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Do Tax Incentives for Investment Work?

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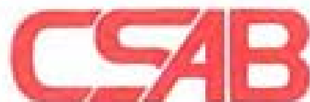

Center for the Study of American Business
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Do Tax Incentives for Investment Work?

by Murray L. Weidenbaum

A mythology has developed concerning tax incentives for business investment. The litany of charges has become predictable—investment incentives don't work; despite the array of incentives, capital spending and employment have been stagnant; companies have merely used the "tax breaks" to cut their tax bills; in fact, the big users of these tax provisions don't pay any taxes at all. We hear these charges so frequently that they are close to becoming adopted as gospel.

This report analyzes each of those charges and shows—to the contrary—that tax incentives have provided substantial benefits to the American economy and that the critics have underestimated the tax payments of many American companies.

Charge #1. "Corporate capital spending has been virtually stagnant since the tax breaks were enacted."[1]

Stagnation is not the description that comes to mind for a rise in such spending from $395 billion in 1981 to $472 billion in 1985 (in constant 1982 dollars). The reality is that, following the 1981-82 recession, the private sector's capital spending has paced the current recovery in the American economy. In its January 1986

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[1]These and the criticisms that follow are taken from *Money for Nothing: The Failure of Corporate Tax Incentives 1981-84* (Washington, D.C.: Citizens for Tax Justice, February 1986).

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annual report, the Council of Economic Advisers described the current situation clearly:

> The sector that has uniformly outperformed average historical experience is gross private domestic investment....above-average growth was recorded for all major categories of private domestic fixed investment and was particularly prominent for real nonresidential fixed investment.

The CEA's somewhat forbidding term, "non-residential fixed investment," is how economists refer to business capital spending. From the recession trough through the end of 1985, real nonresidential fixed investment rose 11.3 percent a year. That rate is almost double the 6.4 percent growth registered in the average expansion since World War II. The growth of real nonresidential fixed investment in the current recovery has been twice that of personal consumption or real GNP. That is hardly a pattern of stagnation on the part of corporate capital spending. Figure 1 shows very clearly the upward trend in business investment.

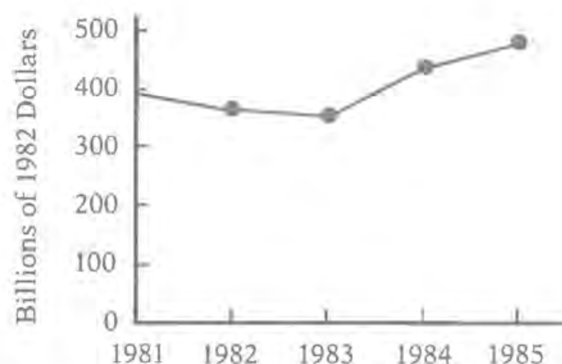
Charge #2. "Corporate Tax Breaks Have Failed to Spur Investment..."

One of the fundamental fallacies that is exposed early in any beginning economics course is "post hoc ergo propter hoc." In plain English, that says avoid jumping to the conclusion that, just because one event followed another event, the first event must have caused the second. On reflection, that is fairly obvious. All sorts of other factors could have caused the second event. A "before and after" analysis is just too simpleminded.

Thus, in measuring the impact of tax policy changes made in 1981, the professionally correct way is not just to look at the next year or two. That procedure ignores the recession in 1981 and 1982. Of course, few companies embarked on a rapid expansion in capital investment during the depths of the recession and their failure to do so is no reflection on the effectiveness of the 1981 tax changes.

Professors of economics—of all political persuasions—explain to their students that the correct method for evaluating the impact of a change in policy is the "with or without" analysis. That is, what would have happened if that first event did not occur? This more comprehensive approach requires taking into account all relevant factors, including changes in tax policy as well as interest rates, sales, earnings, capacity utilization, prices, and foreign competition.

