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U.S. GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

[Tax Expenditures And Results of Study on Investment Tax Credit]

Statement of Harry S. Havens
Director
Program Analysis Division

Before the Subcommittee on Oversight
of the
Committee on Ways and Means
U.S. House of Representatives

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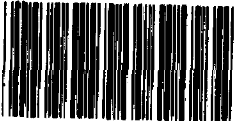
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Mr. Chairman and Members of the Subcommittee:

Thank you for the opportunity to present our views concerning tax expenditures and the results of our recent study on the investment tax credit. I have a rather lengthy formal statement, but in the interest of time I will only summarize the the main points and submit the longer document for the record, if that is acceptable to you.

We fully support your Subcommittee's efforts to examine the issue of the effectiveness of selected tax expenditures and to analyze them against specific criteria. We believe that it is vitally important that the congressional oversight process cover these Federal tax provisions which are called tax expenditures and divert substantial tax revenues from the U.S. Treasury. We believe that the oversight process and budgetary discipline are just as appropriate in the area of tax expenditures as for direct expenditures.

You asked us to address a series of questions concerning tax expenditures. These questions relate to the effectiveness and efficiency of tax expenditures in meeting their stated objectives, whether they are cost-effective, administratively efficient, and whether they create signficant unintended side effects.

Since our testimony today follows two panel discussions of distinguished economists who have presented to the Subcommittee the results of their analyses of the investment tax credit, we will not delve into the technical aspects of the research that has been performed on the subject. Rather, we would prefer to summarize the general thrust and implications of the economic research that has been performed on the investment tax credit.

I would like to focus on three issues:

1. The effectiveness of the investment tax credit in promoting economic stability;
2. The effectiveness of the investment tax credit in stimulating economic growth and development; and
3. The effectiveness of the tax credit in promoting investment compared with alternative policy tools such as loan guarantees, depreciation allowances, or direct investment subsidies to businesses.

Our discussion of three issues will be based in large part on work done in our report to the Congress last May entitled "Investment Tax Credit: Unresolved Issues."

PERSPECTIVES ON THE INVESTMENT TAX CREDIT

At the time of the enactment of the investment tax credit, most of its proponents thought it would increase investment.

However, since 1962, gross private domestic investment as a percentage of the Nation's economic output has not changed appreciably. The slow rate of U.S. investment since the 1974-75 recession has brought renewed attention to this area because of concern about the durability of the current economic recovery. It is still common opinion among economists that recessions are kindled by a sluggish rate of business investment and that for the economy to perform well there must be an adequate level of business spending. Furthermore, investment is a key in assuring the future productivity gains necessary to improve the standard of living in our society.

EFFECTIVENESS OF THE CREDIT AS A STABILIZATION DEVICE

One of the objectives of the investment tax credit legislation was to stimulate the U.S. economy when it was in a recession. It was assumed that an increase in the investment tax credit during a recession would promote economic activity and stimulate a recovery. In reviewing past studies, we found the following:

-- It takes two to four years for there to be a significant response in investment expenditures to a change in the tax credit. That is, an increase in the investment tax credit may generate a response during the recovery phase of the business

cycle and thus accelerate the recovery rather than being a key factor in ending the recession.

-- A large portion of the tax credit goes to reward investment that would have been made whether or not there was a tax credit.

-- The method of financing the cost to the Federal Government of the investment tax credit may be important in determining the potential effectiveness of the tax credit in stimulating business investment spending. That is, it may make a difference whether the tax credit is financed by a budget deficit as opposed to being financed by a reduction in Government expenditures. Thus, the potential effectiveness of the credit is critically dependent on the form of the complete fiscal package.

THE EFFECTIVENESS AS A PROMOTER OF ECONOMIC GROWTH

Another objective of the investment tax credit is to expand the Nation's productive capacity. Economic theory would indicate that the investment tax credit should stimulate business investment and result in productivity improvement and thereby increase the standard of living of our society. Our review of the research done in this area indicates the following:

-- The major thrust of the investment tax credit is to provide incentives to long-term economic growth.

-- It encourages investment in new equipment that is more productive than old equipment; this new investment generates economic growth.

