
Tax Credits

Past Experience and Current Issues

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Foreword

Greater use of tax policy to help in achieving nonrevenue goals or in solving social and economic problems has often been proposed in recent years. These suggestions for supplying "tax incentives" in the form of tax credits have prompted considerable discussion. Proponents believe that tax credits can be effective in more actively involving the private sector in desirable economic and social activities. Other observers doubt the desirability of using tax credits to help solve specific problems, such as the underemployment and lack of job skills in urban and rural poverty areas.

Tax credits have been used to a limited extent by different levels of government in this country, to accomplish several specific objectives. This study reviews this experience and provides background for an evaluation of the efficacy

of tax credits. Emphasis is primarily on Federal tax credits designed to influence action in the private sector. To some extent, however, the discussion is also relevant to the use of such credits by state and local governments, as, for example, the granting of a credit against state taxes for taxes paid to local governments.

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The Tax Foundation is a private, non-profit organization founded in 1937 to engage in non-partisan research and public education on the fiscal and management aspects of government. It serves as a national information agency for individuals and organizations concerned with government fiscal problems.

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Table of Contents

	PAGE
I. INTRODUCTION	5
II. EXPERIENCE WITH TAX CREDITS	7
Tax Credits Designed to Remedy Inequities	7
Tax Credits Designed to Influence Resource Allocation	12
1) By Influencing the Behavior of Governments	12
2) By Influencing the Behavior of Individuals and Businesses	16
Tax Credits Used by States	18
III. PROPOSED TAX CREDITS FOR STATE AND LOCAL TAXES.....	20
Tax Credits as Alternatives to Federal Grants	21
IV. THE MONEY COST OF CREDITS AND OTHER “TAX EXPENDITURES”	22
V. PROPOSALS FOR NEW USE OF CREDITS	24
Tax Credits to Achieve Nonrevenue Objectives	25
VI. MERITS AND DEMERITS OF TAX CREDITS	27
Arguments in Support of Tax Credits	27
Arguments Against Tax Credits	28
VII. SUMMARY	31
VIII. APPENDIX: TAX CREDIT PROPOSALS IN CONGRESS	33

List of Tables

TABLE	PAGE
1. Death Tax Credit	13
2. “Tax Expenditures” and Regular Spending by Function	22
3. Credits against Federal Income Taxes	23

I.

Introduction

Recent discussions suggest that increasing attention will be given to tax inducements to help in dealing with social and economic problems. Under discussion, for example, are proposed tax credits to be given to business for more active involvement in direct attacks on poverty, both rural and urban.

A *tax credit* is an allowance against the amount of tax payable. A credit may serve any of several purposes. Because it obviously benefits the taxpayer, a tax credit can influence individuals and companies to alter their actions. They may do more or less of something, or undertake something quite new. Thus, the tax credit can be a form of what is often called a "tax incentive."¹ The allowance can, of course, be tailored to detailed specifications or framed to apply broadly. The amount may be large or small in relation to associated magnitudes.

A rather different use of tax credits employs them instead of deductions or some other feature of a tax to adjust the final burden. For example, the state income tax of California allows no personal exemption deduction in computing taxable income but permits a married couple a credit of \$50 against tax. Credits can also serve to prevent multiple bur-

dens when more than one tax law applies to a single tax base.

Tax Credits to Promote Social and Economic Goals

In addition to raising money, taxes from time to time have been designed to help in achieving other objectives. From Alexander Hamilton's first tariff to protect "infant industries" from foreign competition, Federal tax policy has often been directed in part toward the promotion of nonrevenue goals. The Employment Act of 1946, for example, represented a commitment by Congress to utilize fiscal machinery to influence aggregate demand and thereby help in attaining high-level employment.

Quite another kind of result is expected from many specific taxing provisions. Depletion deductions are given to encourage mineral exploration. Tax rates have been steeply graduated to redistribute after-tax income and wealth for a variety of reasons, one of which certainly has been to keep heavy taxes from worsening greatly the economic position of lower-income groups.

