sisted on methods which would not cost huge amounts of revenue. At the time (1961 and 1962) the President was opposed to substantial tax reduction as a means of stimulating the economy. The investment tax credit was granted in conjunction with a series of revenue-raising measures. It sought to encourage actions which through history have been associated with high rates of economic growth. Although direct cause-and-effect may be uncertain, the performance of the economy since 1962 has been consistent with the hopes of advocates of the credit.

When first enacted in 1962, the investment tax credit required that the basis of property eligible for the investment credit be reduced by the amount of the credit for the purpose of depreciation. In other words, for an asset costing $100 and eligible for an investment credit of $7, the basis had to be reduced from $100 to $93. This basis adjustment requirement was repealed in 1964, since it was found that the reduction of the basis to which depreciation write-offs could be applied actually reduced the incentive effect of the investment tax credit.

Business leaders in 1961 and 1962 showed little enthusiasm for the investment tax credit. They doubted that it would be of lasting benefit and would have preferred to get relaxation of Treasury restrictions on deduction of depreciation. Although businessmen generally placed high priority on improving rules regarding depreciation, the investment tax credit as passed often went markedly further in increasing the rate of return on new investment than would result from substantial relation of depreciation allowances. As pointed out by the Machinery and Allied Products Institute, the 7 percent tax credit is equivalent to an initial write-off of depreciation of about 25 percent, higher than is generally possible under even accelerated depreciation. For equipment of average service-life expectancy, an investment credit of 7 percent improves the after-tax equity return by about one-seventh or 15 percent.

The investment credit grants an outright tax reduction, over and above all depreciation allowances, whereas a speed-up in depreciation allowances postpones the due date for the investor's tax liability if earnings are realized. The tax postponement does raise the rate of return, but the benefit in most cases is appreciably less than under the credit.

The investment credit of 7 percent is not only effective in raising profitability; it has other advantages as well. As already noted, it is a tax offset, not a deduction which might be treated as an expense in computing income. The credit, therefore, will not be treated in business records as a cost of operation as are increased write-offs under accelerated depreciation. Thus, as compared with accelerated depreciation an advantage claimed for the credit is that it avoids any upward distortion of the costs on which a firm will base its pricing and other decisions. This feature of the credit may be of positive significance when one goal of national policy is to keep the price level from rising (for domestic reasons as well as ability to compete internationally).

Proponents of the investment credit believe that it has less tendency than


11. Accelerated depreciation alters the timing and not the total deducted; the alleged cost-raising tendency of the early years of life of an asset will presumably be offset by a cost-reducing result later.
special depreciation provisions to confuse the problem of stimulating investment with that of properly defining taxable income. In arriving at taxable income, depreciation constitutes a cost. The amount deducted depends on the method of depreciation and the depreciable lives of the assets; both of these are subject to differences of opinion. Special depreciation provisions to encourage investment can interfere with accurate estimating of cost and earnings. The investment credit does not have to affect procedures of computing depreciation and taxable income.

Even though the investment tax credit had been presented as a permanent feature of the tax structure, inflationary pressures in 1966 led the Johnson Administration to propose, and Congress to enact, a suspension of the credit for the period October 1, 1966, to January 1, 1968. The suspension did apparently cause a decline of capital outlays, though analysts are by no means sure whether the amounts were minor or somewhat greater; most business investment plans are not changed on short notice. But the drop in business investment was large enough to induce the Administration to restore the credit as of March 9, 1967, almost 10 months before the suspension period had been scheduled to end. The Restoration Act of 1967 increased the amount of tax credit above the $25,000 limit from 25 to 50 percent of the eligible credit for any given year.

Treasury assurances when asking for suspension of the investment tax credit in 1966, and the unexpectedly quick restoration in the spring of 1967, worked to generate more widely and firmly the belief that the investment tax credit had become a permanent feature of our tax system. However, President Nixon in April 1969 asked Congress to repeal it permanently. This proposal was coupled with a request that the 10 percent tax surcharge extension be shorter than had been indicated earlier and that the rate for a final six months be 5 percent.

With respect to the investment credit, the President said: "This subsidy to business investment no longer has priority over other pressing national needs. . . . While a vigorous pace of capital formation will continue to be needed, national priorities now require that we give attention to the need for general tax relief." The President also indicated that new proposals would be presented later.

Repeal of the investment tax credit is estimated to provide the Federal government with additional revenues — and business with tax burdens — of $3 billion a year.

Tax Credits Used by States

An examination of state income tax structures reveals that states which levy the tax permit a wide variety of credits. Certain types of tax credits appear in several states, such as credits given for persons aged 65 or over, for the blind, or for student dependents. Others are not quite so common, such as those allowed for supporting a mentally retarded child at home, for contributions to political parties or certified educational institutions, or for income received for service in the armed forces of the United States. Then, too, one or two income tax credits are rather uncommon, such as the credit Oklahoma allows for the cost of constructing a radiation fallout shelter or

12. A further modification allowed the credit to apply to property which was ordered during the suspension period but acquired or built on or after May 24, 1967.
that given by Louisiana to taxpayers who have lost one or more limbs. Several states allow some form of tax credit or exemption for the encouragement of pollution control.