-- It changes the composition of investment expenditures in favor of machinery and equipment. In last year's legislation, the tax credit was changed and it now applies to some structures.

-- It may lead to the more intensive use of capital at the expense of labor.

-- It tends to bypass those businesses which would not require a large capital investment or businesses that lack profits or are operating at a loss.

INVESTMENT CREDIT AS A TAX EXPENDITURE

The investment tax credit has been estimated to represent a revenue loss of over $19 billion for fiscal year 1980. Thus it is one of the largest of the tax expenditures, exceeded in size only by the special tax treatment accorded to capital gains.

Since its original enactment in 1962, the investment tax credit has been amended, debated, discussed and amended again on numerous occasions. The simplicity that is sometimes suggested as a reason for using tax expenditures is not

present in this case. Approximately 40 pages of the Internal Revenue Code are devoted to this tax provision, and interpretations and explanations of the credit run into volumes.

In assessing the desirability of the investment tax credit as an incentive for business investment, a number of other alternatives should be considered. In our view, a full analysis should include at least the following options as alternatives to the investment tax credit: (1) a program of direct investment subsidies to businesses in the form of direct payments, loans, or loan guarantees, (2) a general cut in the corporation income tax, and (3) a more generous depreciation allowance for business.

Each of these alternatives has advantages and disadvantages as does the investment tax credit itself. Probably the biggest disadvantage of the investment tax credit is the large part of the $19 billion tax reduction that does not actually generate additional investment. Many of the investments for which the credit is claimed would have been made anyway. In this regard, the investment tax credit does not differ to any great extent from most other tax expenditure provisions.

But each of the major alternatives to the investment tax credit also has serious disadvantages. For example, direct Federal Government investment subsidies could be

targeted to businesses which meet specified criteria designed to assure that the investment activity would be productive. However, any advantages in terms of the ability to control costs of such a direct program would have to be weighed against the much more intrusive Government involvement in the private decisionmaking process which such a program would entail. Official review and approval of private sector investment decisions would represent a much more overt Government involvement than has normally been associated with our mixed economy. It might well be possible to design mechanisms for direct subsidy which would be less intrusive, but they would almost certainly be more costly and would entail less assurance of effectiveness.

Although a general reduction in business taxes would rely mainly on market forces of the economy and would be easy to administer, there is no assurance that it would have a measurble or significant effect upon investment in productive capacity as opposed to simply increasing dividends.

More generous depreciation allowances is another alternative to the investment tax credit. But depreciation deductions, however rapid, spread the investment subsidy over a number of years rather than it occuring in the first year. Smaller businesses are not as likely to take advantage of the deduction as large corporations and high-income individuals.

In summary, the viable alternatives to the investment tax credit are not without their shortcomings. The investment tax credit has deficiencies of its own and in some areas more research and studies need to be performed to determine the real effectiveness of the credit. At this time, however, the credit compares favorably with its major alternatives.

Mr. Chairman, that completes my formal statement. My colleagues and I would be happy to respond to any questions you and the members may have.

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THE INVESTMENT TAX CREDIT: ISSUES AND ANALYSIS

TO ACCOMPANY THE STATEMENT
OF HARRY S. HAVENS, DIRECTOR
PROGRAM ANALYSIS DIVISION

before the

SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

March 27, 1979

BACKGROUND

The level of business investment in the United States continues to be a subject of substantial concern to economic policymakers. This stems in part from the sluggish revival of investment spending in 1975 and 1976 in the aftermath of the 1974-75 recession. It is also based on the belief that certain events of this decade, in particular Federal environmental and safety regulation and the energy crisis, have increased capital requirements in many industries. Without an increase in total investment, these new requirements can only be met at the expense of investment for other purposes.

The GAO analyzed the investment tax credit which is one of the major tools used by the Federal Government to stimulate investment. The results of this review are presented in the GAO report, "Investment Tax Credit: Unresolved Issues" (PAD-78-40; May 8, 1978). The report surveys and assesses the work done by private economists who have investigated the effects of the tax credit on the level, composition, and timing of business investment.

