THE ECONOMIC IMPACT OF LEASING

David G. Mayes and Clive S. Nicholas

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David G. Mayes
Head of Statistics and Head of Computing
National Economic Development Office, London

and

Clive S. Nicholas
Continuing Education and Training Officer
University of Exeter

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Preface

This book was born when David Mayes was Editor at the National Institute of Economic and Social Research in London, in 1980. Part of the Editor's task is to run the team of economists and the econometric model which the Institute uses in its forecasting. At that time we found considerable difficulty in forecasting investment by manufacturing industry, although, of course, we were aware of leasing and its extremely rapid rate of growth.

In the version of the National Institute model then in use – Interim Model IV – leasing was incorporated as a specific item which was added to manufacturing investment and subtracted from investment by the distribution and services sectors. The argument was that leased assets were treated by the user (lessee) in the same way as owned assets. Hence, the appropriate behavioural relationship was to add together investment and leased assets for manufacturing, on the one hand, and to subtract leased assets from the investment undertaken by the owners (lessors) in the distribution and service sectors.[1]

However, this arrangement did not work well. Our equations tended to underforecast manufacturing investment. Despite the rapid fall in profits in manufacturing in the early 1980s and the very high levels of interest rates, both nominal and real, investment including leasing ran at a higher level than we expected. The reason was thought to be clear. Because lessors could offset the whole of their investment against tax it was possible for them to offer relatively attractive terms to lessees, hence, in effect, cutting the cost of investment. Under these circumstances investment could be expected to increase relative to what it would otherwise have been.

Even this was not enough in 1980–1. David Mayes, working with Gay Wenban-Smith (who was responsible for the investment sector at the Institute), suggested that, as taxable profits in manufacturing fell, the number of companies which could benefit from leasing would increase. Similarly, for each company, leasing would become attractive at an earlier point (see Mayes and Wenban-Smith, 1981).

Having the hypothesis was one thing, being able to prove it was quite another. Investment behaviour could have changed for any one or more of a number of reasons, of which the rise of leasing was only one. The National Institute did not have the resources to study the problem so we looked elsewhere for a grant.

The Equipment Leasing Association quickly saw the benefit of the research and offered us financial support to undertake a survey of its members, but we still had to look further for the main funding. Several bodies, including the SSRC, were not convinced of the need for the work but we persevered and eventually in 1984 we were lucky enough to get a substantial grant from the Leverhulme Trust. It is perfectly true to say that without this our research would not have been possible. We hope the Trust approves of what we have been able to achieve with the money, although it should be made clear that it is in no way responsible for the work itself or the views expressed.

By that time neither Gay nor David were working for the National Institute. Gay was with British Gas and not in a position to participate, and David was Head of Statistics at the National Economic Development Office. Fortunately, as an Honorary Research Fellow at the University of Exeter, it was possible for David to undertake the work in the Department of Economics there. It was even more fortuitous to be able to recruit Clive Nicholas as the Research Fellow to work full-time on the project, since he had not only graduated from Exeter but had also been working in the finance industry in the South West with experience of leasing. The chance of finding such an economist who was available at that precise time and place must have been infinitesimal.

We should like to record our thanks here to the large number of people in the leasing industry, in particular, and in the firms in manufacturing industry who took the trouble to fill in our questionnaires. Response rates exceeded our best hopes, perhaps indicating that some felt our work to be worth while. Everyone gave of their time freely, we hope they think we have used it valuably.

It is probably invidious to single out individuals for their contribution, but we must mention the Equipment Leasing Association, especially its Secretary-General, Basil Damer, his two assistants, Charles Ferrier and Andrew Thompson, and its Chairman during the main part of the work, David Beever. The Equipment Leasing Association gave us the opportunity to reach a wider audience. However, tribute for enabling us to inflict our ideas on others must also go to Robert Hawkins of the *Leasing Digest*, who arranged for us to talk at the Lease-Europe meeting in Frankfurt, in 1981, as well as at the World Leasing Congress in London, in 1985.

One disadvantage of the long delay caused by the struggle to obtain finance was that no sooner had the project got under way than the 1984 Finance Bill was introduced, proposing the reduction of 100 per cent capital allowances to a standard 25 per cent writing down allowance. The irony of working on a project to establish the contribution of leasing to the economy, both through increasing the rate of economic growth and through helping to ease the effects of recessions by its countercyclical behaviour, while the government removed the most important single incentive for leasing, was not lost on us. No doubt it was lost on the Chancellor of the Exchequer. I suppose we must thank him for raising the general level of awareness about leasing and its importance. It was, however, rather disconcerting to realise the number of people, overseas as well as in the UK, who regarded leasing as partly a tax fiddle, or not quite as respectable as other, more traditional ways of raising finance for investment.