For computing taxable income, most states follow the Federal precedent and permit a personal exemption deduction. Several states, however, allow the deduction to take the form of a credit against tax in lieu of, or in addition to, the exemption deduction from income. The use of credits instead of exemptions results from the desire to give a certain amount of tax benefit to those with lower incomes and no more to persons with larger incomes which are subject to higher tax rates. The credit offers a benefit which is the same for all taxpayers, whereas tax relief produced by a deduction from income varies with the marginal tax rate. New York gives a tax credit of $25 for married couples and $10 for single taxpayers in addition to personal exemptions. Arkansas, California, Kentucky, Minnesota, and Wisconsin grant a tax credit to be deducted directly from the state tax liability.

In recent years certain states have allowed credits against their income taxes for sales and property taxes paid. Indiana, for example, allows a credit of $8 per dependent for sales taxes paid on food and prescription drugs. Since the sales tax rate is 2 percent, the credit offsets full sales tax on $400 of purchases. Colorado and Nebraska have a similar provision, although the amount of their credit is $7 per person; and the credit is for sales taxes paid on food purchases only. These credits offset part of the sales tax burden on the poor.

At least four states grant residents a measure of property tax relief by permitting income tax credits for property tax paid. These are Michigan, Minnesota, Maryland, and Wisconsin. In Minnesota and Wisconsin the credit is granted only to those age 65 or over.
Proposed Tax Credits for State and Local Taxes

One of the most widely discussed tax credit proposals of recent years aims to give states and localities more revenue, or to enable them to raise more revenue, by allowing taxpayers to offset a portion of their Federal income tax liability by credits for state and local taxes. Some of these tax credit proposals have been advanced in part as a means of dealing with a potential Federal budget surplus in a way that will relieve pressures on state finances. To date, of course, substantial increases in Federal expenditures for both defense and civilian purposes have matched rising revenues; no large budget surplus has yet appeared.

Nevertheless, proposals for credits for state taxes have continued to receive support. One argument sees them as a possible alternative to some present Federal grant-in-aid programs. Grants-in-aid are generally earmarked for one or another function and are spent under Federal direction. The proposed tax credits—if implemented by actions of states to raise their own taxes at Federal expense, i.e., to absorb a credit—would give fuller discretion to state and local authorities to use the funds as they wish.

The different tax credit proposals call for a credit of part of a taxpayer’s local or state income tax, or perhaps sales tax, against the Federal tax liability. Basically, tax credits in the proposed form would allow the deduction of one tax (that of the state) from another (that of the Federal government). State and local taxing units would then be in a position to “pick up” some of the former Federal tax by incorporating a similar tax in their own systems. Most of these proposals, however, include restrictions that would limit the amount of tax offsetting that could take place. Several restrictive formulas have been described.

1. Proportional tax credits. The taxpayer would be allowed to credit (that is deduct) a specified percentage of his state tax against his Federal tax liability.

2. Graduated tax credits. These would divide state tax liabilities into brackets and allow the deduction of differing portions of each: for example, x percent of the first $100 of tax, y percent of the second $100, and z percent of the remainder. Regressive credits (x > y > z) include flat-sum allowances as a special case. Progressive credits (x < y < z) are similar in their effects on distribution of burden to deductions from income when the tax rate is progressive.

1. To some extent the case for granting a credit against Federal taxes for taxes paid to state-local governments applies with equal validity to credits against state taxes for taxes paid to local governments. Some observers in fact advocate the latter type of credit as a means of encouraging initiative and responsibility at the local level, in preference to equivalents in grants-in-aid or direct spending by higher levels of government.

3. Unlimited credits subject to a proportional ceiling. The taxpayer would be allowed to deduct all of his state tax but only up to x percent of his total Federal tax liability.

4. Unlimited credits subject to a graduated ceiling. State income taxes would be fully credited against the Federal individual income tax up to, perhaps, 20 percent of the first $200 of liability, 10 percent of the next $300, and 1 percent of the remainder.

The amount of money that would be made available to the state under any of these plans would depend on the terms involved and state responses. Presently, 13 states do not impose personal income taxes at all. The tax credit schemes would be coercive, in that all states that do not now have the type of tax allowed as a credit, such as a personal income tax, would be virtually compelled to introduce it. Otherwise, their residents would pay more Federal tax than people in states with the credit. States already having the tax qualifying for credit could use it more intensively than at present; they could get more state revenue as the Federal burden declined because of the credit.

The credit could be devised to provide a strong, and perhaps irresistible, incentive to all states not having a personal income tax to adopt one. They could do so up to the amount of any ceiling (and allowing for differences in detail) without adding any cost at all to their own taxpayers, or rather little, above the amount previously paid in taxes. Such credit, then, could bring important financial aid to some state and local governments. Whether other states would benefit appreciably by boosting existing taxes is less clear. Some advocates wish to use the credit to force all states to adopt personal income taxes. Other plans would allow credit for sales and property taxes, thus leaving states free to frame their own tax structures.