Government expenditure and loan programs have been the major weapon for dealing with welfare problems. But,

1. Some observers object to the term "tax incentives," holding that every tax is to some extent a disincentive, and removal of the tax burden merely removes an obstacle. Nevertheless, the term has apparently gained acceptance in standard usage.

tax provisions for economic and other nonrevenue purposes take the form of special deductions, exclusions, exemptions, preferential rates, and perhaps the most powerful as incentives, tax credits.

To distinguish between credits and deductions, the 1954 Internal Revenue Code adopted a uniform style of referring to items to be subtracted from the *tax liability* as "tax credits," and items to be subtracted from *gross income* as "deductions." Per dollar, credits against tax are more attractive to taxpayers than exclusion or deduction allowances. For example, the worth of a deduction differs according to the bracket or brackets from which the amount comes. Four \$600 personal exemption deductions of a \$10,000 family reduce tax by \$516 and

of a \$20,000 family by \$692. Deductions are said to "come off the top" as one looks at the calculation of taxable income or estate, whereas tax credits "come off the bottom," the tax itself.

This report attempts to throw light on the merits and demerits of tax credits as a possible means of dealing with social and economic problems. While discussing "tax credits," this report does not endeavor to cover all ramifications of the nonrevenue aspects of taxation, nor the variety of tax concessions offered. For the most part, the scope is limited to tax credits at the Federal level, and no attempt is made to evaluate the relative merits of the tax credit device according to the level of government by which it is used.

II.

Experience With Tax Credits

Practical experience with the tax credit device in this country has been limited. Most earlier tax credit legislation has either lost much of its importance or has been revoked, leaving only a small number of measures in effect today. A review of the principal tax credit measures calls for a distinction with regard to the nature and objective of tax credits.

Some of the earlier tax credit laws were clearly designed to remedy a real or imagined horizontal inequity, i.e., a violation of the principle that "equals shall be treated as equals"—that those in essentially similar circumstances shall bear the same share of the expense of government. According to this principle, when circumstances of taxpayers differ in ways that are significant for sharing the costs of government, fairness requires that tax loads differ. Tax credits of this nature include the dividend credit, the retirement income credit, and the foreign tax credit.

Another type of tax credit has been quite different in nature and purpose; it seeks to encourage certain actions which presumably would not occur in the absence of the credit. It aims to influence the allocation of resources by in effect *creating* a horizontal inequity, i.e., by taxing "equals" differently depending on certain conditions. Within this second category a further distinction can be made between credits designed to alter

the behavior of government units, and those which would modify the behavior of individuals or businesses. Credits given by the Federal government against taxes paid to state governments under the estate tax and unemployment insurance tax have thus influenced state tax policies. The investment tax credit is the major example of a tax credit intended to influence the behavior of individuals or business enterprises, through encouraging the modernization and expansion of productive facilities.

Tax Credits Designed to Remedy Inequities

(1) THE DIVIDEND CREDIT

Before the enactment of the undistributed profits tax on corporate earnings in 1936, dividends were totally exempt from the normal personal income tax, but subject to the surtax portion of the individual income tax. The rate of normal tax varied from year to year but was often around 4 percent. The undistributed profits tax of 1936 made dividends fully taxable as ordinary income, and this practice of taxing dividends was continued even after the undistributed profits tax was repealed.

The Internal Revenue Code of 1954 introduced a dividend "exclusion" and a tax credit against dividend income. From 1954 to 1963 individuals could exclude the first \$50 of dividends from

gross income and take a credit against the total tax otherwise due amounting to 4 percent of dividends received in excess of \$50. This measure was the result of lengthy discussions and controversy on double taxation of dividend income. The argument about double taxation went as follows:

Income derived from corporations is essentially taxed quite differently from all other income. The corporation itself pays corporate income tax on its profits, and the stockholder pays personal income tax on his dividends. These earnings are thereby subject to double taxation, once on the corporate level and again on the individual income level. This conclusion is, of course, based on the assumption that the corporation income tax is not shifted forward in prices to consumers. There is, however, no assurance about how much of the tax on corporate earnings is passed on to consumers. The assumption that the economic incidence of the Federal corporate income tax is on shareholders rather than customers is often a matter of dispute.

