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The Origins of Affirmative Fiscal Action

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Mirit Eyal-Cohen*

ABSTRACT

This article highlights an anomaly. It shows that two tax rules aimed to achieve a similar goal were introduced at the same time. Both meant to be temporary and bring economic stimuli, but received a dramatically different treatment. The less efficient or economically inferior survived. Its superior counterpart did not. The article reviews the reasons for this paradox. It shows that the reason is both political and an agency problem. The article not only enriches an important and ongoing debate that has received much attention in recent years, but also provides important lessons to policymakers.

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INTRODUCTION

One thing about businessmen—they condition more readily than any maze-running rats or the most impressionable of Pavlov’s dogs. Give them a reward for increasing their investment in new plant and equipment—the 7 percent investment credit—and watch them run for it. Threaten to take it away, and watch them run even faster.

—Albert L. Kraus, N.Y. Times, 1969

The topic of small business continuously receives congressional attention. Regulatory compliance costs, credit problems, and the federal tax burden of small businesses have persistently remained on the political agenda. Every so often, politicians promise benefits to the “little guy” to win the public vote. However, the preferential treatment of small businesses raises several policy issues. Recent literature has shown that small business favoritism is not necessarily justified on economic grounds and, in fact, creates more economic harm than good.

The importance of capital investment incentives in the U.S. may be observed in the fact that in recent years they represented approximately $818 billion, and more than half of net business income. This figure goes a long way to explain why this subject has been of interest to

1 Albert L. Kraus, Investment credit—Possible Suspension Sparks Advance in Spending on Plant and Equipment, N.Y. TIMES, Mar. 26, 1969, at 61.


5 Undistributed corporate profits in the same year amounted to $8.3 billion, and were therefore only about one-third as large as depreciation deductions as a source of funds or cash flow. See Internal Revenue Code, Statistics of Income-2003, Table 2.-Number of Businesses, Business Receipts, Net Income, Deficit, and Other Selected Items, by Form of Business, Industry, and Business Receipt Size, Tax Year 2003, available at http://www.irs.gov/uac/SOL-Tax-Stats-Integrated-Business-Data.
businessmen, accountants, lawyers, economists, and the Treasury. Investment incentives comprise of many tax advantages. They allow taxpayers to recover their cost faster, lower the effective tax rate on such investments, and reduce the net cost of acquiring new assets. These incentives increase the rate of return on cash flow from investments in certain assets. By incentivizing equipment purchases, proponents claim that investment tax incentives stimulate the economy and help drive economic growth.

However, seldom, if ever, do the subject of depreciation and other technical tax allowances for business investment receive much attention in the media. It is only when they become the subject of presidential and committee discussions on repealing such benefits that this state of affairs somewhat changes. This was the case for the recent discussion over the new temporary bonus depreciation. It is virtually an axiom that once a tax benefit is granted to a specific group of taxpayers, even if introduced as a short-term measure, Congress will extend it, and rarely, if ever, rescind it. The debates during last year’s “fiscal cliff” demonstrated such truism.

The immediate expensing rule is a tax preference that reflects this historical path dependency. Enacted as a temporary measure in the late 1950s, Congress has perpetually extended it to the present day.

7 For example, such interest was generated during the discussions to repeal the investment credit. See, e.g., President’s Proposal to Repeal Investment Tax Credit and To Extend Tax Surcharge and Certain Excise Tax Rates, 91st Cong. 187-90 (1969) (statement of Rep. Edward Garmatz, Member, H. Comm. on Ways and Means).
8 Laura Saunders, The Tax Mess Deepens, WALL ST. J., Nov. 26 2011; Binyamin Appelbaum, Tax Break Increases Deficit, but may have a Silver Lining, N.Y. TIMES, Feb. 4, 2012 (describing the bonus depreciation as a tax subsidy); John D. McKinnon, House Committee Approves Permanent Depreciation Tax Break; Proposal Allowing Businesses to Deduct 50% of Capital Purchases Up Front Heads to Full Senate, WALL ST. J., May 29, 2014; Maxwell Murphy and Emily Chasan, Clock is Ticking on some Major Tax Breaks; Executives Fret about R&D Credit, Rule on Shifting Certain Foreign Profits, WALL ST. J., Oct. 29, 2013; Bill Smith, Small Business Advice: Hurry, these Four Tax Breaks Expire at the End of the Year, WALL. POST, Jan. 3, 2014.
10 Richard Q. Lewis III, Are Tax Expenditures Reaching Their Goals? A View From the Fiscal Cliff, 87 FLA. BAR J. 28 (2013) (“Using the tax code as a policy tool, the government has sought, among other aspirations, to increase home ownership and college enrollment among low- and middle-class taxpayers.”). See also J. D. Harrison, How the Fiscal Cliff Deal Affects Entrepreneurs and Small Businesses, WASH. POST, Jan. 4, 2013 (reporting Congress’s attempts to appease small business by providing extension of immediate expensing and the bonus depreciation in order to provide a boost for small employers planning to invest back into their firms in 2013); De A. Conrad, For Small Businesses, Tax Law has Become a Moving Target, N.Y. TIMES, Feb. 10 2013; Don Lee, and Jim Puzzanghera, The Economy: Cliff Deal Lifts Stocks and Doubts; Spending and Hiring are Expected to Suffer Over Uncertainties about the U.S. Debt, L.A. TIMES, Jan. 3 2013.
Currently, under Section 179 of the Internal Revenue Code (“Code”), taxpayers can immediately deduct up to $500,000 of the total cost of new and used qualified assets. This relieves taxpayers from having to capitalize the cost of these assets over their useful life. This tax benefit begins to phase out, dollar for dollar, when a taxpayer’s purchase cost surpasses $2 million.