Two major objectives of the investment tax credit have been put forth. First is its potential contribution in the longer-run (two years plus) to the nation's productive capacity. Second is its possible use as an economic stabilization

measure in the short-run. In both cases, the effectiveness of the tax credit will depend on the amount of investment which it promotes. However, its success as a stabilization measure will also depend on the length of time required for this effect to be realized. Our analysis questions the effectiveness of the investment tax credit to promote economic stability--primarily because it takes a long period of time, perhaps two years or more, to have its full impact upon the economy. We believe that further study of the long-run effects of the credit is needed.

In the long-run the effectiveness of the investment tax credit should be judged by its contribution to capital formation, productivity, and economic growth. The major question which needs to be answered in this regard is how much additional investment has been spurred by the investment credit. A casual glance at the record of investment spending in the United States since the credit was enacted in 1962 may raise some doubts about its effectiveness. The share of gross private domestic investment in GNP has not increased appreciably over this period. By itself, this is not conclusive evidence. A supporter of the investment credit can reply that this share would have declined substantially had the credit not existed. In other words, the

credit may have offset changes in the economy which would have tended to depress investment in its absence. However, the evidence is also consistent with the view that the credit merely subsidizes investment which would have been undertaken in any event and, therefore, the credit has had no stimulating effect on investment spending.

There are reputable economists on both sides of this question. To clarify their views, some deeper understanding of the investment process and the way the tax credit impinges on it is needed. Without a theory which isolates and measures the crucial determinants of investment, no conclusions about the effectiveness of the credit can be drawn.

THE THEORETICAL UNDERPINNINGS OF INVESTMENT BEHAVIOR

Most economists who have studied investment take as their point of departure the proposition that businesses invest in order to earn a profit, and that investment will be carried to the point where that profit is as large as possible. Although this proposition is not universally accepted, even within the economics profession, most of the disagreement concerning investment centers not on the proposition itself but on its quantitative implications for investment spending.

Starting from this point one can deduce that the amount of investment firms wish to undertake will depend on the

expected increase in their future sales and second on the cost of additions to capacity. A third possible influence on the investment decision, suggested by some observers, is the level of current profits. The latter would exert an influence to the extent that they indicate future profitability associated with expansion or if imperfections in the credit market force firms to rely primarily on internally generated funds for expansion.

The investment tax credit permits investors to reduce their income taxes by a fraction of the amount they spend on investment in new equipment and the rehabilitation of older structures. In effect, this lowers the cost of these forms of capital. It is reasonable to conclude that a lower cost of capital should increase the demand for capital. That is, the credit directly affects the cost of additions to new capacity. However, this effect may be offset in various ways.

THE EVIDENCE

It is difficult to predict in advance what the overall stimulus exerted by the tax credit will be. First of all, while in principle firms will react to a reduction in the cost of capital by expanding investment, this reaction may be so slight as to be scarcely reflected in available information. A good part of the controversy among economists concerning

investment centers precisely on the actual size of this reaction to a change in the cost of capital. If, in the economist's language, the demand for capital is highly insensitive to price effects (inelastic), the effect of the credit will be small. On the other hand, if the demand is sensitive to price effects (elastic), the credit has the potential to significantly affect investment spending. While there are eminent authorities who take the opposite view, we believe that there is sufficient sensitivity to price effects in the demand for capital to assure that the direct effect of the credit has been to increase this demand.

However, this conclusion does not establish that the final effect of the credit has been to increase the capital stock. In order to increase actual investment, resources must be made available for this purpose. When these resources are not available, the only effect of an increased desire to invest is to bid up interest rates which offset whatever change had sparked the increase in investment demand. In the case of the investment tax credit, if no new resources were available for investment, its ultimate effect would be to raise interest rates in such a way that the after-tax cost of capital to business would be unchanged, and the net stimulus would, therefore, be nil.

Many, although by no means all, of the studies of investment can be criticized for neglecting these indirect effects of an increase in investment demand. The size of the effect they attribute to the investment tax credit would be less had these effects been taken into account. Those studies which do attempt to make some allowance for these indirect effects generally reveal that changes in the investment tax credit have had a smaller effect on investment spending than those in which such effects are neglected.