The need for relief from double taxation clearly depends on the extent to which there is in fact double taxation, and this in turn depends on the incidence of the corporation income tax. Traditional economic theory has held that a corporate income tax rests on the corporation and is not shifted either forward to consumers or backwards to employees or suppliers. This position has been questioned on both pragmatic and theoretical grounds and a rather extensive literature has developed on the subject. At present there seems to be fairly widespread uncertainty as to the incidence of the corporation income tax,

with continued arguments as to whether or not the tax is shifted or borne by the shareholders.¹

For purposes of this discussion, it is both correct and adequate to assume that dividends paid to individual stockholders are doubly taxed, both to the corporation and to the individual recipient.

The dividend exclusion and the tax credit for dividend income when first enacted in 1954 were intended as a partial relief from double taxation. The \$50 exemption was designed to give full relief for small stockholders. It was also believed that the exemption and the credit would aid corporations in raising new equity capital, since this tax offset makes investment more attractive.

Between 1954 and 1963 the controversy over the dividend credit was not so much over the justification of relief from double taxation as over the most equitable solution for the achievement of this goal. Different proposals granting tax offset for double taxation of dividends were considered. When the tax credit was enacted in 1954, it was hoped that the rate could eventually be increased to give more tax relief. However, the dividend tax credit was soon attacked as a tax "loophole," and its repeal was voted in the Senate in both 1959 and 1960. The repeal did not become effective until 1964. By that time Congress had voted to reduce the corporate tax by 4 percent and had granted business a new type of tax credit for new investments in productive capital expenditures.

The main objection to the dividend exclusion and the dividend tax credit, it was argued, was that they constituted an inequitable means of relieving the dou-

1. For more discussion of tax incidence see *The Corporation Income Tax: An Examination of Its Role in the Federal Tax System* (New York: Tax Foundation, Inc., 1968), pp. 33-43.

ble taxation of dividend income.² Critics of the dividend tax credit also argued that the tax credit gave no relief where there was no double taxation, e.g., to stockholders not subject to tax, such as pension funds and non-profit organizations.

The 1964 law discontinued the dividend tax credit, but increased the "dividend exemption" to \$100 (\$200 for a married couple). The exemption is essentially a concession to low-income dividend receivers. It was hoped that the increase in dividend exemption would encourage a broader stock ownership among individuals with relatively low incomes.

The 4 percentage point cut (8 percent) in corporate income taxes granted by the Revenue Act of 1964 and the earlier adoption of the 7 percent investment tax credit placed corporations in a better position to raise new equity capital than under the investment incentive generated by the dividend tax credit.

(2) THE RETIREMENT INCOME CREDIT

Payments received under the Social Security Act by retired persons are exempt from tax. Persons not eligible for social security benefits were given a similar exemption in 1954 when a special tax credit for "retirement income" was enacted. As modified since, the law now permits a taxpayer who is 65 years of age or over to apply a credit against his tax liability equal to the amount of his "retirement income" up to \$1,524, multiplied by 15 percent or a maximum credit of \$228.60 - \$457.20 on a joint return. "Retirement income" is defined to include pensions and annuities, in-

terest, and dividends. However, to avoid duplication, the law requires that the amount of an individual's retirement income (on which the credit is to be computed) be reduced by social security and other retirement benefits which are excluded from gross income for tax purposes. Few people now qualify for this credit. The retirement income credit had primarily been intended as a stopgap to provide equity until social security coverage would become general.

