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United States Federal Tax Policy Surrounding The Investment Tax Credit: A Review of Legislative Intent and Empirical Research Findings Over Thirty Years (1962-1991)

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UNITED STATES FEDERAL TAX POLICY SURROUNDING THE INVESTMENT TAX CREDIT: A REVIEW OF LEGISLATIVE INTENT AND EMPIRICAL RESEARCH FINDINGS OVER THIRTY YEARS (1962-1991)*

by

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INTRODUCTION

Congress enacts tax legislation amidst numerous concerns beyond mere revenue raising. Significant congressional tax policy consideration is conferred upon social objectives, equity concerns, administrative matters, and macro-economic goals. Within the purview of macro-economic goals can be found federal tax policy relating to investments in fixed assets — which assets are depreciable, the allowable depreciation methods, depreciable lives, and the investment tax credit. Federal tax policy concerning the investment tax credit (ITC) is the topic of this article.[1]

First proposed and legislated during the administration of President Kennedy, the ITC was designed as a method for spurring expansion and modernization of the nation's productive facilities.[2] Although originally foreseen as a permanent component of federal tax law,[3] it has been far from immutable. Since its original enactment (1962),[4] the credit has been suspended (1966),[5]

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1 The ITC is a nonrefundable reduction in a taxpayer's federal tax bill granted for undertaking certain fixed asset investment behavior deemed desirable by Congress. For example, if a firm invested in a $100,000 piece of machinery qualifying for an ITC of ten percent, the firm could reduce its tax bill in the year of acquisition by an amount equal to $10,000. Additionally, if the earned ITC is not fully utilized in the current year, any unused portion may operate, under extensive carryover rules, to provide a refund for past income taxes paid and/or a decrease in amounts due under future tax returns.

2 Special Message to the Congress: Program for Economic Growth and Recovery, 1967 PUB. PAPERS 41, 51.

3 Joel Barlow, *Effects of the Investment Credit and Depreciation Allowances on Business Expansion*, 1967 NAT'L TAX ASSOC. — PROCEEDINGS 139, 145.

4 Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 960 (1962) (codified as amended in scattered sections of 26 U.S.C.).

5 Pub. L. No. 89-800, 80 Stat. 1508 (1966) (as amended by Pub. L. No. 90-26, 81 Stat. 57 (1967)).

reinstated (1967),[6] repealed (1969),[7] and reincarnated (1971);[8] the rate of credit has been increased (1975)[9] and effectively increased (1981);[10] and, most recently, it was repealed for a second time (1986).[11] Further, in a continuation of this time-honored tradition of change, President Bush proposed legislation calling for a new and enhanced version of the venerable ITC.[12] The diverse explanations for such an on-again, off-again history run the gamut from the simple (push-pull of the political process) to the complex (a perceived desirable/undesirable relationship with inflation). Yet, throughout all the varying rationales, subsuming all manner of reasoning, flows the notion that Congress and the President discern some favorable macro-economic benefits from ongoing alterations in this tax policy.

The massive Tax Reform Act of 1986,[13] which encompasses the latest legislative modification to ITC policy (repeal), left intact the statutory ITC framework.[14] The primary rationale for this action appears related to non-repeal of the historic buildings tax credit.[15] However, the existence of this framework allows one to speculate upon the future of the ITC. Given an ITC framework and past congressional behavior, can it be long before the ITC returns as an active federal tax policy? In that event, is a subsequent repeal or suspension an unlikely possibility? If the past is an indicator of the future, ITC policy will remain an issue for debate, discussion, and legislative action. Therefore, an historical exposition of prior legislative intent and empirical research findings over thirty years of varying tax policy choices is important as a means for facilitating future consideration and evaluation of ITC policy options.

The remainder of this article is organized as follows: First, a brief description of the ITC framework is offered; second, the ITC is chronicled from its ideological foundations in the 1950s through repeal under the Tax Reform Act of 1986[16] in order to gain an historical perspective on legislative intent; third, significant empirical studies concerning ITC effectiveness in modifying targeted investment behavior are reviewed; and last, conclusions are tendered in support of

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6 Pub. L. No. 90-26, 81 Stat. 57 (1967).

7 Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 (1969) (codified as amended in scattered sections of 26 U.S.C.) [Hereinafter *Reform Act of 1969*].

8 Revenue Act of 1971, Pub. L. No. 92-178, 85 Stat. 497 (1971) (codified as amended in scattered sections of 26 U.S.C.) [Hereinafter *Revenue Act of 1971*].

9 Tax Reduction Act of 1975, Pub. L. No. 94-12, 89 Stat. 26 (1975) (codified as amended in scattered sections of 26 U.S.C.) [Hereinafter *Tax Reduction Act of 1975*].

10 Economic Recovery Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (1981) (codified as amended in scattered sections of 26 U.S.C.) [Hereinafter *Recovery Act of 1981*].

11 Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986) (codified as amended in scattered sections of 26 U.S.C.) [Hereinafter *Reform Act of 1986*].

12 Address Before a Joint Session of the Congress on the State of the Union, 28 WEEKLY COMP. PRES. DOC. 173 (Jan. 28, 1992).

13 *Reform Act of 1986, supra* note 11.

14 I.R.C. §§ 38, 46-49 (West 1988).

15 I.R.C. § 46(a)(3) (West 1988).

16 *Reform Act of 1986, supra* note 11.

the ITC as an effective incentive that should have a significant role in future tax policy.

FEDERAL INVESTMENT TAX CREDIT

The ITC was developed to stimulate economic development and facilitate stability by way of capital construction.