The immediate expensing rule is one of numerous tax benefits enacted in 1958 as part of far-reaching auspicious small business legislation. However, a closer look at the immediate expensing rule reveals that its cover does not correspond to its content. De facto, the provision’s language does not confine the benefit to small firms. The requirements governing the use of immediate expensing do not limit the size of the firm that can claim such a benefit, but rather the maximum cost of the property acquired. Nevertheless, this measure has been termed, considered, and promoted a small business tax benefit for political reasons. In fact, although immediate expensing’s label has remained unchanged, in recent years its declared policy removed the focus on small business, and generally declared its aim of stimulating investments for businesses of all sizes. Because today expensing is meant as a general form of stimulus, the “small business” affiliation historically remained in the title for its political value.

A distant cousin of the immediate expensing rule, the late Investment Tax Credit (“Investment Credit”), underwent a different historical narrative. The investment credit was enacted in 1962, suspended in 1966, reinstated in 1967, repealed in 1969, reinstated in 1971, increased in 1975, and rescinded in the tax reform of 1986. The investment credit never reappeared again albeit numerous proposals put forth over the years to reintroduce it. Credits are usually economically superior to deductions because they provide dollar-per-dollar reduction in tax liability. The effect of expensing is more modest. It simply allows faster-than-normal depreciation deduction. Yet, while both measures were enacted during at the same period, expensing survived while the investment credit did not.

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11 Regular depreciation rules can be found in 26 U.S.C. §§ 167-168.
12 This amount is scheduled to be reduced by $200,000 in tax years after 2013. 26 U.S.C. §179.
15 Id.
This article starts by asking: What is the reason for these different legislative accounts? Put differently, why did the less effective or economically inferior rule survived while its superior counterpart did not? The article then offers two obvious answers for this paradox. First, a tax credit is a costly direct subsidy that forgoes a portion of taxable income, whereas immediate expensing is simply a timing rule that provides taxpayers with the benefit of time value of money through accelerated depreciation. Second, the immediate expensing rule enjoyed bipartisan support throughout history because Congress promoted it (unduly) as a small business preference. The investment credit was considered a tax break granted to already profitable big businesses that helped lower their tax bill.

However, politics and revenue loss are too simplistic as explanations for the persistence of the immediate expensing rule and the demise of the investment credit. The Article further argues that the conflation of the immediate expensing rule with small business, and its negligible scope are not the only reasons for its persistence. It identifies an agency problem as a third explanation for this anomaly. It focuses on changes in tax policy and the emergence of fiscal activism in the 1960s. It points out to a growing focus on economic stimulus to elucidate these differing historical accounts of both investment incentives.

The failure of the investment credit was greatly attributed to a built up of political dislike of a new tax policy. New Economics theory relied on Keynesian theories of increased government interference in the market. The new doctrine prescribed increased monetary, economic, and fiscal actions. It shifted the focus from a passive tax policy to a more active fiscal agenda. With the support of the Council of Economic Advisers, the government proposed a flexible policy. Using tax incentives such as the investment credit the administration proposed variable budget positions adjusted as often as necessary. The administration sought the tax system in need of continuous “functional calibration”. It assumed the correct position is the one that is correct for the given conditions and cannot be standardized over time. The investment credit was viewed as a failed experiment and a direct form of government intervention in market forces. Eventually, the demise of faith in government fiscal activism to stimulate the economy led Congress to abandon the investment credit. Yet, curiously, the accelerated expensing rule has continued into the present notwithstanding a lack of clear evidence regarding its efficiency in stimulating new market demand.

The article analyzes the different rules, reviews their history and identifies factors that not only enrich the debate on the use of the tax incentives

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system to influence individuals’ behavior, but may also provide guidance to policymakers. Currently, scholars and legislatures often call for equity, simplicity and neutrality in the design of our tax system.\textsuperscript{17} They argue that tax should be extraneous to people’s motives for taking upon certain actions.\textsuperscript{18} On the other hand, others believe the tax system should serve as a “window on society”.\textsuperscript{19} They see taxation as playing an important role in incentivizing or discouraging certain social goals.\textsuperscript{20} In their eyes, fairness and equity considerations justify introducing tax subsidies, whether credits or deductions. Examples of such tax measures include the Home Mortgage Deduction,\textsuperscript{21} the Student Loan Interest Deduction,\textsuperscript{22} and the Earned Income Tax Credit.\textsuperscript{23} The aim behind these tax incentives is to encourage taxpayers to pursue home ownership, higher education,

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\textsuperscript{18} See, e.g., Martin A. Sullivan, Economic Analysis: Tax Incentives and Economists, 111 Tax Notes 20, 23 (Apr. 3, 2006) (stating that tax incentives distort taxpayer behavior and interfere with the free market’s allocation of resources.) See also, Andrea Monroe, Integrity in Taxation: Rethinking Partnership Tax, 64 Ala. L. Rev. 289 (2012) (advocating for simplicity in partnership taxation to foster the tax system’s values and to nurture a perception of fairness among partners); Xuan-Thao Nguyen & Jeffrey A. Maine, Equity and Efficiency in Intellectual Property Taxation, 76 Brook. L. Rev. 1, 5 (2010).