Now that the research has been completed and the transition envisaged in the 1984 Finance Act has finished, it is more difficult to judge the appropriate use to which the findings can be put. It is clear that leasing has led to a higher rate of investment, which even though it may not have been as productive as the Chancellor would have liked, nevertheless contributed to raising the UK's rate of economic growth. Cyclical stabilisation also appears to be somewhat out of fashion. Here the findings of the research, although positive, were somewhat weaker. The availability of leasing clearly affects the timing of investment as was illustrated by massive surges in the level of leasing in the first quarters of 1985 and 1986 as people tried to beat the two downward steps in initial tax allowances.

It is unrealistic to expect the current government to unwind its legislation, but may lead it to treat leasing more favourably in the future, say, by permitting leveraged leases. No doubt other financial innovations will arise to help fill the gap. The work may also be a pointer to future governments looking for a way to stimulate manufacturing industry.

It would be normal at this point to thank the typist, but it was Clive who attacked the word processor and produced the final report. It is a tribute to this new technology that it has been possible to transport the discs round the world to New Zealand, where David Mayes was Director of the NZ Institute of Economic Research, insert them in a computer and edit the text for this book.

We had various alarums and excursions in performing the computer analysis, which was not aided by geographical separation. We record our thanks to Philip Frater and Sarah Clokie at NEDO, Keith

Cuthbertson at the University of Newcastle upon Tyne, Hassan Feisal at NIESR, Paul Fisher at the ESRC Econometric Modelling Bureau at the University of Warwick, whose facilities were-used for simulating the National Institute model, and Phil Briggs at NZIER. We are grateful to David Walker and others at Exeter for advice as the project progressed. We are unable to blame any of the aforementioned for the result, which remains our own responsibility. We enjoyed doing the work, we hope others enjoy reading about it.

DAVID G. MAYES
CLIVE S. NICHOLAS

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1 Introduction

The major reform of the corporation tax system implemented in the 1984 Finance Act has radically altered the economics of equipment leasing in the UK. Fundamental changes in capital allowances and corporation tax have not only given rise to considerable discussion about the future of leasing as a source of asset finance, but have also focused attention on its past role in the economy.

Since the early 1970s there has been a remarkably rapid expansion in the use of leasing by firms to finance capital expenditure. Accompanying this growth has been the development of an extensive and specialised leasing industry which has become an increasingly significant source of capital formation. Assets leased to manufacturers by companies in the financial sector increased sixfold in real terms over the decade 1972 to 1982 (from £160 million to £1014 million in constant 1980 prices), and rose from 2.5 per cent to 18.5 per cent as a proportion of total manufacturing investment.[1]

1.1 THE ROLE OF TAX INCENTIVES

The rapid growth of leasing has been significantly influenced by the system of tax investment incentives based on capital allowances. These are intended to encourage investment by increasing the after-tax rate of return to the firm. They permit firms to offset their capital expenditure against their taxable profits thereby reducing their corporation tax liability. This cuts costs and improves cash flow in the period immediately after making the investment, thus aiding the firm in the difficult period between incurring the cost of investment and receiving the profits it is designed to generate. Clearly if there are insufficient taxable profits to utilise available capital allowances immediately, particularly in periods of high inflation, the tax benefit will be lower and will fall further in value the longer it has to be postponed.

During the 1970s an increasing number of firms, especially in the manufacturing sector, accumulated tax allowances greater than profits. Several factors were responsible for this. On the one hand, the introduction of the 100 per cent allowance for plant and machinery which offset the entire cost of the investment against tax in the first year together with other concessions, such as that for stock relief, increased the allowances available as inflation rose. On the other hand, a general downturn in profitability decreased the sum against which they could be offset. In these conditions firms had no corporation tax liability and, because they could carry forward unused allowances to offset against future profits, were likely to remain in this position of 'tax exhaustion' for a considerable period.

However, not all firms in the economy experienced tax exhaustion. Others, especially those in the financial sector which had not been adversely affected by inflation and high interest rates in the same way, had maintained profitability and therefore had the profits, or 'taxable capacity', against which capital allowances could be offset.