> The investment tax credit is, in effect, a subsidy provided by the Federal Government through the tax system to encourage investment activity. As such, the investment tax credit involves the transfer of funds from the Government to the private sector. The Government does not send a check to the business firm reimbursing it for a portion of its capital investment, but the Treasury Department does forego some of the revenue that it otherwise would have collected. This foregone revenue represents the cost of the programs. The benefits are the investment expenditures required to achieve the short-run stability and long-run growth.[17]

Simply stated, the ITC is a tax reward mechanism developed to encourage sectors of the economy which are perceived to be in need of additional capital by permitting taxpayers to drastically reduce or eliminate their income tax liabilities as remuneration for participating in targeted business investments.

Targeted investment activities are designated in the statutory framework of the Internal Revenue Code wherein a taxonomy of three credits may be found: regular, rehabilitation, and energy. The first credit is granted for expenditures on depreciable personalty (e.g., cars, computers, furniture, office equipment, and production machinery).[18] Urban recovery and the restoration of older buildings are emphasized with the second credit.[19] The third credit encourages alternative energy sources such as solar, wind, geothermal, biomass, and ocean thermal.[20] In order to limit the scope of this research, this article is confined to the effectiveness of the regular ITC.

Two rationales underlie a normative belief concerning ITC effectiveness: (1) Reducing one's income tax liability is, by itself, quite appealing, and (2) allowance of a tax reduction effectively adds economic viability to an investment by lessening the aggregate expenditure and increasing the rate of return. In a logical sense, if the incentive is satisfactory, taxpayers can be expected to respond in a positive manner.

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17 COMPTROLLER GENERAL OF THE UNITED STATES, U.S. GENERAL ACCOUNTING OFFICE No. PAD-78-40, INVESTMENT TAX CREDIT: UNRESOLVED ISSUES 2 (1978).

18 I.R.C. § 46(a)(1) (West 1988).

19 I.R.C. § 46(a)(3) (West 1988).

20 I.R.C. § 46(a)(2) (West 1988).

At the same time, the repeal of a previously allowed credit, a policy counter to enactment, would be expected to foreshadow a decrease in targeted investments.

CHRONOLOGICAL HISTORY AND PERSPECTIVE[21]

An examination of the prismatic, discordant history of the ITC proves helpful in eliciting an understanding of its nature as an investment incentive and the legislative intent leading to enactments of the various policy choices. Further, analysis of the divergent rationales offered in support of enactment, reenactment, rate changes, and repeals sheds light on the perceived effects of the various ITC policies, thus facilitating a more insightful interpretation of empirical research findings.

Economic Foundations

During the 1950s, the United States economy began to awaken from the economic euphoria generated by the abundant consumer demand which followed World War II. The unpleasant realities of economic stagnation became pervasive, proving wholly unsettling to United States economic mavens.

> It was generally recognized by economists, government planners, and other concerned individuals that the United States had to do something to make its industrial capacity and output more efficient and more competitive.... It was feared that unless the competitive position were to improve, demand would increasingly be supplied by foreign producers.... Therefore, because of the low level of domestic demand, lagging employment, and accelerated growth in foreign countries, a sense of urgency existed calling for an increase in the rates of growth and investment.[22]

While many people eloquently argued the need for investment stimuli, one author, E. Cary Brown, suggested a potentially promising catalyst for increased investment growth. Brown elucidated the notion of a tax credit for investment as a stimulus alternative to accelerated depreciation in a report to the Subcommittee on Tax Policy of the Joint Committee on the Economic Report in 1955.[23] At the

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[21] For a comprehensive historical summary of the legislative process concerning the ITC from 1945 through 1977, see Clyde L. Posey, An Historical Analysis of the Events Leading to the Establishment of the Investment Tax Credit and Its Modificaiton through June 30, 1977 (1978) (unpublished Ph.D. dissertation, Oklahoma State University).

[22] David M. Maloney, A Study of the Association of the Inventment Tax Credit with Investment Spending 24 (1984) (unpublished Ph.D. dissertation, University of Illinois at Urbana-Champaign).

[23] STAFF OF THE JOINT COMM. ON THE ECONOMIC REP., 84th Cong., 1st Sess. FEDERAL TAX POLICY FOR ECONOMIC GROWTH AND STABILITY 495 (JOINT COMM. PRINT 1955). (Compellation of papers submitted by panelists appearing before the subcommittee on Tax Policy).

time, the ITC idea was novel although not original, some argue, as a similar tax credit had been adopted in Belgium in 1954.[24]

Policy Recommendation

The concept of an ITC saw fruition during the earliest days of the Kennedy Administration. Assistant Secretary of the Treasury, Stanley S. Surrey, advocated the credit as an investment incentive in a tax policy report presented to the newly-elected President prior to his inauguration.[25] President Kennedy endorsed the concept in a message presented to the Congress on February 2, 1961[26] and, subsequently, incorporated a rather complex, three-tiered ITC recommendation in his proposal for tax reform delivered to Congress on April 20, 1961.[27]

Legislative Convocations

Congressional hearings in regard to the President's tax proposal were convened during mid-1961. Proponents of the incentive advanced arguments that vested the ITC as a pathway to increased economic growth and investment.[28] Opponents argued a pressing need for depreciation reform, economic discrimination, complexity, uncertainty concerning tenure and rate, discriminatory exclusion of certain groups (particularly utilities), and last, though certainly not least, the lack of a Treasury Department monograph in support of the premise advanced by the ITC concept.[29]