Figure 1
TREND OF REAL NONRESIDENTIAL FIXED INVESTMENT



Source: U.S. Department of Commerce

There is no need to guess about the results from doing a "with or without analysis" of the impact of the 1981 tax incentives on business investment. Serious studies have been made by several outstanding ecnomists. Michael J. Boskin, professor of economics at Stanford University, performed such an analysis in 1985. He reached the following conclusions with reference to the 1981 and 1982 tax laws that established the system of liberalized depreciation known as the Accelerated Cost Recovery System (ACRS) and made changes in the investment tax credit (ITC):

> Using alternative methodologies, various definitions of the variables, employing sensitivity analyses, and comparing our results to those of most other studies, we conclude that the incentive effects of ACRS and the extended ITC

very likely contributed substantially to net investment in the United States in the 1982-84 period. Our estimates hover around 20% of net investment being directly attributable to the changes in the investment incentives.[2]

Boskin's overall conclusion that the tax incentives contribute "around 20 percent of net investment" demolishes the critics. After presenting and examining detailed statistical and econometric analyses from a great variety of sources, the Boskin report concludes, "We believe the preponderance of the evidence suggests that the investment incentives worked, in the sense that they stimulated investment substantially."

"The preponderance of the evidence suggests that investment incentives worked...they stimulated investment substantially."

Boskin has lots of distinguished company in arriving at that conclusion. For example, Dr. John Makin of the American Enterprise Institute and Dr. Raymond Sauer of the University of New Mexico show that the investment incentives enacted in 1981 strengthened the investment expansion underway in 1983 and 1984.

Dr. Allen Sinai, chief economist of Shearson Lehman Brothers, and his associates reach similar conclusions, demonstrating how the investment incentives are far more cost-effective than the alternative of rate reductions. They also go on to show that removing such targeted incentives as ITC and ACRS—and even substituting some reductions of corporate profits taxes—"should reduce output, lower business equipment and plant outlays, lessen the associated borrowing, depress employment, reduce wages, and cut after-tax corporate profits in the most capital-intensive sectors and industries of the U.S. economy."

Martin Feldstein of Harvard University, in a recent working paper issued by the National Bureau of Economic Research, reaches similar conclusions. He shows, for example, that enactment of the House of Representatives tax reform bill would reduce the investment-to-GNP ratio by about half of its increase from the 1979-81 level.

Three of my colleagues at Washington University—Laurence Meyer, Joel Prakken, and Chris Varvares—have estimated the detailed effects of eliminating the investment tax credit and cutting back on accelerated depreciation (as the House of Representatives voted to do in the tax reform bill it passed in December 1985). Such action would, by 1991, lower the gross national product by 2.2 percent and raise unemployment by 1.1 million, compared with the growth and employment that would be expected under the current law.

Charge #3. The "striking failure of tax 'incentives' to produce more...jobs...."

Some observers complain about the supposed lack of new jobs that were expected to accompany the rise in capital spending following the enactment of the 1981 tax incentives. But the employment resulting from new capital investment is extensive. It is not just a matter of examining the employment figures for the company (Corporation A) that makes the capital investment. We must also take account of the jobs created in the firms building the new factories (Corporations B and C) and producing the new equipment (Corporations D, E, and F)—and then we also should examine the employment in the manufacturing and service companies (G, H, I, J, K, etc.) that use the products that Corporation A makes.

We can obtain a good first approximation of this complete process from overall data on employment in the United States. The results are extremely positive. In fact, they are the envy of the rest of the world; employment in Western Europe has been stagnant in recent years while job creation in the United States has been robust.

[2]Michael J. Boskin, *The Impact of the 1981-82 Investment Incentives on Business Fixed Investment* (Washington, D.C.: National Chamber Foundation, 1985).

Since 1981, 8.5 million new jobs have been created in this country, with total civilian employment in the private sector rising from 100.4 million in 1981 to 108.9 million in April 1986 (see Table 1). So much for the allegation of "striking failure" to create new jobs.

The experience of the General Electric Company provides a good example of the effectiveness of tax incentives for corporate investment. From the time that the Economic Recovery Tax Act went into effect in 1981 until the end of 1985, General Electric and its finance subsidiaries invested $22 billion in its own plants and in other U.S. factories, utilities, airlines, and railroads. The company estimates that these investments created or preserved at least 250,000 jobs. Moreover, the investments helped to make the company more competitive and to achieve a $2.6 billion trade surplus in 1985, a year when the United States suffered a merchandise trade deficit of $150 billion.

Charge #4. Capital-intensive companies "...paid little or nothing in federal income taxes over the 1981-84 period."

The activist organization known as Citizens for Tax Justice has circulated a list of 44 large companies that supposedly paid no federal income taxes over the period 1981-84. Indeed, as a group, the 44 companies are alleged to have received refunds of $2.1 billion from the U.S. Treasury. What is the truth of the matter?