As a tax concession to elderly persons, the retirement income credit may be said to be preferable to the granting of increased personal exemptions or a deduction or exclusion from gross income, in that the credit provides a uniform rate of benefit to all taxpayers eligible for its use. Thus, no taxpayer, however high his marginal rate of tax, can benefit by more than 15 percent of the amount, with a top of \$228.60. In contrast, if \$1,524 of retirement income were allowed as a deduction or exclusion, the tax benefit would vary, depending upon the taxpayer's top bracket rate. The present credit does, however, discriminate against elderly persons whose income still derives, for the most part, from employment activities.

In 1967 the Johnson Administration recommended recasting of the special provisions for taxing the elderly. The retirement credit would have been replaced, by a special exemption; Congress, however, did not accept the recommendation.

(3) THE FOREIGN TAX CREDIT³

Foreign taxes of all types except gift and inheritance taxes are deductible

2. In the political debates on these measures, different ways of viewing tax relief or "equity" brought forth numerous alternative computations of the effect of the credit and of the exclusion, leading to conflicting conclusions about their equity effects. For a fuller discussion, see Dan Throop Smith, *Federal Tax Reform* (New York: McGraw-Hill, 1961), pp. 215-218.

3. This discussion does not deal with the effects of tax treaties.

from gross income earned abroad when computing taxable income of U. S. corporations, citizens, and residents with income from abroad. Included in creditable foreign taxes are withholding taxes on dividends, as well as the basic tax on corporate income. The objective of the foreign tax credit is to relieve international double taxation of income and thereby to remove any impediment to the flow of international investments. The law allows foreign income taxes (and taxes in lieu of income), at the option of the taxpayer, to be credited directly against the U. S. income tax rather than being deducted from gross income. In other words, to the extent that taxes have been paid on foreign income, they may be offset against U. S. income tax liability. They thus reduce the U. S. tax on foreign income dollar for dollar rather than to the smaller extent resulting from deduction in computing income.

The foreign tax credit also serves the purpose of preserving tax equality under U. S. taxing concepts; that is, foreign source income is taxed by the United States at the same rate as domestic income. To tax foreign source income at a higher rate, of course, would be to discriminate against such income and discourage foreign investment by U. S. interests.

The foreign tax credit is said to encourage countries with considerable corporate investments from the United States to raise their tax rates to the rate level of the United States. Whenever the tax rate abroad is lower than the U. S. rate—say 30 percent as against our 48 percent—a tax becomes due to the United States on the foreign-source income at a rate equal to the excess of the U. S. rate over the foreign rate—18 per-

cent in this illustration. By raising its tax rate, the foreign government can get funds for its treasury at the expense of the United States. When the foreign rate equals or exceeds the U. S. rate, the credit cancels the U.S. tax liability on foreign source income.

The foreign tax credit provision reflects a concern for achieving fair tax results, by avoiding discriminately and discouragingly heavy tax burdens, for income subject to tax in more than one country. In the absence of such special provisions, U. S. citizens and corporations would be fully taxed on foreign income by both our government and the governments of the foreign countries in which the income is earned.

When first enacted in 1918, the credit was allowed dollar for dollar; but the 1921 Revenue Act provided that the total credit might not exceed that proportion of the U.S. tax which the income from outside the United States bore to total income. In 1932, Congress enacted a per-country limitation in addition to this over-all limitation.

The effect of the over-all limitation meant that if a company already operating abroad started operations in another foreign country with the expectation of losses for the first few years, its losses would be applied against the income from other foreign countries, reducing thereby the over-all foreign income and with it the amount of foreign tax which could be credited. If the taxes in the countries where operations were profitable were substantially the same as the U.S. taxes on the same income before the loss activity was started, total taxes actually paid would be increased. This perverse result of the over-all credit led to its repeal in 1954.