Two of the opposition arguments demanded resolution if the ITC was to emerge — depreciation reform and complexity. To resolve the former issue and placate depreciation reform advocates, the Administration issued recommendations supporting extensive depreciation revisions.[30] The complexity issue was settled by House committee substitution of a flat rate credit.[31] Removal of these two significant barriers paved the way for a tax bill containing provisions enacting an ITC to clear the House Ways and Means Committee on March 12, 1962.[32]

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24 William H. White, *Illusions in the Marginal Investment Subsidy*, 15 NATL TAX J. 26 (1962).
25 *Posey, supra* note 21, at 47.
26 Special Message to the Congress: Program for Economic Growth and Recovery, *supra* note 2, at 51.
27 Special Message to the Congress on Taxation, 1961 PUB. PAPERS 290, 292.
28 Posey, *supra* note 21, at 46, 56-57.
29 *Id.* at 47-52.
30 *Id.* at 54.
31 *Congress Enacts Major Tax Law Revisions*, 18 CONG. Q. ALMANAC 478 (1962).
32 H.R. 10650, 87th Cong., 2d Sess. (1962).

Enactment: January 1, 1962

Following extensive debate and requisite modifications, the ITC became law on October 16, 1962, with passage of the Revenue Act of 1962.[33] The allowable credit was seven percent (three percent for most public utilities) of the cost of qualifying assets acquired after January 1, 1962.[34] The full credit was available for qualifying assets with depreciable lives of at least eight years,[35] while a reduced credit was allowed for qualifying assets with useful lives of four to eight years.[36] On the negative side, the "Long Amendment"[37] required a reduction to the depreciable basis of qualifying assets by an amount equal to the potential ITC.[38]

The ITC gained expanded legislative and administrative support after its enactment. First, the legislature enacted the Revenue Act of 1964[39] repealing the onerous requirements of the "Long Amendment." Second, the Treasury Department reacted to the perceived success of the ITC by attempting to extend the concept into several other arenas, most notably, investments in certain underdeveloped countries.[40]

Suspension: October 10, 1966

United States military involvement in the Vietnam War expanded throughout 1965 and 1966, culminating in aggravated inflationary pressures within the United States economy. A new course of action in federal tax policy was indicated. In response, Congress enacted the Investment Credit and Accelerated Depreciation Suspension Act of 1966[41] suspending the ITC from October 10, 1966, to December 31, 1967.[42]

> The purpose here, of course, is not so much to raise revenue as to moderate the economy to a more sustainable level of growth. In other words, we are trying to build new plants and machine tools —

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33 *Revenue Act of 1962*, *supra* note 4. Pub. L. No. 87-834.

34 *Id.* § 2(b)(46)(a)(1), 76 Stat. 960, 962.

35 *Id.* § 2(b)(46)(c)(2), 76 Stat. 960, 962.

36 *Id.*

37 Robert D. Novak, *Senate Panel Votes Tax Revisions, But Bill Is Far From Kennedy Bill,* WALL ST. J., Aug. 1, 1962, at 3. The "Long Amendment" required taxpayers to reduce their depreciable basis in assets qualifying for the ITC by an amount equal to the credit claimed. The direct consequences of this adjustment are two-fold: (1) smaller aggregate depreciation deductions throughout an asset's life lowers the tax benefit derived from the ITC by a taxpayer and (2) fewer depreciation deductions facilitates lower estimates of lost revenue anticipated to accompany enactment of an ITC (of considerable interest to and motivation for Senator Long).

38 *Revenue Act of 1962*, *supra* note 4, § 4(b)(48)(g)(1).

39 Revenue Act of 1964, Pub. L. No. 88-272, 78 Stat. 19 (1964) (codified as amended in scattered sections of 26 U.S.C.).

40 Robert Metz, *Treasury Plans Tax Incentives to Spur Foreign Investment,* N.Y. TIMES, Sept. 22, 1964, at 51; *U.S. Tax Treaty With India Has 7% Investment Credit,* N.Y. TIMES, Apr. 1, 1965, at 51.

41 Pub. L. No. 89-800, 80 Stat. 1508 (1966) (as amended by Pub. L. No. 90-26, 81 Stat. 57 (1967)).

42 *Id.* § 1(a). Pub. L. No. 89-800 § 1(a), 80 Stat. 1508-09.

> and acquire them from abroad, as well as from within this country — at too rapid a rate at this time.[43]

However, substantially decreased investment expenditures in certain industries (e.g., railroads) during the early months of suspension resulted in an early termination of the suspension on March 10, 1967.[44]

First Repeal: April 21, 1969

Forces opposed to the ITC gathered momentum during the early days of 1969. They portrayed the credit as primarily responsible for inflation or, worse yet, as merely a tax loophole. Congressman Reuss, in a speech delivered to the House entitled "One of the Best Ways to Fight Inflation and Plug Tax Loopholes: Repeal the Seven Percent Investment Tax Credit," stated:

> An economic analysis of the investment credit will, I am convinced, prove that it contributes to instability in the long term as well as in the short; that it may very well encourage the export of capital; and that it encourages inflationary potentials of the economy whenever the economy tends to approach high employment levels as in recent years.[45]

Representative Vanik added his support for repeal of the ITC by proclaiming: "The seven percent investment credit is the most troublesome tax loophole in existence today. There is no better way to 'modify the inflationary psychology' of which the President complains."[46]

President Nixon, apparently in agreement with the views of these members of Congress, as well as others, recommended a permanent repeal of the ITC on April 21, 1969.[47] The President's support was unconditional although it was certainly politically interwoven with his desire to abrogate the surtax in effect at that time.[48] His recommendation would become reality as part of the Tax Reform Act of 1969[49] signed into law on December 30, 1969.