Critics of providing investment incentives for businesses underestimate the true size of corporate tax burdens in the United States.

Upon inspection, it turns out that the critics omit a major share of the corporate tax liabilities of these companies for 1981-84 and ignore virtually all of their tax payments during that period.

For example, they purposely omit the entire category of deferred taxes, which many accounting authorities would seriously question. Taking advantage of such ignorance, critics of providing investment incentives for businesses underestimate the true size of corporate tax burdens in the United States.

Even if, for the sake of argument, we omit all deferred taxes from the calculations, we do not come up with anything like the CTJ charge that the 44 companies paid no federal income taxes at all. Thus, even arbitrarily leaving out the entire category of deferred taxes, we find that these same companies actually paid over $1.3 billion in current Federal taxes for 1981-84. The data in Table 2 compare the authoritative numbers of Standard and Poor's Compustat Services with the CTJ estimates.

A major factor in explaining the large discrepancy between Federal taxes paid and the CTJ figures is CTJ's erroneous "adjustments" for safe harbor leasing. Safe harbor leasing is the term applied to selling of unusable tax benefits related to investments in new equipment. (The tax benefits were unusable because the firms had insufficient taxable income to offset against them.) Most of this activity occurred after the enactment of the Economic Recovery

Table 1
EMPLOYMENT TRENDS, 1981-1986
(in millions)

Year	Civilian Employment	Cumulative Change
1981	100.4	—
1982	99.5	−0.9
1983	100.8	+0.4
1984	105.0	+4.6
1985	107.2	+6.8
April 1986	108.9	+8.5

Source: U.S. Department of Labor

Table 2
CURRENT FEDERAL TAXES PAID BY U.S. CORPORATIONS
Comparison of Compustat Data and CTJ Estimates, 1981-84
(in millions)

Company	Compustat Data	CTJ Estimates	Difference
1. ITT	$315.7[a]	($177.7)	$493.4
2. Dow	(180.0)	(180.0)	0.0
3. Ashland	(62.0)	(62.0)	0.0
4. Tesoro	(22.4)	(22.5)	0.1
5. Piedmont	0.1	(25.4)	22.5
6. Boeing	(13.7)	(285.0)	271.3
7. Int.Min&Chem	2.3	(43.7)	46.0
8. Northrup	(46.4)	(46.4)	0.0
9. IC Industries	11.3	(55.4)	66.7
10. Sun Chemical	(10.4)	(10.4)	0.0
11. Mitchell Energy	(23.7)	(41.1)	17.4
12. Pepsico	482.6	(135.8)	618.4
13. Georgia-Pacific	(18.0)	(59.0)	41.0
14. Int. Multifoods	(3.2)	(3.2)	0.0
15. General Dynamics	NR	(103.8)	103.8
16. Weyerhaeuser	57.3	(59.1)	116.4
17. Harris	(3.9)	(19.5)	15.6
18. Singer	0.9	(11.6)	12.5
19. Santa Fe/Southern Pacific	174.5	(133.4)	307.9
20. Scott Paper	108.4	(30.5)	138.9
21. Tenneco	(227.0)	(166.0)	(61.0)
22. Centex	(10.3)	(10.2)	(0.1)
23. Southwest Air	3.0	(8.1)	11.1
24. Texaco	(68.0)	(68.0)	0.0
25. Union Carbide	36.0	(26.0)	62.0
26. Intl. Paper	5.3	(32.6)	37.9
27. Greyhound	67.4	(10.4)	77.8
28. Allied/Signal	11.0[b]	(17.0)	28.0
29. Panhandle Eastern	(63.7)	(28.8)	(34.9)
30. Ogden	21.8[c]	(5.6)	27.4
31. Ohio Edison	252.7	(31.8)	284.5
32. Northern Indiana PSC	(14.6)	(14.6)	(0.0)
33. Philadelphia Elec.	299.0	(30.3)	329.3
34. Tysons Foods	20.9	(1.0)	21.9
35. Columbia Gas	(12.9)	(15.9)	3.0
36. Jim Walter	(7.8)	(4.1)	(3.7)
37. Arizona PSC	35.4	(14.1)	49.5
38. General Electric	$(130.0)	$(98.0)	$(32.0)

Table 2 (continued)
CURRENT FEDERAL TAXES PAID BY U.S. CORPORATIONS
Comparison of Compustat Data and CTJ Estimates, 1981-84
(in millions)