**Tax Credits as Alternatives to Federal Grants**

Tax credits are one of a number of proposals which have been put forward either as supplements to, or substitutes for, present Federal grant programs, as well as to aid states in raising more revenue themselves. Grants may distribute as much as $25 billion to state and local governments in fiscal 1970. Alternatives which have been under debate would accomplish various combinations of objectives. To attempt to compare different possible tax credits with such other alternatives as unconditional grants and forms of “tax sharing” — i.e., giving the states a larger stake in present Federal revenues from income taxes — would go beyond the scope of this report.

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3. Excluding New Hampshire, Rhode Island, and Tennessee, which tax only dividends and interest, and New Jersey, which levies its tax only on New Jersey—New York commuters’ earnings. Two states have no income tax at all, but local income taxes are used extensively (Ohio and Pennsylvania).


IV.

The Money Cost of Credits and Other "Tax Expenditures"¹

Special tax provisions take many different forms. Under some, certain types of income are excluded from the tax base, e.g., interest on state and local government bonds, half of realized long-term capital gains, social security benefits for the aged, and some employer payments of fringe benefits, such as hospitalization, surgical, and group life insurance premiums. Other tax provisions take the form of deductions for certain personal outlays—charitable contributions, medical expenses, and interest payments.

Still other special provisions allow deductions for business expenditures in excess of actual cost (some percentage depletion and bad debt reserves) or permit deductions without adding the worth of the benefit for which the costs are actually occurred, e.g., some agricultural expenses, research and development outlays, and some costs of exploration and discovery of natural resources. The costs of these special tax provisions are difficult to estimate; traditionally, they are not entered in the Federal budget, since they bring in no revenue and require no disbursement by the Treasury. Professor Stanley S. Survey, when Assistant Secretary of the Treasury, termed these revenue effects "tax expenditures." If these special tax provisions could be grouped in customary budgetary categories—assis-

¹. The discussion in this section deals chiefly with income taxes. To a varying degree this discussion also applies to estate, gift, payroll, excise, and property taxes.

Table 2

"Tax Expenditures" and Regular Spending by Function
Fiscal Years 1968-1970

<table>
<thead>
<tr>
<th>Function</th>
<th>Tax expenditures (Billions)</th>
<th>Regular spending (Billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>National defense</td>
<td>0.5</td>
<td>0.6</td>
</tr>
<tr>
<td>International affairs</td>
<td>0.4</td>
<td>0.4</td>
</tr>
<tr>
<td>Agriculture and agricultural resources</td>
<td>0.9</td>
<td>1.0</td>
</tr>
<tr>
<td>Natural resources</td>
<td>1.6</td>
<td>1.7</td>
</tr>
<tr>
<td>Commerce and transportation</td>
<td>7.8</td>
<td>9.2</td>
</tr>
<tr>
<td>Community development and housing</td>
<td>4.0</td>
<td>4.7</td>
</tr>
<tr>
<td>Health and welfare</td>
<td>15.6</td>
<td>18.0</td>
</tr>
<tr>
<td>Education and manpower</td>
<td>0.7</td>
<td>0.8</td>
</tr>
<tr>
<td>Veterans benefits and services</td>
<td>0.6</td>
<td>0.6</td>
</tr>
</tbody>
</table>

a. Loss in Federal tax revenue through special tax provisions. Not included are the foreign tax credit, estate tax credit, and the unemployment insurance credit.

Source: Treasury Department.
Table 3

Credits Against Federal Income Taxes
Income Years 1962-1966
(Millions)

<table>
<thead>
<tr>
<th>Year</th>
<th>Corporation</th>
<th></th>
<th></th>
<th>Individual</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Investment tax credit</td>
<td>Foreign tax credit</td>
<td></td>
<td>Investment tax credit</td>
<td>Foreign tax credit</td>
<td>Retirement income tax</td>
<td>Dividends received</td>
</tr>
<tr>
<td>1962</td>
<td>$ 834</td>
<td>$1,564</td>
<td></td>
<td>$119</td>
<td>$32</td>
<td>$116</td>
<td>$291</td>
</tr>
<tr>
<td>1963</td>
<td>1,106</td>
<td>1,915</td>
<td></td>
<td>159</td>
<td>n.a.</td>
<td>136</td>
<td>318</td>
</tr>
<tr>
<td>1964</td>
<td>1,319</td>
<td>2,270</td>
<td></td>
<td>172</td>
<td>46</td>
<td>121</td>
<td>—</td>
</tr>
<tr>
<td>1965</td>
<td>1,716</td>
<td>2,716</td>
<td></td>
<td>206</td>
<td>59</td>
<td>110</td>
<td>—</td>
</tr>
<tr>
<td>1966</td>
<td>2,019a</td>
<td>n.a.</td>
<td></td>
<td>234</td>
<td>68</td>
<td>120</td>
<td>—</td>
</tr>
</tbody>
</table>

a. For most corporations the fiscal year corresponds to the calendar year.
b. Excluding Investment tax credit claimed by small business.
c. Preliminary.

Source: Statistics of Income, Treasury Department.

The recent Treasury study also emphasized that getting a true and complete picture of the Federal government’s impact on the economy is impossible as long as “tax expenditures” are not included in the analysis. The various features which lead to these “tax expenditures” have effects which include many alterations of actions. Individuals and businesses change their behavior as a result of the opportunities to reduce tax. But our knowledge of the many results remains incomplete.