The remarks of two influential Congressmen, each on opposite ends of this argument, provide insight. Representative Patman, Chairman of the Joint Economic Committee, on why this committee supported repeal, declared:

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43 112 CONG. REC. 26850, 26853 (1966) (statement of Sen. Long).
44 Pub. L. No. 90-26 § 1, 81 Stat. 57-58 (1967).
45 115 CONG. REC. 1821-22 (1969).
46 115 CONG. REC. 8505 (1969).
47 Special Message to the Congress on Reform of the Federal Tax System, 1969 PUB. PAPERS 310, 312.
48 *Id.* at 313.
49 Reform Act of 1969, *supra* note 7.

> First. The rate of expenditure on plant and equipment is and has been excessive. In the face of a sharply lower operating rate of less than 84 percent in manufacturing, business has reported plans for increasing investment outlays this year by 13 to 14 percent. Even more is planned for 1970-72, according to the McGraw-Hill survey.
>
> Second. The investment tax credit promotes the business cycle, encouraging larger swings in activity instead of damping down fluctuations as good tax policy should.
>
> Third. The credit distorts business incentives, encouraging investment in lower paying projects which business should not be undertaking either from the standpoint of its own long-term rate of return on capital or from the social viewpoint of encouraging a high productivity economy.
>
> Fourth. The investment tax credit tends to promote inflation since it encourages excessive investment in boom years and then requires that additional demand stimulus be provided in the resulting recessions if unemployment is to be cured.
>
> Fifth. Business has an adequate flow of funds to finance its investments even without this credit, hence this device may be causing excess funds to flow abroad, worsening the balance of payments.
>
> Sixth. At a time when . . . we face extension of the 10 percent surtax, the investment tax credit costs the Treasury a revenue loss of at least $3 billion per year.
>
> Seventh. The investment tax credit is very discriminatory and if the time ever comes that a demand stimulus is needed again, the appropriate course would be a tax cut for consumers.[50]

Congressman Ullman, a future Chairman of the House Ways and Means Committee, in opposition to ITC repeal, foreshadowed a subsequent reenactment when he stated:

> [W]e are making a very sad mistake today by repealing the investment tax credit. The investment tax credit is not a tax loophole.

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[50] 115 CONG. REC. 13286-87 (1969).

> On the contrary, if you will recall when we instituted the investment tax credit, it was a tax reform measure. It was designed to bring growth into a stagnant economy. It was designed to gain revenue and not to lose revenue. *I predict it is not going to be very many months before we will very desperately need the investment tax credit.*
>
> When you are voting for this bill, you are voting to repeal . . . one of the finest vehicles for growth . . . ever invented in the American economy.[51]

Reenactment: August 15, 1971

Representative Ullman is deserving of the highest marks as a tax policy prognosticator. The ITC, like the mythical Arabian phoenix, would ascend from the charred ashes of its Congressional funeral pyre. President Nixon provided the needed legislative catalyst on August 15, 1971, by proposing enactment of a "jobs development credit."[52] The name was new; however, the concept was, without a doubt, the venerable ITC — an incentive to "invest in new machinery and equipment that will create new jobs for Americans."[53]

Tax hearings were assembled in both bodies of Congress. The testimony presented, both for and against the proposed reenactment, was for the most part old, repetitive, and all too familiar. In light of this lack of fresh evidence, the wisdom of convening these forums, and in particular, redundant forums, is open to question. Yet, for better or worse, the views of all concerned parties must be aired. Clearly, future policy changes involving the ITC, whether suspension, repeal, rate change, or reenactment, will not be spared an analogous procedure.

Following its hearings, the House Ways and Means Committee reported legislation containing a jobs development credit to the floor.[54] The accompanying report offered three reasons in support of the credit. It would:

(1) create jobs by encouraging expenditures on machinery and equipment.
(2) combat inflation by increasing the flow of goods into the marketplace.

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51 115 CONG. REC. 17799 (1969).
52 Address to the Nation Outlining a New Economic Policy: "The Challenge of Peace," PUB. PAPERS 886-87 (Aug. 15, 1971).
53 *Id.* at 887.
54 *Revenue Act of 1971, supra* note 8.

(3) have a positive influence on the balance of payments.[55]

Significantly, Item 2 purports a position contrary to that advocated as the principal reason supporting ITC repeal in 1969. In a similar fashion, the Senate Finance Committee concluded that the credit:

> should be restored as a means of providing stimulus to the lagging domestic economy by reducing the cost of capital to U. S. manufacturers. This [would] also serve to place them in a more competitive position with foreign manufacturers and in that manner [would] help improve our present serious balance-of-payments situation.[56]

With President Nixon's backing,[57] and considerable legislative support, the jobs development credit became law with passage of the Revenue Act of 1971.[58]

Rate Increase: January 21, 1975

The three years preceding 1975 witnessed an agreeable lull in legislative activity surrounding the ITC. During 1972, with the Democratic platform advocating repeal of the ITC, President Nixon, a supporter of the ITC concept, soared to an overwhelming re-election victory. Shortly thereafter, the President, the American people, and the world were overcome by the disgraceful, senseless crimes known as Watergate. A legislative catalepsy ensued with little meaningful government business transpiring during 1973 and 1974.