Leasing provided a solution to this imbalance. Firms with taxable capacity, principally in the financial sector, were able to purchase assets and lease them out to firms in other sectors. By so doing both were able to benefit from the tax advantages of capital allowances in some proportion. The effect of claiming capital allowances on such assets was to defer tax liability for the financial firm. This tax benefit was passed on in part to the user in the form of lease payments which were lower than the equivalent payments for borrowing the money for investment. The lessor retained the remainder of the benefit for its own profit. Therefore, by leasing, tax-exhausted firms were able to capture much of the benefit of capital allowances in the form of asset finance which was effectively lower in cost than other types of finance.

The phasing out of first-year capital allowances and the move to a standard 25 per cent writing down allowance on investment in plant and machinery, resulting from the 1984 Finance Act, has serious implications for leasing. The removal of these allowances will make leasing more expensive and will generally increase the cost of capital to firms. Against this there is a simultaneous reduction in the rate of corporation tax which will reduce the tax liability of those firms which are not tax exhausted. The picture is therefore complex. Some firms with high profits, which would not have been tax exhausted in any case, will now have lower tax bills because of the lower allowances, and firms which would have been tax exhausted will not now be able to obtain the use of further assets through leasing at such cheap rates as before, nor will financial firms with taxable capacity be able to reduce their own tax liabilities or offer such favourable leasing rates as previously. It is largely against this background that the present study has been undertaken.

1.2 THE MOTIVATION FOR THE STUDY

Although the substantial increase in the use of leasing since the early 1970s has led to a growing academic and professional interest in this form of finance, until now much of the existing study of the subject has been primarily concerned with leasing as a financial decision-making problem from the perspective of the individual user firm or analysis of the working and structure of the leasing industry.[2] Little attention has as yet been given specifically to the wider examination of the impact of the growth of leasing on the economy as a whole and, in particular, to its possible effects on investment.[3] Undoubtedly part of the increased use of leasing by firms has arisen from displacement of other sources of finance but there is prima facie evidence to indicate that leasing may actually have directly influenced levels of capital expenditure in the economy. During the late 1970s and early 1980s actual investment including leased assets, especially in the manufacturing sector, maintained a higher level than forecast by some econometric models. This suggests that leasing might play a role in investment behaviour above that of simply providing an alternative source of finance to firms. It may result in more investment and hence in a faster rate of economic growth and higher income per head. The purpose of our study has therefore been to determine the nature of this relationship, namely, the effects of leasing on the investment behaviour of firms and its macroeconomic implications.

1.3 THE NATURE OF LEASING

Today leasing is used to describe transactions ranging from the short-term hire of a motor vehicle to the renting of major items of oil extraction and processing plant and equipment. Despite the wide diversity of leasing activity, the basic concept is in fact very simple. In return for specified payments (rentals) the owner of an asset (the lessor) grants exclusive use of it for an agreed period to the hirer (the lessee). Leasing is thus a method of financing the use of an asset without actually purchasing it. The fundamental characteristic of a leasing agreement is the division of the use and ownership of an asset into distinct legal and economic activities. Under existing UK legislation the lessor remains legal owner whilst the lessee has right to economic use providing that the terms of the agreement are maintained.[4] Unlike the practice in some other countries an option for the lessee to purchase the leased asset may not be given.[5] This distinction is very important for it is this which makes leasing a unique form of financial instrument and from which the economic effects of leasing are largely generated. If ownership could be transferred then leasing would be largely indistinguishable from hire purchase and the benefits of capital allowances would not accrue to the lessor.

It is now common in the leasing industry to structure leasing agreements to suit the particular requirements of the lessor and lessee with the result that many forms of agreement exist. However, it is generally accepted that leases may be broadly divided into two broad categories – finance leases and operating leases. Finance leasing and operating leasing differ widely both in practice and in underlying economic rationale.