\textsuperscript{19} See, e.g., Samuel A. Donaldson, The Easy Case Against Tax Simplification, 22 Va. Tax Rev. 645 (2003)(holding that simplicity is not necessarily good, tax complexity is not necessarily bad); Deborah L. Paul, The Sources of Tax Complexity: How Much Simplicity Can Fundamental Tax Reform Achieve?, 76 N.C. L. Rev. 151, 163 (1997) (claiming complexity is inherent in any regime that is committed to raising revenues but in an equitable way); Edward Zelinsky, Another Look at Tax Law Simplicity, 47 Tax Notes 1225, 1225-28 (June 4, 1990) (arguing there is a balance between the tax law’s complexity and substantive tax policy).

\textsuperscript{20} Brian Galle, The Tragedy of the Carrots: Economics and Politics in the Choice of Price Instruments, 64 Stan. L. Rev. 797 (2012)(asserting that “carrots” (tax incentives) and “sticks” (tax penalties) give producers incentives to invest in learning about potential negative externalities in advance of government regulation). See also Deborah H. Schenk, Exploiting the Salience Bias in Designing Taxes, 28 Yale J. on Reg. 253 (2011) (“Almost all provisions in tax legislation are incremental changes to the law as it exists, and most benefit specific interest groups, usually business.”).


\textsuperscript{22} 26 U.S.C. §221.

\textsuperscript{23} 26 U.S.C. §32.
and employment, respectively. Congress also created business incentives such as the Research and Development Credit,\textsuperscript{24} the New Markets Credit,\textsuperscript{25} and the Business Start-up Cost Deduction\textsuperscript{26}, to promote investment in innovation, community development, and risk taking, respectively. Once introduced, these business and non-business tax incentives become entrenched in our tax system and are politically hard to retract.

This discussion is particularly relevant today as we put new investment tax incentives to the test. The most recent debate over the bonus depreciation in section 168(k) of the Code included inquiries as to whether the tax system should provide investment incentives.\textsuperscript{27} It also included discussions about the optimal form of such incentives.\textsuperscript{28} Whether we should use credits or deductions for stimulus purposes is an

\textsuperscript{24} 26 U.S.C. §41.
\textsuperscript{25} 26 U.S.C. §45D.
\textsuperscript{26} 26 C.F.R. 1.195-1, 1.248-1, and 1.709-1.
\textsuperscript{27} See, e.g., Michael J. Graetz and Rachael Doud, \textit{Technological Innovation, international Competition, and The Challenges of International Income Taxation}, 113 \textit{COLUM. L. REV.} 347 (2013) (using the bonus depreciation to point out that nations choose to subsidize technological innovation because, in the absence of such subsidies, crucial research and development would be underproduced); Tom C.W. Lin, \textit{The New Financial Industry}, 65 \textit{ALAMA. L. REV.} 567 (2013) (claiming that an incentive-based approach would be to encourage industry participants to enhance their cyber defense by allowing participants to use bonus depreciation.); \textit{But see} Anthony C. Infanti \textit{Tax Reform Discourse}, 32 VA. TAX REV. 205 (2012) (noting tax incentives such as the bonus depreciation encourage investment in capital at the expense of investment in labor); Calvin H. Johnson, \textit{Taxing GE and Other Masters of the Universe}, 132 TAX NOTES 175, 183-84 (2011) (pointing to the negative impact and the bias of bonus depreciation on the effective corporate tax rate); Theodore P. Seto, \textit{The Problem with Bonus Depreciation}, 126 TAX NOTES 782, 782-83 (2010) (criticizing the enactment of the bonus depreciation as an effort to end the recession in 2001 and arguing it had the effect of creating "jobless recoveries" by shifting businesses toward greater use of capital and less use of labor).

important decision in designing tax measures. This Article provides insights on these questions and accounts for the feasibility of each option. Following this introduction, Part I discusses the legislative history of the immediate expensing rule as a small business measure, and the emergence of the investment credit. It describes the initial reaction of the business community and the advantages and disadvantages of credits v. deductions. Part II narrates the shift in tax policy toward New Economics theory. Part III describes the experimentation with fiscal activism through the investment credit’s suspension, reinstatement, repeal, reenactment, increase, and, finally, demise. Part IV concludes by providing some insights regarding these two narratives, alongside the recent debate over the new bonus depreciation.

I. SMALL BUSINESS CAPITAL INVESTMENT INCENTIVES

Immediate expensing is an extreme form of depreciation. It works to recover the cost of the acquired property faster than usual recovery periods, thereby providing taxpayers with the advantage of time value of money. For example, in 2013, taxpayers were permitted immediate expensing of up to $500,000 of qualified property that cost up to $2 million. Accordingly, they could expense their cost of qualified investments until those total expenditures reached $2,500,000. A taxpayer who purchased equipment for $650,000 could expense $500,000 immediately during the first year the property was placed in service. In addition, immediate expensing can be combined with bonus depreciation, which allows taxpayers to deduct an additional 50% of their cost of qualified property in the first year of service. Thus, another $150,000 bonus depreciation expense transports the entire purchase to an immediate write-off in lieu of recovering the cost of the equipment over its useful life. Assuming a 35% tax rate, and that the taxpayer has a positive income this year against which he or she can take this immediate deduction, the taxpayer can benefit from total tax savings of $227,500, and a net cost for the equipment of $422,500, greatly lowering the effective tax rate on income derived from the investment in this equipment.