In 1975, as the United States emerged from the depths of Watergate, it entered a period of unprecedented economic upheaval. Inflation and the policies of OPEC undermined the very fabric of the American economic system. In this corrosive atmosphere, President Ford proposed increasing the statutory ITC rate to 12 percent.[59] Congress responded by introducing a plethora of ITC rate change

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55 H.R. REP. NO. 533, 92d Cong., 1st Sess., *reprinted in* 1971 U.S.C.C.A.N. 1825.

56 S. REP. NO. 437, 92d Cong., 1st Sess., *reprinted in* 1971 U.S.C.C.A.N. 1918, 1931.

57 President Nixon's support for ITC enactment in 1971 was directly opposed to his desire for repeal in 1969. Yet, in each situation, he appeared merely to follow the politically appropriate course. In the first instance, as a newly elected Republican president, with a platform advocating an end to the Vietnam War, perhaps he saw his support for repeal as an action that would not alienate the Democratic majority in Congress who strongly desired repeal and whose support he needed for his war efforts and tax reforms (in particular, removal of the income tax surtax in effect at that time). In the second instance, with the recession of 1971, continuing war efforts, and an election in the near future, perhaps he viewed support for ITC reenactment, especially if it had a different name, the jobs development credit, as the politically astute course of action.

58 *Revenue Act of 1971*, *supra* note 8.

59 Address to the Nation on Energy and Economic Programs, 1975 PUB. PAPERS 30, 32; Address Before a Joint Session of the Congress Reporting on the State of the Union, 1975 PUB. PAPERS 36, 37-38.

bills;[60] however, the legislators seemed, for the most part, to support a smaller increase in the ITC rate.

Representative Ullman, Chairman of the House Ways and Means Committee, authored a bill recommending an increase in the ITC rate to ten percent.[61] This bill would become the forerunner to three significant legislative enactments regarding the ITC rate structure. First, as a temporary measure, the Tax Reduction Act of 1975[62] increased the rate to ten percent;[63] next, the temporary increase was extended in the Tax Reform Act of 1976;[64] and last, codification of a permanent ten percent rate occurred in the Revenue Act of 1978.[65] The House Ways and Means Committee report concerning the Tax Reform Act of 1976 stated:

> The temporary liberalization of the investment tax credit provided by the 1975 Tax Reduction Act was adopted for two reasons. First, encouraging investment in new equipment, and modernization of existing facilities was thought to improve the long-run ability of the economy to achieve economic growth without inflationary pressure. Second, increasing aggregate demand in the short-run was considered to be an important part of the program for recovery from the worst recession in more than two decades.
>
> Since the beginning of 1975, investment plans have been repeatedly reduced, and planned expenditures in new plant and equipment are expected to be 10 percent lower in 1975 as compared to 1974. Because of the need to provide greater certainty to investors about the availability of the credit in the future, and the need to provide a continuing stimulus to the economy, the 10 percent investment tax credit was extended four additional years.[66]

Under parallel rationales, Congress deemed it prudent to make the higher ITC rate permanent.[67]

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60 Posey, *supra* note 21, at 171.

61 H.R. 3148, 94th Cong., 1st Sess. (1975).

62 *Tax Reduction Act of 1975, supra* note 9.

63 Pub. L. No. 94-12 § 301, 89 Stat. 26-27.

64 Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (1976) (codified as amended in scattered sections of 26 U.S.C.).

65 Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763 (1978) (codified as amended in scattered sections of 26 U.S.C.).

66 H.R. REP. NO. 658, 94th Cong., 2d Sess. 188, *reprinted in* 1976 U.S.C.C.A.N. 2897, 3081-82.

67 S. REP. NO. 938, 94th Cong., 2d Sess., *reprinted in* 1976 U.S.C.C.A.N. 3439.

Effective Rate Increase: January 1, 1981

The unostentatious legislative ambience of the Carter years faded into history, replaced by the piranha-like parliamentary frenzy of the Reagan Administration. Immediately upon assuming the presidency, President Reagan, a sincere, faithful proponent of supply-side, "laissez faire," economic theory, proposed a drastic tax reform agenda.

> [T]he Administration is proposing a national recovery plan to reverse the debilitating combination of sustained inflation and economic distress. . . . Were we to stay with existing policies, the results would be predictable: a rising government presence in the economy, more inflation, stagnating productivity, and higher unemployment. Indeed, there is reason to fear that if we remain on this course, our economy may suffer even more calamitously.[68]

A key component of President Reagan's proposed reform was the Accelerated Cost Recovery System (ACRS) — a complete, comprehensive overhaul of depreciation allowances.

> The present depreciation system is obsolete, needlessly complex, and economically unproductive. Very simply, it bases depreciation of plant machinery and vehicles and tools on their original cost, with no recognition of how inflation has increased their cost.
>
> We are proposing a much shorter write-off time than is presently allowed — we propose a five-year write-off for machinery, three years for vehicles and trucks, and a ten-year write-off for plants.[69]

The Administration offered as primary support for legislative enactment of ACRS depreciation:

> Acceleration of capital allowances is a key measure to improve incentives for business investments as a foundation for increased productivity and sustained economic growth. In recent years, the real value of depreciation allowances has been greatly eroded by inflation at the same time that the country's capital needs have become more urgent. Adoption of this proposal will reduce

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[68] RONALD REAGAN, AMERICA'S NEW BEGINNING: A PROGRAM FOR ECONOMIC RECOVERY 15 (1981).

[69] *Id.* at 7.

> substantially the burden of Federal Income Taxes on the return to investing in business plant and equipment.[70]

Further, since the ITC is statutorily intermingled with the depreciation network of the Internal Revenue Code, adoption of ACRS would necessitate changing the ITC.