Additional resources for new investment may be provided in several ways. If private saving is responsive to increases in the rate of interest, then the private sector will respond to an increase in the investment tax credit by voluntarily reducing consumption and freeing resources for new investment. After the credit is increased, interest rates will rise, inducing additional saving. In the end, the after-tax cost of capital to investors will be somewhat less, and interest rates and saving will be somewhat larger. In recent years economists interested in capital formation have increasingly turned their attention to the responsiveness of saving and consumption to such changes. These economists realize that in a fully employed economy this responsiveness is crucial to the effectiveness of any Federal policy aimed at spurring capital formation.

An alternative method of providing these resources is through a reduction in the deficit of the Federal Government. However, this would require that the revenue foregone as a result of the investment tax credit be replaced by an increase in other taxes or else that the spending financed by the foregone revenue be eliminated. Indeed, it would be necessary to more than offset the foregone revenues if the deficit is to be reduced rather than held constant.

If the economy is operating at less than full capacity with unemployed resources available for production at unchanging prices, then the resources called for by an increase in investment demand can be provided out of increased production. However, it is questionable whether an increase in the investment tax credit under these circumstances would result in much increased investment. With unused capacity available, firms are unlikely to make further additions to that capacity--even if the cost of doing so declines. By the time it becomes attractive for them to respond to the tax credit the previously available resources will be employed and the desired increases in investment will be possible only if private or public saving increases.

The current credit does not cover all investment, but only investment in new equipment or the rehabilitation of

older structures, and to qualify for the credit, firms must be earning positive profits. This means that some of the increased demand stimulated by the credit may have been satisfied by shifting the composition of investment. Thus, investment in structures and human capital may have declined relative to investment in those forms of capital for which the credit was available. Investment in new enterprises where profits typically are low may also have been reduced. Thus, the credit could have been effective in promoting investment in some forms of capitl at the expense of others.

In light of these serious caveats, we believe that further study of the determinants of investment with a concentration on the availability of resources for this purpose would be highly desirable. The ultimate effectiveness of the investment tax credit cannot be finally determined until this work is completed.

THE CREDIT AS A STABILIZATION DEVICE

In the short-run, business investment is important because it is a significant component of the total or aggregate demand for the nation's output of goods and services. Variations in investment have been viewed by many as the crucial element in the business cycle. Successful economic stabilization requires that these variations

either be moderated or offset by changes in other components of demand. Those who believe the investment tax credit can be used for economic stabilization claim that it can be used to moderate these cyclical movements in investment spending.

If the credit is to be used for this purpose it must affect the total amount of investment and in addition, this effect must occur at the right time. An increase in investment spending during an economic boom is inflationary and destabilizing. Similarly, a decrease in investment spending during an economic downturn will drive the economy further into recession. GAO believes these are real possibilities if the investment tax credit is used as a stabilization measure.

In order to use the investment tax credit effectively to stabilize the economy, Congress must be willing not only to maintain the credit as it currently exists but to change it from time to time. An investment tax credit that remains at a predetermined level would not be a stabilization measure. Congress must be willing to increase it, reduce it, or perhaps even suspend it temporarily for this measure to be used effectively as a fiscal tool to stimulate or restrain the economy. It is only by changing the credit that Congress can hope to moderate fluctuations in investment.

Generally, the business community has supported the use of increases in the credit for stabilization. However, the business community has opposed decreases for stabilization purposes on the grounds that such downward movements are arbitrary and create an uncertain economic environment. If congressional debates delay passage of the change appropriate for stabilization purposes, and then, for example, the economic boom which led to the policy discussion of a downward adjustment is succeeded by a recession which would call for an upward revision in the credit, this criticism would be justified. However, delays in the political process have encumbered other forms of discretionary fiscal policy.

There are other technical problems associated with the investment tax credit. There is a long lag between the time when a change occurs in the investment tax credit and the time when this change produces a substantial effect on investment spending. Even after it becomes clear to investors that the change in the credit has altered the profitability of investment and consequently made it worthwhile to spend more or less on new capital goods, it takes time to act upon this perception. In the case of an increase in the credit which stimulates new investment, time will be required to design new projects or modify existing plans. Additional financing will need to be arranged, and that takes time.