Company	Compustat Data	CTJ Estimates	Difference
39. Dupont	(40.0)	(40.0)	0.0
40. Xerox	158.7	(9.2)	167.9
41. Pennsylvania P&L	177.7	(10.0)	187.7
42. Burlington Northern	48.8[a]	(1.1)	49.9
43. Grumman	0.0	0.0	0.0
44. Lockheed	0.0	0.0	0.0
	$1,332.8	(2,148.3)	$3,481.1

[a]Excludes 1984
[b]Excludes 1983-84
[c]1984 only
NR = Not reported

Tax Act of 1981 and before the repeal of safe harbor leasing by the Tax Equity and Fiscal Responsibility Act of 1982.

In essence, safe harbor leasing allowed certain companies which invested in new equipment to realize the present value of the related tax benefits by selling them to another, more profitable company, which would then be entitled to claim the tax benefits on its own tax return. Obviously, only one party to this transaction—namely the buyer—realizes a reduction in its tax liability. The seller receives some value for this, but it does not represent a reduction in its tax liability.

Unfortunately, CTJ failed to understand the nature of these transactions and ended up double counting the tax benefits related to them. CTJ counted both the buyer and the seller as realizing the tax benefits from safe harbor leasing.

To put the matter simply but accurately, if any of the companies had made adjustments in their reports to the SEC or the IRS similar to the

ones made in the CTJ report, CTJ would probably have lambasted them for "cooking the books."

If any of the companies criticized by Citizens for Tax Justice had made adjustments in their financial reports similar to the ones made in the CTJ report, CTJ would probably have lambasted them for "cooking the books."

An inspection of Table 2 is quite enlightening. Pepsico, for example, is estimated by CTJ to have paid no federal income taxes in 1981-84 and supposedly having received net refunds of $135.8 million. But according to the Compustat data, the company paid almost $482.6 million in federal income taxes during that period. Ohio Edison, supposedly a recipient of $31.8 million in refunds, actually paid $252.7 million in federal income tax over the period.

A few of the mistakes in the often-quoted CTJ data go the other way. For example, Tenneco received refunds (or credits) of $227 million rather than $166 million and Panhandle Eastern $63.7 million instead of $28.8 million. But, in the aggregate, the CTJ "adjustments" missed over $3 billion of federal corporate income taxes paid during 1981-84.

Some Final Thoughts

The critics ignore the fact that the investment tax credit and ACRS are only second-best substitutes for dealing with the severe economic shortcomings of conventional tax accounting and for the bias in the tax system against saving and investment. It is well known that the existing tax system ignores the inroads of inflation on capital assets as well as on corporate earnings. But none of the presently considered tax reform measures would replace the archaic historical-cost basis of accounting now in use with economic or replacement cost accounting.

Some critics seem preoccupied with tax incentives to business, especially in the area of capital formation. Totally ignored is the host of government expenditures and credit subsidies to promote capital formation and other business purposes—the many billions of dollars that have been spent for these purposes in recent years by the Synthetic Fuels Corporation, the Corps of Engineers, the Bureau of Reclamation, the Small Business Administration and by other activities of the Departments of Commerce, Defense, Energy, Interior, and Transportation.

The attack on tax incentives, in good measure, is an assault on the role and importance of the private sector in the American economy and on the location of economic decisionmaking.

Perhaps the preoccupation arises because of the fundamental but ignored distinction between general-purpose tax incentives and closely targeted expenditure subsidies for capital formation. Under the tax approach, the individual business firm takes the initiative in selecting an investment project and it incurs the bulk of the risk involved. Under the government expenditure approach, in striking contrast, a federal agency determines which specific capital projects are to be financed and the government winds up bearing all or most of the risk.

Thus, the attack on tax incentives involves more serious questions than appear on the surface. In good measure, it is an assault on the role and importance of the private sector in the American economy and on the location of economic decisionmaking. A reduction in tax incentives and an increase in expenditure subsidies would result in an expansion of the direct role of the federal government in choosing capital investments—and a reduction of private risk-bearing.

Regardless of whether there is a hidden agenda behind the tax analyses published by

the Citizens for Tax Justice, the fact remains that their figures are simply wrong. Basing tax policy on such flawed information would be a serious mistake and would lead to tax laws that discourage economic growth and ultimately penalize both workers and consumers.