As to the money cost of present tax credits, Table 3 provides a detailed breakdown.

In 1964, the total foreign tax credit claimed by corporations and individuals together amounted to $2,316 million. The investment tax credit, by comparison, amounted to $1,490 million in 1964, but it is estimated to be around $3 billion for fiscal 1965 and perhaps nearly as much as that for foreign income tax.

tance to business, natural resources, agriculture, aid to the elderly, medical assistance, and so on—the amounts could be compared with cash outlays of the more familiar type.

To show the Federal tax revenue “lost” through different special tax provisions, the Treasury Department in 1968 prepared estimates giving a functional breakdown of the money amounts involved (Table 2).

The estimated total of such “tax expenditures” for fiscal year 1970 is in the neighborhood of $40 billion. Critics of figures such as these say that they reflect an underlying philosophy—one not admitted openly—that government in some pervading sense owns, or has first claim to everyone’s income; that what it does not take is left as an act of grace. Whether or not this criticism of the “tax expenditure” approach is valid, the decision not to take something from people is not quite the same as collecting dollars and then paying them out.
V.

Proposals for New Use of Credits

Welfare programs for the needy, medical care for the poor, and education have traditionally been considered state and local responsibilities though in recent years the financing of these functions by Federal funds has increased. Pressure for more Federal action has also grown. Some specific proposals would make use of tax credits.

The population shift of the last three decades has seen the growth in metropolitan regions of areas having little tax-paying ability relative to the expenses of welfare, schools, and other governmental programs. The amount needed to meet the full public service costs has generally outstripped the revenue sources available. Federal grant programs and direct spending have increased year after year in the effort to assist states and localities. However, welfare spending, whether by Federal, state, or local governments, is said to have yielded unsatisfactory results, partly because its attack on the source of the problems has been deficient. Welfare needs of most metropolitan areas have grown to a dimension that has rendered them a matter of national concern. Faster progress in dealing with hard-core economic distress, it is said, requires more participation by business, and tax credits can help.

American business has not, of course, remained insensitive to these problems. A conference sponsored by the National Industrial Conference Board in January 1968 provided valuable proof of some impressive pilot programs in the field of low-cost housing, job training for the hard-core unemployed, and business-sponsored aid to basic education.

An outstanding initiative in this field led to the creation of the National Alliance of Businessmen (NAB) in 1968. This organization aims to encourage private industry in the 50 largest cities to place 500,000 disadvantaged people in jobs by June 30, 1971. The Federal government, through the Job Opportunities in the Business Sector (JOBS) program, reimburses employers for the added costs of hiring and training the disadvantaged. JOBS is currently placing people in private industry for training and employment at the rate of 20,000 per month, and reached its interim goal of 100,000 some months ahead of schedule. In 1970, the Federal contribution will be double that of 1969, with $420 million in budget authority to underwrite 140,000 training opportunities. Other manpower programs conducted jointly with the private sector are the industry incentive portion of the Office for Economic Opportunity (OEO) "Special Impact Program" and the Labor Department's on-the-job training program.

In the field of low-income housing, a 1967 pledge by life insurance companies of $1 billion toward the redevelopment of urban ghetto areas is an outstanding, but not a unique, example of an initiative
by the private sector to help ease social and economic problems. No special tax incentive is connected with this pledge. The life insurance companies made another $1 billion available in April 1969 for the same purpose.

The concern with social problems was revealed in a 1969 article in Fortune. Interviews with business leaders showed that next to ending the war in Vietnam and the control of inflation, business expects the Nixon administration to channel a far greater share of the nation's resources into solving the myriad problems of the cities and the poor.

**Tax Credits to Achieve Nonrevenue Objectives**

The belief that private enterprise—not only government—should be involved in solving the nation's economic, and also the related social problems has the support of President Nixon. His approach, as reflected during the campaign, would be to offer tax and credit incentives to corporations and individuals for rebuilding city slums, locating plants in "ghetto" areas, and training the hard-core unemployed.

Under this approach Federal tax burdens would be reduced for those who qualify for new types of tax credits. Those who make special effort to help in solving problems of special importance could thus retain a larger portion of their income after tax. Such reduction of the prospective income tax burden follows the logic of the long-standing American belief that money devoted to agreed upon social purposes should be untaxed.

Secretary of the Treasury Kennedy recently noted the Administration's interest in the use of tax credits to meet social problems. He stated, "The Treasury is examining closely some of the more promising approaches recommended by the President's Task Force on Taxation. We shall proceed with these studies as rapidly as possible."

Tax credit proposals range over a wide variety of goals, reaching from specific social or economic problems (e.g., rural and urban job incentives and slum housing) to programs of general interest such as pollution control facilities and expenses of higher education.

Several tax credit proposals were selected for brief discussion and summary in the appendix of this report. They illustrate the aims and particular provisions included in specific tax credit proposals. The bills discussed represent proposals in specific areas; but this selection gives no indication of the range of areas for which tax credits have been proposed.