Further time will be required to order, manufacture, and install new equipment. It may be possible to speed up the process but it is also likely to be costly. The existence of these lags means that a substantial period of time must pass before a change in the credit has a significant effect on investment spending.

Estimates of the time required vary, but most of the existing evidence suggests it lies between two and four years. This evidence implies that a change in the investment credit in 1978 may not significantly affect investment until 1980 or later. Moreover, the situation is further complicated by the fact that these lags are variable. Consequently, the time required for a substantial effect to occur cannot be precisely predicted. It will vary from one business cycle to another.

While these lags have no bearing on the long-run effectiveness of the investment tax credit, they are crucial for the credit's role as a short-run stabilization measure. The existence of the lags requires that changes in the tax credit should not be based on the current state of the economy but instead on the expected state of the economy at a distant date. Even if the time required for the credit to have a substantial effect were exactly two years, it would be extremely difficult to predict with any degree of accuracy

the economic conditions at that time. At a time when the probable state of the economy six month's hence is the subject of some dispute, this point is particularly relevant.

One can also question whether a tax credit has any stimulative effect on investment during an economic downturn. If business waits until the recovery to react to the credit, it will be destabilizing rather than stabilizing.

The stabilizing effect of changes in the credit will also depend on how these changes are financed by the Federal Government. Four possibilities exist:

1. Other taxes can be changed in an offsetting way.
2. Expenditures can be changed to offset the change in revenues.
3. The Government can sell securities to the public to replace the revenue lost when the credit is increased.
4. The Government can borrow from the Federal Reserve System to compensate for the foregone revenue when the credit is increased.

In the first two cases the deficit in the Federal budget is not affected by the change in the tax credit, and when they are used, the credit can be expected to have the smallest effect on total spending. In the third case the deficit is affected, and in the fourth case both the deficit and the money supply are affected. The greatest

stimulus resulting from an increase in the credit occurs if it is financed by an increase in the money supply. However, in this case one might wish to consider this a change in monetary rather than fiscal policy.

This analysis has been based on the premise that variations in investment spending are the major independent cause of the business cycle. There is a growing body of evidence and an increasing number of economists who would dispute this point. In their view, the business cycle is primarily a monetary phenomenon caused by variations in the rate of growth of the supply of money. If this is a valid description of the economy, then fiscal measures like the investment tax credit have no stabilization role to play except as they affect the borrowing requirements of the Federal Government. This of course does not mean that the credit is without effect on the long-run allocation of resources between investment and consumption.

Given the long and variable lags in the investment process, the credit is likely to be least effective during an economic downturn and an unreliable as a stabilization tool.

INVESTMENT CREDIT AS A TAX EXPENDITURE

However effective the investment tax credit may be in stimulating growth, the costs of this tax incentive

are not small. Special Analysis G of the 1980 Budget of the United States Government presents estimated revenue losses of over $19 billion in fiscal year 1980 from the investment tax credit provisions. This is one of the most expensive tax expenditures; only the revenue losses attributed to capital gains are larger.

There is little argument that the investment credit _is_ a tax expenditure. Yet, it differs from most other tax expenditures in at least two ways. One of the characteristics of tax expenditures is low visibility; they tend to be enacted and ignored. This has certainly not been the case with the investment credit. It has been amended, discussed, debated, and amended again almost continuously since 1962. On the other hand, one of the alleged advantages of tax expenditures is the simplicity that results from few Government rules and regulations. In this case, however, approximately 40 pages in the Internal Revenue Code are devoted to the investment tax credit. The interpretations and explanations of the credit run into volumes.

TAX CREDITS AND DIRECT SUBSIDIES

If the investment tax credit is seen as the equivalent of a direct Government payment for the same purpose of promoting investment, one obvious way to evaluate it is to compare it to a similar program funded by direct payments.

Great Britain, for example, has at different times used both devices, sometimes allowing tax incentives for investments and sometimes paying direct investment subsidies. Direct payments, loans, and loan guarantees to private business are not uncommon in U.S. history. The constuction of railroads in the 19th century may be the most familiar example, but similar subsidies have reappeared in various forms down to the present time.