1.3.1 Finance Leasing

In finance leasing the role of the lessor is principally limited to the provision of finance to enable the firm to obtain the use of an asset. It is therefore carried out mainly by financial institutions, such as banks and their leasing subsidiaries, although in recent years large companies outside the financial sector have engaged in finance leasing when they had taxable capacity. The initial investment decision to acquire an asset and the choice of supplier are made by the lessee. The asset is purchased by the lessor. Rentals in the leasing agreements are calculated to allow the lessor to recover the cost of the asset and to make a profit. Payments are spread over a primary period which does not extend beyond the useful life of the asset and hence the residual value at the end of this period is not of significance to the lessor. However, it is important to the lessor that the lease is not terminated before the primary period is completed as many assets do not have a ready resale market nor clearly determinable resale value. Finance leases therefore tend to include quite heavy penalties for early cancellation to try to avoid encountering these difficulties or costs. At the end of the primary period the asset may be sold to a third party, in which case the lessee receives a major proportion of the sale proceeds as a 'rebate of rentals', or a secondary period of leasing may be agreed with nominal rentals. Throughout the lease, insurance and maintenance are the responsibility of the lessee. A finance lease in effect 'transfers substantially all the risks and rewards of ownership of an asset to the lessee'[6] and, although legal ownership remains with the lessor, is similar to purchase using other forms of instalment debt.

1.3.2 Operating Leasing

Operating leasing is very different. It is concerned with the provision of a complete service to the lessee rather than simply a financial arrangement. Operating lessors are typically specialists in the types of asset they lease out and possess a detailed knowledge of equipment and equipment markets. The asset is purchased, maintained and insured by the lessor who will often hold stocks of such assets. Unlike finance leasing, the lessor does not recover the asset cost over a single lease period. Profit may derive from leasing the asset over a number of relatively short periods to successive lessees, from ancilliary arrangements (such as service contracts), or from the sale of the asset. The residual value of the asset is consequently of considerable importance and, because of the alternatives of re-leasing or selling available to the lessor, an operating lease is not normally difficult to cancel. While a finance lease effectively transfers the risks and rewards of ownership to the lessee, with an operating lease these risks, especially obsolescence, are borne by the lessor. Operating leasing is therefore widely used in relation to assets such as computers where technological development is rapid.

Although a clear distinction has been drawn between operating leasing and finance leasing, in practice many leasing contracts contain elements of both forms and are not easily categorised. Nevertheless, the distinction is of significance for, as the descriptions of finance leasing and operating leasing imply, different types of leasing may be used for varying reasons and not all forms of leasing will have precisely the same effects on investment.

1.4 WHY FIRMS LEASE

At the microeconomic level, the effects of leasing on investment behaviour will be largely influenced by the underlying reasons why firms decide to use this method of finance. Leasing presents a range of advantages to the firm and it might be expected that the reasons firms use leasing will tend to vary widely depending on the particular conditions experienced by the individual firm when the decision to lease is made.

The advantages generally attributed to leasing include:

1. An Additional Source of Finance

It finances the use of an asset without using existing resources. A leasing agreement can cover the full cost of an asset and payment is spread over a period so avoiding lump sum expenditure. Existing resources are conserved which may be utilised for other purposes and cash flow advantages arise.

2. Lower Cost

If a firm has insufficient taxable profits to be able to absorb capital allowances immediately, leasing provides a mechanism for recovering part of the benefit in the form of reduced rental payments. This can effectively lower the cost of finance to the firm and enables it to gain from investment tax incentives which otherwise might be eroded in value or ultimately forgone.

3. Reductions in Risk

Certain risks may be reduced through the use of leasing. An operating lease, for example, transfers the risks of ownership such as technological obsolescence away from the firm to the lessor. Leasing can also form a hedge against inflationary increases in the cost of capital assets by enabling the firm to acquire the use of an asset with rentals based on current costs and to fund such rental payments from future and possibly inflated earnings.

4. Longer-term Finance

Large sums of finance for sizeable investment programmes, such as those encountered in the oil industry, can be raised over relatively long terms through leasing which may not be forthcoming from other sources. Financial institutions may prefer to fund by leasing secured on specific assets rather than by other forms of lending.

5. Improved Portfolio Balance

Leasing is an alternative source of finance to the firm and can assist in forming a balance of funding between various forms of funding operations. It is also commonly held that leasing can increase the debt capacity of the firm.

6. Ease and Flexibility

Compared with other sources of finance, leasing is often easier to arrange and the form of agreement can be very flexible. Payment of rentals may be structured to meet revenue patterns which can be beneficial to cash flow.

7. Off-balance Sheet

Although changes have been announced in the publication of 'Statement of Standard Accounting Practice No. 21' (SSAP 21), in August 1984, concerning the disclosure of finance leases in the accounts of the lessee, leasing has been considered an off-balance sheet form of finance which does not affect balance sheet gearing ratios.