It should be clear that all tax credits are subject to restrictions and conditions to carry out the specific aims of each proposal.

For example, the granting of the investment tax credit is limited to "qualified" investments in productive capital facilities with a life expectancy of at least four years. Excluded from the tax credit were: property used to furnish lodging (e.g., hotels); property used by tax-exempt organizations, and by governmental units; livestock; and property used outside the United States. Used property was only partially eligible for the credit. The credit was limited to 7 percent of investment expenditures

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and could be applied in full only against tax liability up to $25,000. (It could apply against a limited percentage—at first 25, then 50, percent—of tax liability in excess of $25,000.) In no case could the credit exceed the total tax burden. Any investment tax credit which cannot be used in a specific taxable year because of this limitation can be carried back for use to each of the three preceding taxable years and carried forward similarly to any of the following five taxable years.

The declared aim of the investment tax credit was to offer an incentive to business for investments in tangible property that would further expansion and modernization of production facilities. The forementioned regulations and controls are designed to aid the achievement of these objectives.

Similar restrictions are part of the current tax credit proposals presently in Congress. Restrictions and controls generally include guidelines as to the time period for which such credits are to be granted, the amount of credit, and the specific conditions and eligibility requirements for the recipient of a credit. Tax credits should thus not be thought of as easy and generous give-away programs of Federal funds. On the contrary, tax credit legislation is generally accompanied by stringent regulations that aim at the achievement of the agreed upon objectives.
VI.
Merits and Demerits of Tax Credits

Tax credits can be used to offer incentives to the private sector of the economy to help in achieving our national goals. Past experiences, however limited, tend to justify support for serious consideration of tax credit legislation in the context of current economic and social problems.

An evaluation of the merits and demerits of tax credit legislation poses a particularly difficult problem. Some of the earlier tax credits have either lost much of their importance or have been revoked altogether, and only a limited number of tax credits are still in effect today.

Arguments in Support of Tax Credits

The value and effectiveness of tax credit legislation cannot be estimated for tax credits in general. What is meaningful is an evaluation of specific tax credit legislation in the context of the needs and requirements when such legislation is enacted. The main criteria for evaluation should be the effectiveness of such legislation and the flexibility with which it responds to changing needs and priorities. While testing the effect of such tax incentives is particularly difficult, tax credit legislation has been slow to respond to newly arising priorities. This discussion suggests that tax credits can effectively be used for non-revenue goals, dependent on stringent controls that nevertheless permit adaptability to changing needs. The presence of regulations that combine such safeguards with flexibility seems to justify a positive view on the potentials of tax credit legislation.

Advocates of tax credits believe that greater use of tax incentives offers a means of promoting the national interest. They will often point to Western European countries which reportedly used tax incentives successfully to stimulate economic recovery and growth after World War II.

Proponents also argue that in the presence of persistent urban and rural poverty, approaches to solutions which use tax inducements warrant more attention. Tax credits are an alternative to other measures, including direct government outlays. Credits encourage the private sector to become involved in different programs, e.g., to give job training and employment to the undereducated, especially to those who make up much of the hard-core unemployment in areas that lack an adequate economic structure. These are also areas with high welfare needs. A more active involvement of business would, hopefully, bring more use of dynamic approaches, and more imagination and initiative, in dealing with problems of poverty that to date have not been solved by our highly prosperous economy or by the various attempts made through government.

One argument favoring tax credits is that they interfere less with business
decisions than do direct outlay programs or loans by government. Expenditures, obviously, are subject to annual budgetary scrutiny and to uncertainty about the amounts to be available or the conditions to be attached. The possibility of budget cuts is always real. Federal loan programs are also subject to substantial change from year to year. Tax credits, once enacted, might be more sheltered from annual review by Congress. Consequently, businesses and others involved could rely with greater certainty on these tax credits than upon the availability of low-interest government loans or direct government expenditures. In terms of practical reality tax credits also have impressive appeal in that they offer scope for great flexibility in managerial decision-making, depending, of course, on the detail of regulations and conditions attached to each specific tax credit law; in general, expenditure and loan programs are almost certain to impose more confining constraints on initiative, adaptation to diversity, and progressive response to both success and failure that can be expected with tax credits.

The champions of tax credits argue that even though in some cases tax credits may be less efficient than a direct expenditure program, tax incentives have at least one great advantage: they grant more freedom to the company or individual in the use of knowledge about conditions of the particular time, place, and combination of circumstances and in the choice of ways and means to deal with each problem.

It could also be argued that the investment incentive route encourages the private sector to participate in desired activities in a way which keeps it more directly in contact with private consumer markets, as distinguished from public expenditure programs in which the private sector delivers to government procurement authorities.

**Arguments Against Tax Credits**

In spite of the strong support given to tax credits for nonrevenue goals, many observers view such legislation critically.

Some critics argue that tax credits do constitute a form of “tax expenditure” and should therefore be subject to frequent Congressional scrutiny. If not, how can proper priorities be maintained in an economy of endless changes? Moreover, experience with the investment tax credit shows that certainty cannot be counted upon. The absence of government control over details, which has positive value in providing freedom and flexibility, troubles some observers. Can not civil servants exert constructive influence if only by speeding use of the benefits of experience, good and bad, resulting from projects in many places?