Probably the biggest disadvantage of the investment credit is the waste associated with it. Even though it is not possible to quantify this waste to a precise degree, a large part of the $19 billion tax reduction does not go to stimulate additional investment. Many of the investments for which the credit is claimed would have been made anyway, and most likely in the same manner and at the same time. In this regard, the investment credit does not differ greatly from other tax expenditure provisions. It is difficult to design a tax incentive that does not reward taxpayers for doing what they would have done anyway.

The investment tax credit is not confined to productive or income-producing assets. It applies to any tangible personal property used in trade or business, even if that use is not directly related to production. (A Senate committee report mentions "carpets," "ornamental fixtures,"

and "beverage bars" as property to be considered eligible for the credit.)

A direct payment program that required approval of investment projects before the Government subsidy was paid might alleviate these problems and produce the same effects on productive capacity and employment at considerably less cost (after allowing for increased administrative costs and perhaps also delays in payment).

Another disadvantage of the investment credit is that, like all tax expenditures, the costs of the investment credit depend almost entirely on private choices and the state of the economy. Having set the tax rates, the Government exercises no further control over costs until the rates themselves are readjusted. The costs of a direct program could be limited to whatever sums the Congress wished to appropriate.

The benefits of a tax reduction are necessarily limited to those persons or enterprises that would otherwise pay taxes. The investment tax credit provides little incentive to companies with low taxes and none whatsoever to organizaions or persons that are already nontaxable. This may reduce its effectiveness. It might be desirable to stimulate investment by some nonprofit organizations (universities

or research institutions, for example), and it may improve both the equity and effectiveness of the tax system to provide investment subsidies to new or rapidly growing businesses that have not yet become profitable enough to use all their available credits. A direct payment program not tied to taxes would benefit both profitable and unprofitable enterprises.

However, limiting Government investment subsidies to companies that have demonstrated the ability to make a profit may be desirable in some ways. Casting the investment subsidy in the form of a nonrefundable tax reduction at least requires the recipient of the subsidy to be efficient enough to owe taxes before he receives the subsidy. This is really the only test in the present program for determining whether the company is able to use the subsidy effectively, and this fact needs to be weighed in deciding whether to make the credit refundable. A more tightly structured direct subsidy program designed to use Government funds to subsidize business investment could contain other tests also--for example, limiting its use to assets that produce income.

The tax expenditures approach has both advantages and disadvantages. The superiority in cost control of a direct program is offset to some degree by extensive Government

involvement in the private decisionmaking process. Official review and approval of investment decisions by private enterprise is more overt Government involvement than has normally been associated with the mixed economy in the U.S. Many Americans might feel that it would be too high a price to pay even if a large fraction of the $19 billion cost of the program might thereby be trimmed.

Promptness of payment is a major advantage of a tax expenditure, especially as perceived by the beneficiary. The Federal Government pays the subsidy when the taxpayer files his return.

On balance, we believe that a direct subsidy is not necessarily superior to a tax expenditure as a device for subsidizing investment. If the Government intends to assume a part of a businessman's cost of new investment, it may well be easier and less disruptive to do so through the tax system.

INVESTMENT CREDIT AND BUSINESS TAX REDUCTIONS

As discussed earlier, the investment credit operates in part by reducing the cost of investment property, thus increasing the after-tax rate of return on it. But the credit also increases the company's available cash; the business that pays less of its profits in taxes will have more money to spend for other purposes, including buying

new assets. The credit operates, in this respect, like a selective tax cut, and a possible alternative could be a cut in business taxes of equal amount. Such a cut would increase the cash flow of businesses by the same amount, but would not dictate that the funds should be used in a particular way.

The selective tax cut--the tax expenditures approach--was adopted in 1962 in combination with a general tax cut to stimulate the economy. The implicit assumption in the general tax cut was that the added demand would not induce businessmen to undertake as much new investment (or at least not soon enough) as was thought desirable. It was also felt, as is often argued today, that the income tax, inflation, and Government regulation create disincentives to investment that can be partially offset by the selective tax cut.

A reduction in business taxes would have at least two advantages over the tax incentive approach. It would put the money in the hands of businessmen and let market forces, rather than the Government, determine what should be done with it. This approach would minimize Government interference and would entail no administrative costs for either businesses or the Government.