It was urged at that time that each company should have an option to select either the over-all or the per-country limitation. The per-country limitation, left in the law after 1954, can be restrictive if rates in some countries are higher than in the United States and lower in others, or if allocations of income have produced uncreditable taxes in some countries. Also, it was argued, since many companies consider all of their foreign operations as a single division, an option should be given that would permit taxpayers to compute the allowable foreign tax credit either on a per-country or on an over-all basis. The law was amended effective in 1961 giving taxpayers a one-time option to select either the over-all or the per-country limitation.

Prior to the Revenue Act of 1962, the income of controlled foreign corporations was taxed by the United States only when distributed. A corporation is considered controlled if more than 50 percent of its voting stock is controlled by U. S. persons or companies. A marked difference resulted in the tax treatment of foreign branches as opposed to foreign subsidiaries of domestic firms. The income of foreign branches was taxed currently, but the tax on the income of foreign subsidiaries was deferred until such income was actually repatriated to the shareholding corporation. This means of postponing tax aroused criticism. Moreover, there was growing concern over the balance of international payments and criticism of the effects on tax equity of the use of foreign "tax havens."

Before 1962, the accumulated income of foreign corporations could sometimes be converted from ordinary income to capital gains at the time of repatriation

through the sale of the stock of the corporation which had earned the foreign income. The 1962 act, however, provided that gains realized by a shareholder owning 10 percent or more of a foreign corporation, regardless of the transactions prior to the repatriation, would be viewed as dividends. The act also provided for taxing the full sales price of a patent, copyright, secret formula, or similar item sold by a parent corporation to a controlled subsidiary as to be taxed as ordinary income.

When a domestic corporation receives dividends from a foreign subsidiary (except for a corporation located in a less-developed country) and elects to take the foreign tax credit, it must "gross up" its tax base. It does so by including not only the dividends received, but also the income tax paid by the foreign corporation on the earnings from which the dividends were paid. For example, a U. S. corporation which received \$100,000 of dividends from a subsidiary in a developed country where the tax rate on net income is 20 percent includes \$125,000 in its U. S. gross income and claims a tax credit for foreign taxes paid of \$25,000. Prior to 1962 no "gross up" for foreign income tax was required. In effect, the law now treats the tax credit itself as something of value to be included in the base on which U. S. tax is to be computed.

The effect of the gross-up provision can be seen in the following illustration: A United States corporation has a subsidiary doing business in a foreign country. The tax credit under the gross-up rule is computed as follows:

Income earned by subsidiary	
in foreign country	\$100.00
Foreign Tax (40% rate)	40.00
Subsidiary's net profit after tax	\$ 60.00

U. S. Corporation	
Dividend income (from subsidiary)	\$ 60.00
"“Gross-up” of tax “deemed paid”	<u>40.00</u>
United States taxable income	<u>\$100.00</u>
United States tax (52.8% rate)	52.80
Foreign tax credit	<u>40.00</u>
Net United States tax due	<u>\$ 12.80</u>

Total taxes paid of \$52.80 ($40.00 + 12.80$) or an effective tax rate of 52.8%, or normal corporate tax rate.

The effects of provisions governing the investment tax credit for foreign investment, and the influence on private investment abroad, have occasioned considerable discussion. While there is no denying that the outflows of capital funds tend to weaken our already strained balance-of-payments position in the year in which such outflows occur, these investments do have a positive effect on the balance-of-payments situation in the long run. The income remitted from the foreign earnings of U. S. direct investments abroad, in the form of dividends, interest and branch profits, have exceeded the outflow of capital investments in every year of this decade. At the same time, U. S. exports of capital equipment, parts, and components for use and production abroad, have been encouraged by the flow of private investments abroad.

Nevertheless, a major problem now concerns ways of preserving tax incentives for private investments in less-developed countries without unduly en-

couraging the outflow of funds to nations whose development is already advanced.