> ACRS retains the rules of present law governing the character of property eligible for the credit. It does, however, change the rules . . . .
>
> Under ACRS, a full regular ten percent investment tax credit is allowed for all eligible 10-year and 5-year personal property and a six percent credit is allowed for all eligible 3-year property.[71]

ACRS depreciation and the new requirements concerning the ITC became law under the Economic Recovery Act of 1981.[72] These provisions permitted property that previously had not qualified for the ITC, as a result of a short depreciable life, now to qualify;[73] as such, adoption of the ACRS depreciation system constituted an effective rate increase in the ITC.

The Tax Equity and Fiscal Responsibility Act of 1982[74] codified provisions aimed at dampening the perceived over-stimulative effects of the ITC. Taxpayers eligible for the benefits of this incentive were required to select among two alternatives, these choices being designed to decrease the aggregate tax deductions afforded. They were: (1) a basis reduction equal to one-half the amount of the ITC[75] or (2) in exchange for full depreciation allowances, a reduced ITC credit.[76] The effective ITC rate adjustment resulting from this policy alteration is thought to be minimal at best.

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70 *Id.* at 286.

71 *Id.* at 293-94.

72 *Recovery Act of 1981, supra* note 10, §§ 201-14.

73 Prior to ACRS depreciation standards, an asset's depreciable life was established by the taxpayer through reference to his particular tax situation and utilization of the asset. An ITC was granted to qualifying assets based on their respective taxpayer identified life with no credit allowed for assets with a taxpayer identified useful life less than three years. Under the statutory provisions of ACRS, three categories of depreciable assets were defined: three-, five-, and ten-year property. Each category was granted an ITC with a reduced credit available for assets falling into the three-year group. Thus, while taxpayers were no longer permitted latitude for identifying an asset's depreciable life, all long-lived personalty now qualified and earned the ITC.

74 Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324 (1982) (codified as amended in scattered sections of 26 U.S.C.).

75 Pub. L. No. 97-248 § 205(a)(1)(q)(1), 96 Stat. 324, 333.

76 *Id.* § 205(a)(1)(q)(4), 96 Stat. 324, 333.

Second Repeal: January 1, 1986

On May 29, 1985, the Reagan Administration proposed the most extensive renovation of the federal income tax system since codification of the Internal Revenue Code of 1954.[77] The changes proposed ran the gamut from fairness and compassion to simplicity and efficiency. Ultimately, many of the numerous thought-provoking changes became law and the tax code, accordingly, was renamed the Internal Revenue Code of 1986.[78]

A major focus of the President's tax proposal was upon the perceived "tax-induced distortions" generated by some investment incentives: principally, ACRS depreciation and the ITC. By means of justification for ITC repeal, the Administration stated:

> The investment tax credit was originally introduced and has been modified to serve two principal purposes--to prevent capital consumption allowances based on historical cost from being eroded by inflation and to stimulate increased levels of investment. Under current law, the investment tax credit, in combination with the Accelerated Cost Recovery System ("ACRS") provides investment incentives that are neither systematically protected from inflation nor allocated in a neutral or efficient manner. . . .
>
> The investment tax credit is . . . excessively "front-loaded." The one-time, up-front credit makes possible the sheltering of an investor's unrelated income. Thus, the investment tax credit is a standard element of numerous tax shelter offerings. . . .
>
> The front-loading of the credit also limits its incentive effect for start-up, fast-growing or currently unprofitable businesses.
>
> The capital formation objectives for which the investment credit was adopted would be better served under . . . a new Capital Cost Recovery System ("CCRS"). Investment incentives would be built into depreciation allowances in a manner that would be inflation-proof, relatively neutral across assets, and distributed more evenly over the life of the investment.
>
> [A]lthough the concept of the investment tax credit is straightforward, the applicable statutory provisions are exceedingly

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77 H.R. 8300, 83d Cong., 2d Sess. (1954).

78 *Reform Act of 1986, supra* note 11, § 2(a).

> complex. Repeal of the credit would substantially simplify the tax system. . . .[79]

Therefore, as a part of the Tax Reform Act of 1986,[80] the ITC was revoked for the second time.

SIGNIFICANT EMPIRICAL RESEARCH FINDINGS

Empirical research concentrates on the explanation and prediction of occurrences in the real world. In specific, empirical tax policy research investigates the economic consequences of tax policy choices: Is the desired goal a natural by-product of the chosen policy? In the ITC policy arena, choices involving enactment, rate changes, and repeal are predicated on the belief that allowance, as well as rate increases, stimulates investment activity, whereas repeal will have a dampening effect. Hence, the empirical question concerning ITC effectiveness becomes: Does the ITC existence, rate increase, or repeal alter investment behavior of targeted investors and, most importantly, in the direction presumed by the chosen policy?

Economists' Empirical Research[81]

The patriarchs of econometric research in regard to the ITC effectiveness issue were Hall and Jorgenson (1967, 1969, 1971).[82] In their initial study, they formulated an investment model based on neoclassical econometric theory. Under certain restrictive conditions, their empirical tests of ITC effectiveness led them to conclude that ITC:

> policy has been highly effective in changing the level and timing as well as the composition of investment expenditures. The investment tax credit, which was limited to certain equipment, shifted investment away from structures and toward equipment. Thus, changes in tax policy are said to have substantially stimulated the level of investment expenditures.[83]

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79 RONALD REAGAN, THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY 160-61 (1985).