Capital investment incentives provide up-front additional cash flow to help finance the equipment purchase. If financed with debt, they can even produce negative taxes, as the taxpayer receives a tax benefit

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32 $650,000 x 35% = 227,500 tax savings results in $650,000-$227,500=$422,500 after-tax cost for the equipment. See generally, THEODORE P. SETO, FEDERAL INCOME TAXATION: CASES, PROBLEMS, AND MATERIALS, 235 (2012).
without bearing any risk. The negative tax acts like cash payments or subsidies for projects, regardless of their economic merit. In fact, the taxpayer receives a double tax saving from being able to both deduct the interest on the debt used to purchase the equipment, and the tax savings from being able to immediately deduct the cost of the asset against positive income.

Professor Calvin Johnson argued against the use of capital investment tax incentives, claiming that they change the balance between supply of, and demand for investment projects. Congressional Research Services echoed this notion, stating that immediate expensing has the potential to restrain economic growth by encouraging a greater flow of capital into investments that may produce lower pre-tax returns than investments not favored by these incentives. Professor Ted Seto added that investment tax incentives are not only tax subsidies for certain capital investments, but are also tax penalties on labor, and are partially responsible for high borrowing and “jobless economic recoveries” during the 2001-2004 and 2008-2011 recession years.

Although scholars maintain that the merits of capital investment incentives are dubious, we have witnessed a massive expansion of their scope in the last half century. This part tracks down the historical roots of the immediate expensing rule and the investment credit. It focuses on the role that small businesses played in the enactment and persistence of the immediate expensing rule, compared to other capital investment incentives that did not benefit from such affiliation. Specifically, it points out to rhetoric used to portray expensing as a temporary and innocent small business tax preference. Expensing meant to help small business retain internal earnings for equipment replacement and expansion, while the investment credit had the onerous task of stimulating the economy.

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33 For example, if our taxpayer had borrowed $650,000, both the interest on the loan and the immediate expensing would be currently deductible, creating “double dipping” of tax benefits. See Linda Sugin, Encouraging Corporate Charity, 26 VA. TAX REV. 125, 156 (2006).

34 Alan J. Auerbach, The New Economics of Accelerated Depreciation, 23 B.C.L. REV. 1327, 1346-48 (1982)(demonstrating in tables 5 & 6 that the present value of accelerated cost recovery system deductions, plus the investment credit on a $1 investment, was greater than $1, producing a negative effective tax rate.).


38 For example, the immediate expensing rule limits started at $2,000 in 1958 and currently stand at $2 million. 26 U.S.C. §179. The bonus depreciation provided for 30% additional bonus depreciation in 2002 was increased to 100% in 2011, and today stands at 50% bonus depreciation. 26 U.S.C. §168(k).
A. Recessions and the Need to Close the Obsolescence Gap

The concept of faster-than-normal depreciation, or rapid amortization, appeared during times of crises, primarily during World Wars I and II, by way of the government issuing “write-off certificates” for the restoration and renewal of certain defense property.\(^{39}\) Faster-than-normal recovery periods were offered as a way of preventing losses for companies that installed plants exclusively for wartime use.\(^{40}\) With the end of World War II, rapid depreciation was not restored until the Korean War broke out in 1950, and even then was applied only to defense facilities. Overall, very few certificates of necessity granting rapid write-offs have been issued.\(^{41}\)

At that time, it became apparent that there was a major gap between the capital recovery rules set by the Code and the actual wear and tear of the property, especially in the first year the property was placed in service, also known as the “obsolescence gap”.\(^{42}\) Many foreign nations addressed the first-year obsolescence problem by providing additional initial allowances of 20%–50%, but under the U.S. Code, there remained a need to provide evidence of additional technological obsolescence to deviate from normal depreciation schedules.\(^{43}\) This was a major hurdle, and a principal deficiency of the old depreciation system.\(^{44}\)

Technological obsolescence was a direct consequence and a major part of postwar industrial inefficiencies. With the advance of industrial developments and the scientific technical revolution during the 1940s, there was a growing need to update and replace old machinery.\(^{45}\) Studies indicate that the modernization of U.S. industry was much needed at that time,\(^{46}\) the American industry was in the process of producing modern weapons of the atomic and space age with ineffective and obsolete tools. However, even when new equipment was purchased, a rapid wear and tear usually occurred in the first year of its life.\(^{47}\)

\(^{39}\) Add cite
\(^{40}\) The Defense Production Act of 1940, 54 Stat. 714, ch. 508, § 6 (July 2, 1940), somewhat alleviated the situation by allowing a 5-year write-off of war and defense plants.
\(^{44}\) Id. (“Although the [technological] obsolescence will inevitably take place in this first year, it simply cannot be proved but only predicted, at the time the facility is acquired.”).
\(^{46}\) Id.
\(^{47}\) Id.
The 1954 reform provided benefits to a wide range of groups and individuals.\(^{48}\) The comprehensive tax reform lowered the normal corporate tax rate from 30% to 25%, included a dividend relief, and somewhat alleviated the tax on accumulated earnings.\(^{49}\) However, the primary enhancement of the 1954 reform was revision of depreciation allowances.\(^{50}\) Congress relaxed depreciation guidelines, and introduced accelerated depreciation methods and 60-month amortization allowances. Double-declining balance depreciation was introduced for the first time, to accelerate recovery of capital investment, and this began a trend for using accelerated capital recovery provisions as incentives for capital investments.\(^{51}\)