It would certainly be fallacious to think of tax credits or other tax incentives as simple, automatic, and self-enforcing solutions for any big problem of society. On the contrary, any tax incentive legislation is likely to encounter difficulties which are inherent in the specific characteristics of the problem at hand. Tax credits of even massive size will not train or educate, build housing, or reduce pollution. Real limitations of human effort and ability, of productive capacity and market organization, will inevitably keep accomplishments below aspirations.

As for effectiveness, a tax credit, like a deduction allowance, is not useful at all when there is no tax liability, e.g., where there is no taxable income. And the effectiveness of a tax credit depends upon both the amount of incentive of-
fered and the ability of the taxpayer to act in the ways desired. Anything which reduces the tax payable enhances the ability of the taxpayer by leaving him with more dollars and thus greater capacity to find the funds needed to finance the activity. When there is no tax liability, however, the credit will not release funds to permit a business to pay for some program. In such cases an expenditure by government promises to be more effective than a tax credit.

The differences among tax credits—dividend credit, retirement income, foreign, estate tax, unemployment insurance, investment—make generalizations somewhat hazardous. A tax credit designed to remedy an inequity might be criticized if the inequity which is to be remedied is thought to be unreal (e.g., the dividend credit). Other tax credits, such as the unemployment insurance tax credit, are subject to the criticism that political considerations have taken priority over economic considerations. Some general points can be made here.

Skeptics about the true contribution of a tax credit, or any tax incentive measure, emphasize this point: The net effect may be much less than appears because a good deal would have been done even in the absence of the credit. How could one possibly set up a tax (or expenditure) incentive system which would give the benefit for only what would not be done otherwise? Can anyone predict with confident assurance how much would be done without the tax credit? Rarely, if ever. It will certainly be hard, probably impossible, to judge how much any sacrifice of revenue actually produces, i.e., results that would not have occurred otherwise. The cost of the additional result may be low, reasonable, high, or exorbitant.

Tax credits are not shown as outlays in the Federal budget, whereas direct government expenditure programs, being recorded, are subject to scrutiny by Congress in the annual appropriations process. Most tax expenditures are somewhat hidden, and their total cost until recently remained unknown. Tax credits, however, have been identifiable, after some lag, in published statistics of taxation; but little or no effort has been made to measure the results against the revenue loss. New programs along the lines of any of the four described above would raise serious problems of comparing costs and benefits.

Chairman Wilbur C. Mills of the House Committee on Ways and Means has pointed out that the use of tax incentives and other tax expenditures leads to a tax base erosion and undercuts control over government expenditures. He sees tax credits as a device for “back door spending.”

“... the grant of tax credits has precisely the same effect on the budget as an outright expenditure. The only difference is they appear as a negative receipt rather than as expenditure. The grant of the additional tax credits increases the size of the budget deficit just as surely as an additional expenditure. That is why I refer to the tax credits as back door spending.”

He goes on, “... The increase in expenditure for the particular purpose that results from a tax credit could be achieved at a much lower cost... if the additional investment were financed through direct expenditures. The ex-

1. The carryback and the carryforward can make a tax credit available in years in which there are no net earnings—but only if there had been profit in other years.
penditures could more readily be channeled only to those who would not otherwise undertake the activity."²

The 1968 Treasury study of the cost of "tax expenditures" establishes a procedure for disclosure on a regular basis. To include these "tax expenditures" along with the annual direct outlays and net lending programs grouped by functions would permit periodic review and encourage revision to take account of changes in objectives. Tax credits in particular would no longer be so nearly hidden costs, and their cost-benefit relationships could be estimated more adequately.

Benefits, of course, may be difficult to identify and measure. Some may develop only gradually. The adoption of new tax credit incentive plans will initially result in a loss of Federal revenue as taxpayers take advantage of them. Yet even revenue results may be positive if, as supporters hope, the credits do effectively generate better economic growth and a faster rise in tax payments than would otherwise occur. This happy result will not, of course, become a reality merely because it is a possibility.

Recent discussions suggest that increasing attention will be given to tax credits to help in dealing with social and economic problems. A tax credit is an allowance that can be directly offset against the tax liability of an individual or business, in contrast to a tax deduction, which is subtracted from gross income before tax. A tax credit is thereby likely to have an appreciable "incentive effect."

Government expenditure and loan programs have long been used as a major weapon for dealing with welfare problems. Federal grants and direct outlays have increased year after year in the effort to assist states and localities. Welfare spending, whether by Federal, state, or local governments, however, is said to have yielded unsatisfactory results, partly because its attack on the source of the problems has been deficient. New types of tax credits, aimed at greater participation by business, have been proposed as an aid to the solution of such problems.

Tax credits have been used in this country to a limited extent by different levels of government. The principal tax credit measures used on the Federal level are of two major types: (1) those designed to remedy a real or imagined horizontal inequity, such as the dividend credit, the retirement income credit, and the foreign tax credit; and (2) credits aimed at encouraging certain actions which presumably would not occur in the absence of the credit. Credits of the second type influence the allocation of resources by in effect creating a horizontal inequity. Within this second category a further distinction can be made between (a) credits designed to alter the behavior of government units; and (b) those which would modify the behavior of individuals or businesses, e.g., the investment tax credit. Interest currently centers on credits which fall in the category "2-b."