8. Avoids Controls

It can provide finance which may not be available from other sources as a result of institutional factors. In periods of strict credit control, leasing may be exempt from regulation or there may simply exist a shortage of medium-term finance from financial institutions.

9. Fixed Agreement

Leasing is a fixed form of agreement which can ease administration, budgetary accuracy and cash flow forecasting.

10. Revenue Not Capital Account Transaction

Leasing rentals are met from revenue and so it is possible to avoid capital expenditure limits or borrowing restrictions.

Each of these advantages may to varying degrees have an effect on the investment behaviour of firms. The decision to invest is likely to be influenced by a range of internal and external factors relating not only to past and present conditions but also to expectations of the future. Furthermore, the firm does not normally operate in what would be described as a 'free market' but faces financial, organisational and technological constraints which will affect the investment process and the volume of investment undertaken. These include the structure of existing assets and liabilities, operating limits laid down by principal creditors, capital expenditure limits, indivisability of large capital items and the need for compatibility with existing plant and machinery. Leasing presents a further option to the decision-maker when considering investment opportunities, and as such may enable investment to occur that might not otherwise have taken place or may enable the timing of the investment decision to be brought forward.

Advantages such as the avoidance of lump sum expenditure, convenience and flexibility can facilitate the investment process. Although some of these factors appear to be minor and may perhaps arguably apply rather more to the small rather than large firm, their cumulative effects on investment may be significant.

Whilst it is true that the influence of financial variables upon investment has been the subject of considerable debate and conflicting evidence,[7] it remains arguable that both the availability and the cost of finance may have an effect on investment.

Leasing is an additional source of finance which may assist in the optimal use of available funds by the firm. More efficient use of finance could imply increased investment. Leasing will also influence investment behaviour if funds are not available from other sources. A general shortage of medium-term finance or indeed reluctance on the part of financial institutions to fund large projects through other forms of finance are widely reported examples of such market imperfections.

However, there is a further aspect of leasing in relation to the availability of finance which arises from its effects upon the debt capacity of the firm. In theory, leasing and debt are held to be equivalent and consequently leasing will displace debt on a 'pound for pound' basis. Given the existence of an optimal capital structure of debt to equity for the firm and limits on the willingness of lenders to provide finance above certain levels of risk, it should be the case that leasing cannot increase the debt capacity of the firm. Nevertheless, this does not appear to be the case in practice. Previous surveys of lessee behaviour have found a large number of instances where leasing is an additional source which can increase the level of finance available to the firm.[8]

Several reasons have been put forward to explain this apparent inconsistency.[9] Potential lenders may have imperfect knowledge of the leasing commitments of firms and therefore be willing to extend credit. Prior to the introduction of SSAP 21 there was no obligation on the part of lessees to disclose leasing agreements in their published accounts, and leasing had long been considered an 'off-balance sheet' form of finance. However, given the growth of leasing in the UK and accounting recommendations before SSAP 21, it seems unlikely that lenders would ignore leasing completely.

Nevertheless, the anomaly has persisted. An alternative explanation might be found in the suggestion that leasing involves less risk than other forms of finance, as the asset may be more easily recovered if the lessee defaults and therefore lessors might be willing to 'lend' more than would be the case with other types of finance. A further possibility is that leasing would be expected to increase debt capacity if no optimal debt–equity structure exists. Each of these explanations is open to question and yet in practice leasing does appear to be utilised to expand debt capacity. In situations where borrowing limits have been reached firms tend to regard leasing as a further source of finance.

Leasing has also influenced the cost of finance to the firm. As mentioned earlier, tax considerations have played a major part in the growth of leasing. In addition to the capture of unused capital allowances already described, it is possible for a firm to bring forward the benefits of capital allowances by using a lessor with an earlier year end than its own. If leasing results in the reduction of the cost of finance then it may increase the level of investment.

1.5 MACROECONOMIC EFFECTS

At the macroeconomic level, leasing may have had a significant effect on the level and timing of investment. As we have seen, leasing was in part a response to distortions in the system of taxation and investment incentives. Since it effectively reduced the cost of finance to non-taxpaying firms it may have stimulated investment. By raising the level of investment in recessionary periods when conditions of declining profitability might be expected to be encountered, leasing may also act in a counter-cyclical manner by allowing investment to be brought forward.

The gains from this change in timing may be very important to the economy both in counteracting the effects of the traditional trade cycle and in counteracting some of the factors of recent tight monetary policy most harmful to economic growth. In the first case, the appropriate timing for investment expenditure by firms during the