In the years that followed World War II the U.S. economy saw a capital investment boom. Plant and equipment expenditures were at the height of their rates.\(^{52}\) However, overproduction by large industrial firms and a series of natural disasters resulted in the American economy entering a deep recession period.\(^{53}\) In 1957, industrial production severely plummeted, prices on the New York Stock Exchange dropped, and consumer prices rose to record levels.\(^{54}\) In 1958, the number of business failures reached 1,100 a month, the highest rate since 1940,\(^{55}\) and unemployment reached 7.5%.\(^{56}\) Small and new businesses accounted for the majority of the business failures at that time.\(^{57}\) Small business witnesses appeared before specialized tax committees and presented a


\(^{54}\) President’s 1961 Tax Recommendations, Volume 2, 87th Cong. 987 (1961) (statement of Joe Barlow, Member of the Taxation Comm. of the U.S. Chamber of Commerce, H. Comm. on Ways and Means).

\(^{55}\) Business failures in 1956 reached 52 per 10,000 (the highest rate since 1940) and, that year, manufacturing profits worth less than $1,000,000 represented just 4.7% of U.S. manufacturers’ total earnings, down from 13.8% in 1947. Richard Sutch, Business Incorporations and Failures—Numbers and Liabilities: 1857-1998 Table Ch408-413, in Historical Statistics of the United States, Earliest Times to the Present: Millennial Edition Ch408-413 (Susan B. Carter et al. eds., 2006).


\(^{57}\) Keeping the Records Straight, TIME, Aug. 20, 1956, at 82, 82. See also, Needed: Talent, Training & Tax Cuts, TIME, Nov. 12, 1956, at 98 ("the newest figures on small business are cause for some alarm.").
gloomy picture of their affairs,\textsuperscript{58} attesting that they had had to borrow funds in order to pay taxes, purchase equipment, and continue operations.\textsuperscript{59}

Financing the replacement of machinery and equipment turned out to be a challenging task, especially for small businesses that relied on their internal earnings.\textsuperscript{60} Professionals, scholars, and businesspersons urged the Treasury to provide faster depreciation schedules; they saw the solution to the obsolescence gap as permitting the recovery of the investment in a shorter time. The Department of Commerce identified two main reasons for the post-World War II equipment replacement problem: the rise of inflation and the rapid rate of obsolescence with the advance of technology.\textsuperscript{61} Consequently, it acted to revise depreciation policy and to provide investment incentives to maintain the U.S.' competitive position at the same level as that of the rest of the world.\textsuperscript{62}

There was a growing consensus for the need to adopt a permanent, integrated, capital-recovery structure that was as liberal and realistic as the tax structures of the other principal industrial nations. One of the proposals even went as far as allowing taxpayers choose the depreciable life of the property.\textsuperscript{63} However, these proposals were rejected by virtue of being expensive and complex.\textsuperscript{64} The next section depicts the creation of the expensing rule as a route Congress took to address some of these issues.


\textsuperscript{61} Other than the temporary exceptions during World War II and the Korean War, inflation rates remained relatively low in the 1950s and 1960s. The average inflation rate surged from 3.2% in 1972 to 6.2% in 1973, and to 11% in 1974. These high inflation rates were significantly lower in subsequent years, but then spiked again at the beginning of the 1980s from 11.3% in 1979, to 13.5% in 1980, and to 10.3% in 1981. Historically, these inflation rates were the highest the U.S. economy had experienced. \textit{See Table of Historical Inflation Rates by Month and Year (1914-2013), available at: http://www.usinflationcalculator.com/inflation/historical-inflation-rates/}


\textsuperscript{63} Provided it was not less than 5 years for new plant and facilities and 3 years for used facilities. \textit{See, e.g.} Sidney Davidson and David F. Drake, \textit{The “Best” Tax Depreciation Method-1964}, 37 J. OF BUS. 258 (1964).

B. The Birth of the Immediate Expensing Rule

The recession years of the late 1950s, and the financial predicaments of that time, found Congress in a “mood” to help and encourage small business, and augmented its sense of responsibility to their well-being. The introduction of massive small business tax preferences in 1958 was a major part of Congress’s plan for national economic recovery. At that time, Congress viewed small business as an important element in stimulating economic activity and creating jobs, therefore, helping small businesses was viewed as assisting the recovery of the economy.

During committee-hearings on the topic of depreciation policies, representatives from the machine-tool industry, an apparent interest group that benefits from any equipment incentives, argued that depreciation rates did not provide adequate allowances essential for investments in new machinery by small businesses at that time. These representatives supported small businesses by expressing concerns regarding their ability to maintain modern equipment and compete with larger firms. They emphasized the crucial need to reduce the investment risk in small businesses, and to improve the credit condition as a way of stimulating economic growth. One of their proposals was to permit taxpayers greater flexibility in determining the length of the depreciation period, and allow more rapid tax-free recovery on investments.

