurry of activity, but that benefit came at the expense of 2000 first-half purchases. And while the Nasdaq did scream higher for the first three months of 2000, the handwriting was already on wall. Indeed, it can be argued that the preannouncement period in March of 2000 was, at least in part, the pin that helped prick the bubble. (We all recall what happened after March 21, 2000).

While our technical work does not suggest a similar crash is imminent, we can and should expect a similar phenomena in terms of pull through. Many of the second half 2004 purchases will come at the expense of first half of 2005 sales.

Conclusion

Accelerated depreciation helped stimulate capital spending at a time when the economy had become inert. But it accomplished this at a cost. Corporate management, given an incentive to make capital purchases, did so at the expense of hiring. We saw that in the corporate preference for equipment over labor these last few years. That could ultimately make this economic recovery somewhat more muted than prior upturns.

There is reason to hope that hiring will begin to swing upward in 2005. With the tax incentive to choose equipment over labor removed, there will be one less obstacle in the way away of corporate hiring. And if that were to occur, it would bode well for further economic expansion.

Please refer to page 6 of this report for important disclosures

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