Tax credit proposals presently under discussion rest on the belief that business, and not government alone, should be involved in solving the nation's economic and related social problems. President Nixon has given support to this principle. His approach, as reflected during the campaign, would be to offer tax and credit incentives to corporations and individuals for rebuilding city slums, locating plants in "ghetto" areas, and training the hard-core unemployed. Numerous proposals have been introduced in Congress to achieve these and a variety of other goals.

Tax credits should not be thought of as easy and generous give-away programs of Federal funds, or as simple, automatic, and self-enforcing solutions for any big social problem. On the contrary, tax credit legislation is generally accompanied by stringent controls and regulations that aim at the achievement of agreed upon objectives. It should also be expected that any such legislation would be exposed to difficulties which are inherent in the specific character of the problems to be solved.

The experience with earlier tax credits gives only limited insight into the value
and effectiveness of any newly enacted tax credit measure. No general evaluation of tax credits can be made here; what is required is an evaluation of specific tax credit proposals in the context of the needs and requirements present at the time such proposals are considered. Nevertheless, some major arguments for and against the extended use of tax credits are presented.

Great uncertainty exists in evaluating the probable effectiveness of tax credits in attracting more industry into such problem areas as job training for the undereducated, the establishment of plants in "ghetto" areas, and improving the quality of housing for low-income groups. Taxes would be only one of many factors to be considered by business. Greater importance would attach to the normal determinants of business decisions on such matters—access to markets, availability and cost of labor, transportation costs, water and fuel supplies, availability of raw materials, the quality of public services, and so on. The importance of tax credits would vary with each particular problem and from one industry to another. For some possible programs the degree of capital intensity would make some difference.

Earlier experiences with the tax credit device were on the whole different in their objective from the tax credit proposals presently under discussion. The effectiveness of tax credits with regard to present day social and economic problems, therefore, remains to be tested.
Appendix

TAX CREDIT PROPOSALS IN CONGRESS

The Rural Job Development Act (S.15)

The bill was introduced in January 1969 by Senator Pearson and others. It provides income tax benefits for employers operating certain industrial or commercial enterprises in rural job development areas.

The Secretary of Agriculture is directed to certify as eligible for benefits certain new facilities or new parts of facilities which meet specified requirements, including

1. The creation of new, full-time jobs for at least ten persons;
2. Employment of persons in at least 50 percent of the jobs who reside within the rural job development area, who have served at least one year on active duty in the Armed Forces, or who have been enrolled at least one year in the Job Corps;
3. Employment of persons in at least 33 percent of the jobs who are heads of families whose income was less than $3,000 in the year immediately preceding employment, or persons described in (2).

The Secretary is authorized to require certified businesses to file reports, and to give criminal sanctions for filing false reports.

The Act would offer an income tax credit for investment in certified depreciable property in rural job development areas. The amount of credit for the year would be 7 percent of the qualified expenditures made in real property, or 14 percent of the qualified expenditures in personal property as defined, limited to the taxpayer’s liability for the year. Carryback and carryover are provided for the credit in excess of the deduction. The Act provides for tax increases to recapture credit if property for which credits were allowed is disposed of under certain circumstances within 10 years in the case of real property, or 4 years for personal property.1

The Secretaries of Labor and of Health, Education, and Welfare would be authorized to provide training programs and training allowances for low-income individuals in rural job development areas who are unemployed and who are to be employed by a person operating a business certified under this Act. Appropriations of $20,000,000 for fiscal 1969 and of such amounts as may be necessary would be authorized.

The Secretary of Agriculture is charged to collect, analyze, and publish economic data for the information and guidance of businessmen seeking to establish job creating enterprises in rural job development areas. The Bill authorizes $250,000 for this purpose. It also calls for the creation of a National Public Advisory Committee on Rural Industrialization, to be composed of twenty-five members appointed by the Secretary of Agriculture to assist in administering this Act. The Secretary is directed to make an annual report to Congress concerning its operations under this Act.

The declared aims are to use the human and natural resources of rural America more fully and effectively, to slow the migration from rural areas due to the lack of economic opportunity, and to reduce population pressures in urban centers resulting from such migration.

The Human Investment Act (S.1167, H.8824)

Senator Prouty introduced this Bill in February 1969 in the Senate, and Representative Steiger in the House.

A tax credit would be given for employee training expenses up to a total of $25,000 per employer each year plus 50 percent of the tax liability in excess of $25,000. If training expenses exceed these limits, unused credits may be carried back three years and forward seven.

Wages and salaries of apprentices, employees enrolled in on-the-job training programs, and employees who are participating in certain cooperative educational programs are considered to be employee training expenses.