With the endorsement of small business institutions, such as House and Senate Small Business Committees and the Small Business

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66 For example, the government approved many expansions of the SBA loan program during the 1960s to address the tight credit problem of small firms. See, Small Business Agency Loan Ceiling Increase is Approved by House, Wall St. J., July 3, 1962, at 3; House Unit Votes to Raise SBA’s Ceiling on Loans, Wall St. J., Jan. 8, 1962, at 26; Small Business Agency Loan Ceiling Raised $250 Million by Senate, Wall St. J., June 15, 1962, at 14; Small Business Agency Curbs Loans to Firms: Cites Disaster Lending, Wall St. J., Nov. 10, 1964, at 3.
67 Id. at 671.
68 Id. at 672.
70 Id. at 667–68 (statement of I.D. McDonald, Chairman, Subcomm. on Tax Policy, National Machine Tool Builders’ Association).
71 Id.
72 Id. at 672.
Administration, the Technical Amendments Act of 1958 was designed as part of comprehensive and far-reaching tax incentives to encourage and foster small business.\textsuperscript{73} The new immediate expensing was titled “Additional First-Year Depreciation Allowance for Small Business” and permitted businesses, individuals, or corporations that purchased depreciated property with a useful life of at least 6 years to take additional first-year depreciation deduction up to a maximum of $2,000 ($4,000 for an individual filing a joint return) during the first year when such property was placed in service.\textsuperscript{74} Congress hoped this mechanism would encourage additional investment in small business, since it provides for a faster recovery of capital before the taxing of earnings.\textsuperscript{75}

Indeed, as presented in Figures I and II, soon after its enactment, it became clear that immediate expensing was not utilized only by small businesses.\textsuperscript{76} Big business organizations concurrently began to push for the expansion of immediate expensing by eliminating the limitation on the maximum amount of the allowed immediate deduction.\textsuperscript{77} Clearly, foreign competition was not the primary concern of small business at that time; rather, they were worried about tight credit problems and national competitive hurdles.\textsuperscript{78} Nonetheless, the Chambers of Commerce pushed for the expansion of the small business immediate expensing rule in the name of foreign competition.

The American Machine Tool Distributors Association, the constituents of which were poised to gain the most from any type of the equipment investment incentives, also advocated for the increase in the scope of immediate expensing.\textsuperscript{79} They too called for a complete removal


\textsuperscript{74} Under this section, if the cost of the property exceeded $10,000 taxpayers were allowed a maximum of 20% of $10,000. This special allowance was granted to taxpayers on top of the ordinary depreciation permitted under the code. See Staff of S. Comm. on Small Bus., 85th Cong., Small Business Tax Adjustments (Contained in the Technical Amendments Act of 1958, P.L. 85-866), 28-32 (Comm. Print 1958).

\textsuperscript{75} Id.


\textsuperscript{77} See, e.g. Chamber of Commerce advocating such expansion, Revising Tax on Gains from Sales of Depreciable Personal Property, 86th Cong. 147 (1960) (statement of Frank T. Powers Jr., President, Powers Chemco, Inc., H. Comm. on Ways and Means).

\textsuperscript{78} J. KEITH BUTTERS & JOHN LINTNER, EFFECTS OF FEDERAL TAXES ON GROWING ENTERPRISES 2–4 (1945).

\textsuperscript{79} President's 1961 Tax Recommendations. Volume 2, 87th Cong. 1537 (1961)
of the maximum limitation on the cost of the property allowed to be expensed and an increase in the amount to be expensed to assist small businesses. 80

Small business lobby and small business institutions also advocated for the extension of temporary immediate expensing and the expansion of its scope. Small business owners praised the new legislation and pleaded with the government to continue to provide them with faster depreciation rules that left them with more internal investment funds to purchase badly needed equipment and machinery. 81 Conversely, some small business owners testified that, due to their dollar limitations, immediate expensing had a restricted effect on encouraging their expansion. 82 Instead, they advocated for a full write-off of all the costs of the asset during the first year the asset was placed in service. 83

During committee hearings, professionals and businessmen stressed the financing cycle of small business, by which the retention of earnings was crucial for the purposes of reinvestment and expansion. 84 Because depreciation deductions were spread over the useful life of the property, it required additional cash for expansion and made growth more dependent on the business’s borrowing power than on its earnings. 85 Small businesses had an inferior position in borrowing due to their inherent risk, which left them primarily dependent on internal funding and retained earnings for any type of expansion. Arguably, the tax benefits simply “leveled the playing field” to account for the higher cost of capital to fund small businesses.