80 *Reform Act of 1986, supra* note 11, § 1.

81 A detailed discussion of the numerous economic theories developed to explain investment behavior is beyond the scope of this article. As such, the economic theory utilized in each study is briefly noted and the interested reader desiring a more complete presentation of the economic foundations is directed to the respective articles.

82 Robert E. Hall and Dale W. Jorgenson, *Tax Policy and Investment Behavior,* 57 AM. ECON. REV. 391 (1967); *Tax Policy and Investment Behavior: Reply And Further Results,* 59 AM. ECON. REV. 388 (1969); and *Application of the Theory of Optimal Capital Accumulation,* TAX INCENTIVES AND CAPITAL SPENDING 9 (Gary Fromm, ed. Brookings Institution 1971).

83 *Supra* note 17, at 11.

While Bischoff (1971)[84] presents evidence in support of the conclusions of Hall and Jorgenson, Coen (1968, 1969)[85] and Eisner (1969, 1973, 1975)[86] assume positions of opposition. Coen criticizes the use of a Cobb-Douglas production function which imposes a unity substitution elasticity between labor and capital. He states that "[n]either their results nor their procedures stand up to close scrutiny, and their study must therefore be regarded as inconclusive with respect to the effectiveness of tax incentives. . . ."[87] Eisner concurs: "[T]he conclusions of Hall and Jorgenson are based on assumption, not empirical evidence; analysis of the empirical data, including basic data made available by Jorgenson, do little to confirm the . . . 'effectiveness of tax policy in altering investment behavior.'"[88] Additionally, Coen and Eisner offer alternative models of the investment function which "suggest that the performance of tax incentives has been disappointing."[89]

These initial econometric studies and their results were dependent upon the investment model selected by a particular researcher, reflecting the fact that economists did not have one generally agreed upon model of investment behavior. Such model disagreement severely limited these initial economic studies — a discord which remains unresolved to this date.[90] Conflicting results and no consensus on the ITC effectiveness issue were the expected and realized outcomes.

Dissertation Research in the 1970s

An abundance of dissertation research has been conducted on the issue of ITC effectiveness. Wilson (1972), investigating at both the micro- and macro-economic levels, found that the ITC had no significant effect on capital equipment expenditures.[91] Questionnaire research was used by Stout (1977) to deduce that the ITC had a positive effect on capital investment.[92] Wunder (1978) employed

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[84] Charles W. Bischoff, *The Effect of Alternative Lag Distributions*, TAX INCENTIVES AND CAPITAL SPENDING 61 (Gary Fromm, ed. Brookings Institution 1971).

[85] Robert M. Coen, *Effects of Tax Policy on Investment in Manufacturing*, 58 AM. ECON. REV. 200 (1968); and *Tax Policy and Investment Behavior: Comment*, 59 AM. ECON. REV. 370 (1969).

[86] Robert Eisner, *Tax Policy and Investment Behavior: Comment*, 59 AM. ECON. REV. 379 (1969); *Tax Incentives for Investment*, 26 NATL TAX J. 397 (1973); and *Tax Policy and Investment: An Analysis of Survey Responses*," 65 AM. ECON. REV. 206 (1975).

[87] Robert Coen, *Tax Policy and Investment Behavior: Comment*, 59 AM. ECON. REV. 370, 378 (1969).

[88] Robert Eisner, *Tax Policy and Investment Behavior: Comment*, 59 AM. ECON. REV. 379 (1969).

[89] Robert Coen, *Effects of Tax Policy on Investment in Manufacturing*, 58 AM. ECON. REV. 200, 210 (1968).

[90] Dale W. Jorgenson, *Econometric Studies of Investment Behavior: A Study*, 9 J. ECON. LITERATURE 1,111 (1971); Daniel T. Waltz, *Bias in Systems of Survey and Econometric Forecasts*, 10 J. MACROECON. 261 (1988).

[91] Harold Wilson, A Study of the Influence of the Investment Tax Credit Upon Capital Investments From 1962 to 1969 (1972) (unpublished D. Bus. Admin. dissertation, University of Colorado), *abstracted in* 33 DISSERTATION ABSTRACTS INTL 1269-A (Xerox Univ. Microfilms Oct. 1972).

[92] Gary R. Stout, Tax Policy and Capital Formation: An Empirical Analysis of the Potential Differential Impact of the Investment Tax Credit (1977) (unpublished D. Bus. Admin. dissertation, University of Southern California), *abstracted in* 38 DISSERTATION ABSTRACTS INTL 4903-A (Univ. Microfilms Int'l Feb. 1978).

the Hall and Jorgenson model to study firm level investment behavior revealing that a significant relationship exists between the ITC and investments.[93] Linear multiple regression was applied at the micro-economic level by Foster (1978), resulting in a conclusion that the impact of the ITC on investment is not significant.[94]

A Compendium on Empirical Research

The General Accounting Office (GAO), in response to a Carter Administration proposal that the ITC be made permanent,[95] undertook a review and evaluation of prior inquiries concerning the ITC. Specifically, GAO (1978) was designed to "assess the investment tax credit as a tool [in] stabilizing the economy in the short-run and as a contributor to long-term economic growth."[96] It concludes that the ITC has been ineffective as both a countercyclical and prolonged growth policy instrument.[97]

However, GAO (1978) is incomplete for two reasons: (1) It fails to assimilate all of the relevant and timely economists' research presented heretofore; and (2) no dissertation endeavors available at that time, as described and discussed below, were incorporated. Therefore, the conclusions drawn from this study are clearly without the benefit of the universe of empirical literature and, as such, are of limited value.