Tax Credits Designed to Influence Resource Allocation

(1) BY INFLUENCING THE BEHAVIOR OF GOVERNMENTS

(a) *The Estate Tax Credit*

When the Federal government in 1916 enacted an estate tax on the transfer of property at death, several states had been taxing inheritances for many years. In response to criticism of Federal “encroachment,” Congress in 1924 provided a credit of 25 percent for state death taxes. The estate tax credit was the first Federal tax credit. A person liable for Federal estate tax could in effect settle at first 25, then 80, percent of this tax with the receipts for the payment of state inheritance or estate tax.

Professor Maxwell points out that this tax credit had several objectives, none of them sharply defined and some of them in conflict.⁴ Congress wanted to reduce tax burdens and the Federal budget surplus. But some influential members wanted to keep the death tax with its progressive rates. By yielding a slice of death tax revenue to the states, Congress could reduce Federal revenues (and tax burdens) but retain the tax with its graduated rates.

Moreover, the credit would reduce interstate competition for wealthy persons and also secure some measure of tax coordination and uniformity out of widely diverse and complex state death taxes. The credit was intended to aid especially those states which imposed significant death taxes. The competition among states for wealthy residents was growing, as a number of states offered

4. James A. Maxwell, *Tax Credits and Intergovernmental Fiscal Relations* (Washington, D.C.: Brookings Institution, 1962), p. 23.

themselves as tax havens for the aged wealthy. The Federal estate tax credit in effect eliminated much of the tax advantage that any state was able to offer.

The increase in the credit to 80 percent in 1926 obviously decreased the Federal tax revenue. But it also enabled states to increase their tax receipts by imposing higher inheritance and estate tax rates than some would have attempted otherwise. However, a change at the same time in the Federal estate tax exemption from \$50,000 to \$100,000 increased the number of estates which received no credit although paying a state tax.

Federal action in offering the credit was effective in getting all but one state (Nevada) to impose an inheritance or estate tax.⁵ The tax in most states was usually, but not always, high enough to absorb most (up to 80 percent) of the Federal death tax credit. The only condition Congress attached to the credit was that a state death tax be levied. The potential of pushing toward greater uniformity was largely overlooked, being limited to merely an inducement for each state to maximize the value of the credit for its taxpayers. Federal interest in revenue remained large enough to justify efforts for strict administration which in fact supplemented state efforts.

In 1932, Congress enacted a supplementary estate tax to increase Federal revenues, but without increasing the credit, which was frozen at the 1926 amounts. Consequently, the credit declined from 76 percent of Federal tax

Table 1
Death Tax Credit

Size of taxable estate	Federal tax before credit	Maximum tax credit
\$ 40,000	\$ 4,800	\$ 0
100,000	20,700	560
500,000	145,700	12,400
1,000,000	325,700	36,560
5,000,000	2,468,200	398,320
10,000,000	6,088,200	1,076,720
100,000,000	75,388,200	15,476,400

Source: Harvard Law School, *World Tax Series, Taxation in the U.S.*, Commerce Clearing House, 1963, p. 229.

liability in 1931 to 10 percent in 1959. Table 1 shows the pattern of credit that has prevailed since 1942. A 1954 revision modified details without altering the amount of credit.⁶

The states, under no pressure to accomplish uniformity, and under growing pressure to secure more revenue, imposed death taxes which varied in type, definition, rate and exemption, so that complexity and structural disorder resulted. Congress has not responded to proposals that call for the use of the death tax credit to bring about greater harmony among state death taxes.

In the effort to aid states in meeting their increased revenue needs, proposals have been made, asking Congress to give up Federal estate taxation, thereby leaving the death tax to the exclusive jurisdiction of the states. Other proposals have been aimed at increasing the share of death tax revenues allowed to states through a greater use of the credit, as a substitute for — or addition to — some existing or projected Federal grants to states.⁷

5. The absence of a death tax in Nevada did not constitute a competitive threat of significant size to other states. Wealthy persons could not save their heirs' death tax by establishing residence in Nevada because, in effect, the tax which Nevada chose not to collect had to be paid, but to the U. S. Treasury.