However, scholars were skeptical about the effectiveness of the new expensing rule, and argued that while it may result in some allocation of

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80 For example, they called for elimination of the $10,000 maximum cost and the 6-year useful-life limitations, and raising of the 20% initial allowance rate to at least 30%. See Id. (“Removal of this limitation would provide the stimulus that is sought through the investment credit but without the subsidy involved in the latter.”).
81 Id. (“By reason of the adoption of immediate expensing, my company and certain of its subsidiaries have already been enabled to acquire badly needed machine tools and other immediate expensing qualified property by tapping investment funds otherwise not available to them....”).
83 Id. (“a small business would be allowed to write off 100% of all additions up to $10,000 and 80% of the next $10,000 and so on up to, say, $50,000.”).
funds for small businesses growth, it was more likely to postpone the timing of tax reckoning and to serve the machinery and equipment production industry.\textsuperscript{86} Thus, if the tax benefit simply accelerated the timing of purchases, rather than increasing the net amount of purchases, it would not have much of an overall long-term stimulative effect. If property was to be purchased every year, it would result in an overall permanent postponement of tax on qualified property.\textsuperscript{87}

During the beginning of the 1960s, congressional debates continued to provide economic stimulus for capital investments. The administration proposed the introduction of a new investment credit for the cost of new equipment and machinery in the first year of the life of those assets, as a complimentary incentive.\textsuperscript{88} However, those proposals were premature at that time, and were denied for the following reasons: The immediate expensing rule was presented as a better alternative for stimulus than the tax credit, because it was considered to be simpler, more administrable, and equitable alternative.\textsuperscript{89} It eliminated uncertainties regarding taxes in future years by expensing more in earlier years, and it presented a more realistic depreciation schedule.\textsuperscript{90} Accordingly, immediate expensing liberalization was favored over the introduction of the new tax credit. The next section describes the chain of events that eventually led to the enactment of the investment credit.

\section*{C. Enactment of a New Tax Credit}

In 1961, President Kennedy and Secretary Dillon proposed a new investment credit as a stimulus for economic growth, and to improve the competitive position of the nation’s industry.\textsuperscript{91} On October 16, 1962, the government passed the Revenue Act of 1962, which added section 38 to the Code, providing a new credit of 7\% of the property’s cost with at least 4 years of useful life.\textsuperscript{92} In the same year, the Treasury also modified

\begin{itemize}
\item \textsuperscript{87} L. Hart Wright and Jerome B. Libint, \textit{Impact of Recent Tax Stimulants on Modest Enterprises} 57 Mich. L. Rev. 1131 (1959).
\item \textsuperscript{88} President Kennedy Appeals to the Congress for a Tax Cut, (April 20, 1961) (“Specifically, therefore, I recommend enactment of an investment tax incentive in the form of a tax credit…”).
\item \textsuperscript{89} President’s 1961 Tax Recommendations, Volume 2, 87th Cong. 1537 (1961) (statements of Clyde McFarlin, U.S. Indep. Tel. Ass’ns. and John Clark, President, Int’l Union of Mine, Mill & Smelter Workers, H. Comm. on Ways and Means)
\item \textsuperscript{90} Revenue Act of 1962. Part 7, 87th Cong. 2905-12 (1962) (statement of Walter A. Slowinski of the U.S. Chamber of Commerce, S. Comm. on Fin.).
\item \textsuperscript{91} Message from the President of the United States titled “Our Federal Tax System,” H.R. Doc. No. 140, 87th Cong., 1st Sess. (1961).
\item \textsuperscript{92} See 26 U.S.C. §46(c) (2) (1962). The credit was limited to 100\% of the tax liability up to $25,000, plus 25\% of any tax liability in excess of $25,000. 26 U.S.C. §§ 46, 48 (1954).
\end{itemize}
the treatment of depreciation, liberalizing depreciable lives and the overall approach to the determination of the depreciation deduction. 93

However, while retaining the view that the primary function of depreciation is to measure net income over time, the Administration had greater plans in mind for the investment credit. The 1962 act declared that its purpose was to stimulate the modernization of plants and equipment. By creating incentives for capital purchases that would not otherwise occurred the act intended to stimulate growth and create new jobs. The act also aimed to serve as a substitute for the accelerated depreciation that had been allowed during World War II94 and the Korean War.95 Senator Kerr (D-OK), who led the floor debates in the Senate for the administration’s tax program, characterized the investment credit as the single most important measure to strengthen and revitalize the U.S. economy enacted by the 87th Congress.96 Harvey E. Brazer, Director of the Office of Tax Analysis at the Treasury Department, noted that the administration’s depreciation program goal was to provide a more realistic revision of the depreciation rules and to equalize U.S. business with its foreign competitors in terms of the tax treatment of capital assets.97

Several interest groups supported the enactment of the new tax credit. The American Machine Tool Distributors Association evidently gained from any kind of equipment purchase incentive, more so when their customers were bigger businesses with stable positive tax liability to offset against the investment credit. Their representative appeared before the Ways and Means Committee, emphasizing the connection between national defense and the need for an efficient and effective national production base.98 When supporting the enactment of the investment credit, the representative argued that the revenue loss from the tax credit could be offset by the saving in cost production resulting from the new machinery and equipment.99

Another lobbying group that was set to benefit from the enactment of any type of investment incentive was the National Machine Tool Builders Association. However, this association believed that the proposed credit was too complex and very limited in its application, due

97 Id. at 7.
99 Id.
to its many restrictions.\textsuperscript{100} Instead, the association urged the committee to expand immediate expensing by eliminating several of the section’s limitations and raising the initial allowance rate.\textsuperscript{101} Immediate expensing was described as a more effective and equitable measure, compared to investment credit.\textsuperscript{102} The next section details the built up in dislike toward the ill-fated investment credit from its early days to help elucidate its ultimate fate.