Of course, a business tax cut might not have as stimulative an effect on investment and employment as a tax

cut targeted on investment. Computer simulations comparing the two usually show the investment tax credit (with or without liberalized depreciation rules) to be more effective. Leaving the Government completely out of the decisionmaking process is not an advantage if market forces would not produce the desired results or if other Government policies, such as environmental or safety regulations, have already altered investment decisions.

In summary, a general cut in business taxes, with other Government policies remaining the same, has certain disadvantages compared with the investment tax credit.

INVESTMENT TAX CREDIT AND DEPRECIATION POLICIES

From time to time the business community has expressed a preference for more generous depreciation allowances over the investment tax credit. Allowing taxpayers to write off the cost of an asset more rapidly than its value declines is a tax advantage that resembles the investment credit in that it increases the after-tax rate of return from a property and thus encourages productive capital investment.

The mechanisms and some of the effects, however, are quite different. The investment credit provides a larger subsidy in the year of purchase and no subsidy in subsequent years. Rapid depreciation deductions spread out the subsidy over the early years of the property. The investment

credit is not subtracted from the depreciable basis of the property, so taxpayers are actually allowed to "recover" through depreciation a cost that they did not pay. Depreciation deductions, however rapid, are limited to the cost of the property. The investment credit is a tax credit that has the same value to all taxpayers. Depreciation is a deduction and thus becomes more valuable as the tax rates increase. For large corporations and high-income individuals, rapid depreciation can result in larger tax savings than a combination of investment credit and less rapid depreciation would.

Smaller businesses should generally prefer the investment credit over larger depreciation deductions; larger businesses in higher tax brackets would often find larger depreciation deductions more beneficial.

UNINTENDED USE OF THE CREDIT

Because it is structured as a credit instead of a deduction and because it is designed for rather specific purposes, the investment tax credit seems to give rise to fewer unintended uses than many tax expenditures. One that has been mentioned already is the eligibility of office luxuries, corporate aircraft, and other management "perks," as well as truly productive property. In dollar terms, this unintended use is not likely to be too large, however,

and any attempt to correct it might create more problems than those it was intended to solve.

Another relatively minor problem concerns the estimated useful life of the property. Since longer-lived property may produce more credit than shorter-lived property, it can be to the taxpayer's advantage to deliberately over-estimate property lives. If the taxpayer later disposes of the property before the estimated useful life is up, he must pay back the excess credit; but in the meantime he will have deferred some of his taxes without penalty. The longer estimated life stretches out his depreciation deduction, so this device is useful primarily to taxpayers who prefer a larger credit to larger deductions, i.e., to taxpayers in lower tax brackets.

One possible unintended use of the credit might be serious. This is the allowance of a credit to lessors of investment credit property. In effect, this provision is a device by which taxpayers with low taxable profits and a need for new investment (a manufacturing company, for example) can transfer ("sell") their credits to taxpayers with high profits and little need for investment in depreciable property (a financial institution, for example). From the point of view of stimulating investment, this may be favorable. However, this tax shelter was eliminated several

years ago for individuals, presumably to improve equity. It is still allowed for corporations and is said to be a popular tax shelter for banks. Whether allowing investment tax credits to lessors is an unintended use or a logical and desirable extension of the basic policy has apparently never been decided.

UNINTENDED EFFECTS

A recent study for the Federal Trade Commission (FTC) suggested that the investment tax credit was one of several tax provisions tending to encourage business concentration.

The most obvious way in which the credit appears to encourage concentration is the empirical fact that it is of greater benefit to larger corporations than to smaller ones. This may be because larger corporations tend to be those in which there is heavier investment in depreciable assets, or because they make a larger profit per dollar invested and thus have larger tax bills to offset by the credit, or because they are more likely to be aware of and take advantage of such tax breaks, or for some other reason.

The FTC study also indicates, however, that the benefits of the investment tax credit are not as slanted toward large corporations as are those conferred by depreciation policies.

Another way in which the credit may encourage concentration is through the "sale" of unused credits. A

profitable company with few credits and an unprofitable one with large unused credits may find a merger beneficial purely on the strengths of the tax savings.