6. For further discussion of the death tax credit and for proposals of alternate solutions see *Coordination of State and Federal Inheritance, Estate, and Gift Taxes*, Advisory Commission on Intergovernmental Relations (Washington, D.C.: 1961).

7. Recent recommendations of the Advisory Commission on Intergovernmental Relations, for example, call for the liberalization and restructuring of the Federal credit for state death tax payments; the Commission proposes an alternative Federal credit for state estate tax payments equivalent to 80 percent of the Federal tax liability on the first \$150,000 of the taxable estate and 20 percent of the tax liability on the balance of the taxable estate.

The present system for dividing death tax revenues between Federal and state governments has the disadvantage of requiring at least two administrative determinations for each estate that is subject to both taxes and likewise, of increasing the work for an estate in complying with each.⁸ However, states could effectively avoid such doubling up by generally adhering to Federal definitions of the gross estate and allowable deductions and providing that final Federal determinations be followed for state death tax purposes. When first enacted, the death tax credit granted appreciable tax revenues to some states. However, presently the death tax credit no longer gives substantial relief from Federal taxation for estate taxes paid to states. In view of the rising needs for state revenues and the pressure for Federal revenues sharing, an increase in death tax credits appears as an alternative worth legislative consideration.

(b) *The Unemployment Insurance Credit*

The Social Security Act of 1935 created a system of unemployment insurance to be administered jointly by the Federal and state governments. Under this system state funds are built up out of which benefits are paid to insured workers when they become unemployed. The immediate purpose is to provide the jobless worker with some financial support. The payment of unemployment benefits also has the secondary effect of maintaining purchasing power and cushioning the shock of unemployment to the community and to the national economy.

Under provisions of the Social Security Act, the Federal government pays

for administrative expenses, enforces certain minimum standards of administration, and serves as repository for the state funds. The real development of the unemployment insurance program is left up to the states.

The method chosen by Congress to give the initial impetus to states for legislation on unemployment insurance was through the use of the tax credit. The Federal government imposed a Federal unemployment tax of 3 percent upon the payrolls of employers with eight or more employees. The employer was permitted to offset (claim credit for) 90 percent of the Federal tax (2.7 percent of taxable payrolls) for the amount paid to an unemployment insurance system under the laws of the state in which he does business.

In this way one of the main obstacles to state unemployment compensation legislation was removed. States had been afraid to establish such programs because of the belief that home business would suffer a competitive disadvantage through the failure of other states to follow suit.

Under the Federal law, employers in states without such programs would have paid the full 3 percent tax to the Federal government without receiving any specific benefit from their tax payments. Employers in states which adopted an unemployment compensation plan paid only .3 of one percent of taxable payrolls to the Federal government. The remainder of their taxes went into their own state unemployment fund.

The use of this tax credit with its attendant conditions was successful in securing the creation of state unemploy-

8. Many estates actually pay some death tax to several states.

ment insurance programs throughout the nation. At the outset, this system had considerable state-to-state uniformity in its major provisions, even though rates and benefits and other regulations were recognized state functions. The importance of state control has been stressed continually by experts in this field.

The basic characteristics of this Federal-state relationship have remained substantially unaltered for more than 30 years. The only major changes in the Federal aspects of unemployment insurance are the increase in Federal tax from 3.0 to 3.1 percent, and the extension of the Federal tax from firms with eight or more employees to those with four or more.

Since 1935 numerous developments have changed the uniform rate of payroll tax into a variety of rates among individual firms. All states continue to levy a standard rate of 2.7 percent in order to give their employers the full tax credit allowed under the Social Security Act. However, actual employer tax rates may be above or below that standard rate, depending upon the employer's employment or benefit experience. The apparent differences in tax rates between states result from experience rating laws. Presently all state laws have in effect some system of experience rating by which individual employers' contribution rates are varied from the standard Federal tax rate (3.1 percent) on the basis of their experience with unemployment risk. This is made possible by a provision in the Social Security Act which allows employers credit for contributions which they have been excused from paying because of their "good" unemployment record.