Dissertation Research in the 1980s

Maloney (1984)[98] introduces a unique two-stage research methodology into the domain of tax policy studies: multiple regression succeeded by time-series intervention analysis. Multiple regression was utilized to isolate variance in the dependent variable (ITC qualified acquisitions) into explainable and residual components through analysis of a set of economic independent variables. Time-series intervention procedures evaluated the attributable effect concomitant with ITC policy alterations via an analytical consideration of the resulting residuals combined with an appropriate legislative chronometry. The findings offer solid support for effectiveness of the ITC — qualified investment spending was

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93 Haroldene F. Wunder, Capital Formation and the Investment Tax Credit: An Empirical Study (1978) (unpublished Ph.D. dissertation, University of South Carolina), *abstracted in* 39 DISSERTATION ABSTRACTS INT'L 6192-A (Univ. Microfilms Int'l Apr. 1979).

94 Cecil G. Foster, Jr., An Empirical Analysis of the Potential Differential Impact of the Investment Tax Credit on Investment in Capital Goods (1981) (unpublished Ph.D. dissertation, University of Georgia), *abstracted in* 42 DISSERTATION ABSTRACTS INT'L 2205-A (Univ. Microfilms Int'l Nov. 1981).

95 INVESTMENT TAX CREDIT: UNRESOLVED ISSUES, *supra* note 17, at 1.

96 *Id.* at 4.

97 *Id.* at 31-33.

98 Maloney, *supra* note 22.

stimulated by enactment in 1962 and further enhanced through the rate increase of 1975.[99]

The Economic Recovery Act of 1981[100] enacted the Accelerated Cost Recovery System and liberalized the requirements for the ITC (an effective rate increase). These tax policy modifications were instituted to invigorate capital spending and their presumed effects provide the hypotheses for Coldwell (1986).[101] Two tax variables, ITC and depreciation, were examined with the results suggesting that neither tax policy alteration had a significant impact upon investment spending.[102]

The most recent study on ITC effectiveness, a comprehensive evaluation of the various policy options surrounding the ITC, was undertaken in Rosacker (1988).[103] Univariate Box-Jenkins time-series intervention analyses were tested for three policy alternatives involving six timeframes: enactment (1962, 1971), rate increase (1975, 1981), and repeal (1969, 1986). The findings support positive effects for the enactments (1962, 1971) and for the actual rate increase (1975); negative effects are attested to for the repeals (1969, 1986); and no support was offered for a positive effect accompanying codification of ACRS of depreciation (1981).[104] It was concluded, therefore, that tax policy respecting the ITC has been efficacious in modifying targeted investment behavior.[105]

SUMMARY

Tax legislators have actively modified policy surrounding the ITC during the first thirty years of its existence. While the encouragement and discouragement of a designated activity is logically satisfying in a normative sense, tests of empirical facts are required to substantiate the presumed effects. This article presented, first, the logical arguments in support of revisions in ITC policy through a review of legislative intent, and second, a discussion on the important empirical research in regard to the issue of ITC effectiveness.

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99 *Id.*, at Abstract.

100 *Recovery Act of 1981, supra* note 10, Pub. L. No. 97-34 § 204-14, 95 Stat. 172, 222-32.

101 Susan G. Coldwell, ERTA as an Investment Stimulus: A Micro-Based Analysis of Firm Investment Behavior (1986) (unpublished Ph.D. dissertation, University of Houston), *abstracted in* 47 DISSERTATION ABSTRACTS INT'L 3474-A (Univ. Microfilsm Int'l Mar. 1987).

102 *Id.*

103 Robert E. Rosacker, A Box-Jenkins Time-Series Interruption Analysis Concerning United States Federal Tax Policy: An Empirical Examination of the Investment Tax Credit (1988) (unpublished Ph.D. dissertation, University of Nebraska). *See also* Robert E. Rosacker & Richard W. Metcalf, ADVANCES IN TAX'N, forthcoming Vol. 5, Aug. 1993.

104 *Id.* at 80-120.

105 *Id.* at 126-27.

The normative evidence in support of ITC effectiveness is, from a legal standpoint, "beyond a reasonable doubt." In fact, it is very difficult to envision a cogent argument in opposition to the ITC as an effective means of prompting targeted investment behavior. On the empirical side, the findings have not been so clear. While two econometric research authors disagreed with Hall and Jorgenson's position supporting ITC effectiveness, the majority of the evidence sustained their position. Dissertation research directed at this issue was divided but weighted toward support of a directional effect accompanying the various policy alternatives. It is possible to conclude, therefore, that the empirical research supports a finding of "clear and convincing" proof that the ITC is an effective tax policy tool.

Throughout its history, the resilient nature of the ITC has become increasingly evident. It is rather certain that the "coup de grace" has not yet been delivered to this tax credit. Indeed, this tax policy is an excellent means for influencing targeted investment behavior and the Congress would be well advised to consider employing such an effective tool when necessary.

> Since the ITC was originally enacted in 1962, it has been temporarily terminated from October 10, 1966 to March 9, 1967 and from April 18, 1967 to August 15, 1971. In both cases, the ITC was reinstated primarily because the lack of incentive for companies to invest in property, plant, and equipment had an adverse economic impact. If the ITC is repealed [as it subsequently would be in the Tax Reform Act of 1986], it is possible that it will be only temporary, since the economic implications have historically caused its reenactment.[106]

[106] Thomas A. Rowles, Investment Tax Credit Studies, 1986 CORP. ACCT. 77.