1. The Act would also provide new and more generous depreciation deductions for property of the type for which credits are allowed and for carryover as a deduction of net operating losses of certified businesses. The Act would also permit an additional (special) deduction of 50 percent of the compensation paid during the taxable year to employees in certified facilities who conform to the residence, Armed Forces, or Job Corps service provisions, or to the low-income descriptions set forth in the certification requirements.
Certain kinds of training are excluded, for example, those not within the United States. Tuition and fees paid under employee training programs are excluded from the gross income of the recipient individual for Federal tax purposes.

By allowing a credit against income tax to employers for the expenses of job training programs, this Bill would provide an incentive to business to "invest" more in the improvement of human resources, hiring, training, and employing presently unemployed workers lacking needed job skills. This would encourage the upgrading of job skills and the creation of new and better job opportunities for workers presently employed or unemployed. Training would be provided close to the job by an employer whose interest would presumably be in developing a better work force. One of the present obstacles would be reduced, namely the fear that much of a company's spending might be lost as workers left for other employers. The tax credit would reduce the net cost to the company. And from the national point of view, the worth of such "tax expenditures" would not depend on where the person worked eventually.

The Urban Employment Opportunities Development Act (H.1381)

This Bill was introduced by Representative Turney in the House early in 1969. It calls for an income tax credit and other benefits to be given to taxpayers operating certain commercial and industrial facilities in urban poverty areas.

The credit against tax would be 7 percent of expenditures made:

(1) For the manufacture, production, construction, purchase, or improvement of real or personal property; and

(2) During the ten year period beginning with the date on which the taxpayer's eligibility for the program is established.

The amount of credit is limited to the amount of the tax liability for each year but with carryback and carryover of unused credits for three and ten years respectively.

Tax liability would be increased—credit given earlier recovered—when the property for which the credit was granted is disposed of under certain circumstances within ten years (for real property) and four years (for personal property) of the date of the qualified expenditures. Recapture would also be required upon termination by the Secretary of Housing and Urban Development of the taxpayer's eligibility.

The Act would provide new regulations for depreciation deductions for property of the same type for which credits are allowed under this Act, and for carryover as a deduction of net operating losses for businesses eligible for the tax benefits of this Act.

The Act would also allow an additional special deduction of 25 percent of the compensation paid during the taxable year to specified employees.

Termination of the eligibility of the taxpaying facility under this Bill would increase the gross income for the taxable year in which the termination occurred by the amount of the deductions for employee compensation allowed in such taxable year and the two preceding taxable years.

The Act would authorize the Secretaries of Labor and of Health, Education, and Welfare to provide training programs and training allowances for low-income individuals in urban poverty areas who are unemployed and are to be employed by a person operating an industrial or commercial enterprise certified as eligible for the benefits of this Act. The Bill calls for appropriations of $20,000,000 for the first fiscal year and of such amounts as may be necessary thereafter.2

(1) Written notice from the governing body of the city in which the poverty area is located that it wishes to participate in the programs of this Act for the creation of new employment opportunities;

(2) Approval by such governing body or an agency designated by it of the enterprise applying for certification;

(3) Determination by the Secretary of HUD that the expected benefits to employment and other aspects of the welfare of the area warrant the granting of the income tax incentives provided by this Act; and

(4) Agreement by the applicant to the rules prescribed by this Act or by the Secre-

2. These conditions are also stipulated in Pearson's rural job development bill described above.
and upper-middle income groups for whom benefits would go to those with low and middle incomes exceeds $15,000 so that the bulk of benefits would go to those with low and middle incomes. Yet there would be help for middle and upper-middle income groups for whom taxes are high and college expenses a difficult burden.

The bill proposes a maximum tax credit of $325 per student. The credit would be computed on the basis of 100 percent of the first $200 of qualifying expenditures for tuition, fees, and books; 25 percent of the next $300, and 5 percent of the subsequent $1,000. No credit would be allowed for student costs above $1,500.

The available credit would begin to be phased out when the taxpayer’s adjusted gross income reached $15,000. One full credit would be phased out at each $10,000 level above $15,000. A family paying the expenses of one college-age child would be entitled to some tax credit up to an income level of $25,000. Similarly, a taxpayer with income above $35,000 could obtain a credit only if he were supporting three or more students. Thus the effect of the credit would be adjusted according to the economic circumstances of the taxpayer.

The aid would go to individuals rather than to the institutions as such; this feature would get around possible difficulties of providing Federal funds to private and church-supported colleges and universities. Some university administrators have not welcomed the tax credit, preferring plans which would channel money to the colleges. The outlays which would qualify would not be limited to tuition; students in tax-supported, low-tuition, colleges would be able to get credits as large as those of persons in private institutions.

The Kennedy and Johnson Administrations opposed any tax credit for college expenses. Objections arise out of belief that the plan would benefit some people whose after-tax incomes could cover college expenses without undue sacrifice while doing little for some of the poor. People with a small income tax liability could claim only a small amount of credit. Supporters of the credit argue that its benefits for the huge majority of families should be the deciding factor, not the special conditions of the relative few at the upper and lower extremes of the income distribution. The objection with greatest influence grows out of the source of the greatest appeal: the annual cost of Senator Ribicoff’s plan has been estimated at about $1.5 billion. Such revenue loss seems to rule out early adoption, even though the popularity of this tax credit may be widely based in influential segments of the population.