Different formulas are used by various states for experience rating. Most of

these plans are alike in that they consider the employer as being responsible for the unemployment of their workers, which causes a loss to the unemployment fund. The different unemployment and merit rating plans encourage employers to stabilize employment by adjusting rates to the risk of unemployment. Unemployment tax rates are therefore reduced for those employers whose contributions are greater than the benefits paid on their behalf.

The adequacy of the present system of unemployment compensation has been seriously challenged in recent years. In 1965, a far-reaching proposal for basic amendments to the Federal-state unemployment insurance system was submitted to the Congress by President Johnson. This proposal would in effect have abolished experience rating, which is a keystone to the present co-operative Federal-state plan, by providing national standards for benefit and unemployment eligibility. The bill also called for higher payments and for conformity in unemployment tax rates by gradually changing the tax base from the present \$3,000 to \$6,600. This bill would have led to a substantial "federalization" of the unemployment insurance system. The states and major corporations strongly opposed the bill as an infringement on state authority in the area of unemployment insurance. Congress, consequently, did not enact the proposed revisions.

The unemployment insurance tax credit has served as an effective incentive for state legislation of unemployment insurance. Beyond this, the tax credit had no further objective. Proposals for changes in the unemployment insurance system do not exclude the further use of this tax credit.

(2) BY INFLUENCING THE BEHAVIOR OF INDIVIDUALS AND BUSINESSES

(a) *The Investment Tax Credit*

Whereas the estate tax credit, and the unemployment insurance tax credit influenced the behavior of governments, the objective of the Federal investment tax credit was to alter the behavior of individuals and businesses.

The investment tax credit was first enacted in 1962. It was designed to encourage the modernization and expansion of American industry through greater capital investment in machinery and equipment. It was hoped that increased capital investment would produce greater productivity and faster economic growth, with positive employment results. Greater capital investment would help lower unit production costs, especially since the new equipment would embody the most advanced technology. One result would be that American industry would gain a better competitive position in world markets.

The Revenue Act of 1962 provided for a credit of 7 percent against tax liability for "qualified" investment in new depreciable machinery and equipment (3 percent for public utilities), provided that the useful lives of the assets were 8 years or more. With respect to capital assets with a shorter useful life, the credit was proportionately lower.

Useful life	Applicable portion of tax credit
8 years or more	Total
6 years or more but less than 8 years	Two thirds
4 years or more but less than 6 years	One third

The investment tax credit applied to investments in "tangible personal property" used for manufacturing, produc-

tion, or extraction, or furnishing electricity, gas, water, or transportation. Capital assets meeting these conditions are known as "Section 38 Property." Not eligible for the investment tax credit were investments in buildings and their structural components.⁹

"Section 38 Property" can be new, used, or even leased. The 7 percent credit, in no case, could exceed the total tax liability. When that tax liability was in excess of \$25,000 the credit could not exceed \$25,000 plus 25 (later raised to 50) percent of the liability in excess of that amount during any one year. "New" property is that portion of Section 38 Property constructed, reconstructed, or erected after 1961. The person claiming the credit must be the original owner. If the total amount of credit exceeds the tax liability for any one year during which the investment was made, the credit may be carried back 3 years and then, if not used up, carried forward 5 years.

"Used" property can qualify for the credit but only up to a limit of \$50,000 invested per year. This provision was intended especially to aid small business, which often relies relatively heavily on used property. The credit in such cases will, of course, make for higher demand and better markets for used machinery.

"Leased" property is subject to special provisions. The lessor has a choice. He can either use the credit himself or pass it on to the lessee — in effect treating the lessee as the person acquiring the property. This option is given with regard only to "new" Section 38 Property.

The Kennedy administration aimed to encourage the modernization and expansion of productive facilities, but it in-

9. These do, however, qualify for accelerated depreciation under the 1954 law.