\textbf{D. The Business Community’s Disapproval of the New Credit}

Apart from these lobby groups, the majority of the business community did not initially approve of the new tax credit. Professionals, scholars, and the media described it as an “utmost liberal device,”\textsuperscript{103} a “sugar coating,”\textsuperscript{104} a “gimmick,”\textsuperscript{105} and an “outright gift” to its intended beneficiaries.\textsuperscript{106} The Rubber Manufacturers Association labeled it as an “unwanted federal subsidy,” arguing that it was a major departure from the general tax principles and an unjustified appropriation.\textsuperscript{107} The American Federation of Labor and Congress of Industrial Organizations referred to the investment credit as a “multi-billion dollar windfall that will not really contribute anything to our national goal.”\textsuperscript{108} The business community was in turmoil.\textsuperscript{109} The investment credit was considered by many to be inequitable, because they believed it gave preferential tax treatment to certain groups of taxpayers.\textsuperscript{110}

\begin{flushright}
\footnotesize
\textsuperscript{100} President’s 1961 Tax Recommendations. Volume 2, 87th Cong. 1537 (1961).
\textsuperscript{101} Id. (statements of Clyde McFarlin, U.S. Indep. Tel. Ass’ns. and John Clark, President, Int’l Union of Mine, Mill & Smelter Workers, H. Comm. on Ways and Means).
\textsuperscript{102} Id. ("Unlike the proposed credit, an initial allowance provision can be both simple and equitable in its application. A first step of this kind was adopted in this country in 1958 with the enactment of a limited first year depreciation allowance as immediate expensing of the Internal Revenue Code.").
\textsuperscript{103} J. Henry Wilkinson, Jr., The Investment credit Under the Revenue Act of 1962, 42 Tex. L. Rev. 498, 500 (1964).
\textsuperscript{104} Daniel Candee Knickerbocker, Jr., The New Investment credit, 8 Prac. Law. 43 (1962)(“The sugar coating on the President’s 1961 tax proposals was the so-called ‘investment credit’.")
\textsuperscript{105} President’s 1961 Tax Recommendations. Volume 2, 87th Cong. 987 (1961) (citing to a Business Week magazine article calling the investment credit a gimmick).
\textsuperscript{108} Hearings Before the Ways and Means Committee on the tax recommendations of the President contained in his message transmitted to the Congress, April 20, 1961, 87th Cong., 1st Sess., at 1140-51 (1961).
\textsuperscript{110} For example, it was sought that firms in the public utilities industry would be given a
In its recommendation to the President, the Chamber argued that the new tax credit was unfairly and unreasonably discriminatory between taxpayers within the business community in certain industries, and businesses that were in the position of making large investments that would not provide a sufficient stimulus. The Chamber’s representative argued that small and marginal businesses were also discriminated against by the new credit, because it only applied to firms with positive tax liability against which they could offset the credit.

The Chamber of Commerce desired a general reduction in business tax rates, and was worried that the investment credit would hinder such awaited reform and removal of other presiding tax-restraints on economic growth. Instead, it proposed an overall liberalization of the tax depreciation allowance system and immediate expensing by eliminating the maximum limitation on the initial first-year allowance altogether. They argued that this liberalization of depreciation rules should not be perceived as a subsidy, but as a more reasonable measure of obsolescence actually incurred by property owners.

The small-business lobby also expressed its disapproval of the idea of investment credit. It was clear to them that this credit was a mechanism aimed at larger businesses, and would be primarily beneficial to firms that were already capable of expansion. Small businessmen claimed that the new credit would not encourage their expansion, especially because it initially applied only to new property, which they could not often afford, compared to newly acquired, used property.

3% credit, as compared to 7% for other industries. See, e.g., Revenue Act of 1962. Part 2, 87th Cong. 468 (1962) (statement of Walter A. Slowinski of the U.S. Chamber of Commerce, S. Comm. on Fin.) (“As a tax reduction provision, the investment credit is discriminatory.”)

Id. (“If there is to be a tax credit subsidy for investment in productive facilities, it should be given to all taxpayers in proportion to their investment in productive facilities.”).

Id. (“...Marginal firms in large industries will probably not get the full advantage of the plan and this is unfortunate for they need it most.”).


Id.

Id. (statement of the Smaller Business Association of New England).

Id. (“the plan provides the greatest advantages to companies with adequate financing available for needed expansion; (2) the plan in granting a subsidy type of credit furthers a managed economy concept, which we abhor; (3) the plan has little application to non-manufacturers; and (4) the plan ignores our need for retention of earnings.”).

Many small businesses purchased refurbished or used property. Others, that did not have access to loans and outside funding, used lease financing in order to obtain capital equipment. See President's 1961 Tax Recommendations. Volume 2, 87th Cong. 987 (1961) (statement of Joe Barlow, Member of the Taxation Comm. of the U.S. Chamber of Commerce, H. Comm. on Ways and Means). See also, Revenue Act of 1962. Part 2, 87th Cong. 468 (1962)
They argued that instead of enacting a new apparatus, it would be far better to liberalize the existing system of depreciation and work toward a general reduction in income tax rates. In order for them to utilize the tax credit, they required strong borrowing power and positive tax liability. Businesses with losses or negative tax liability could not utilize the investment credit, but could carry it forward to the year where they would incur a positive tax balance.

Political organizations, such as Americans for Democratic Action—one of the nation’s oldest liberal groups—also advocated against the new tax credit and for liberalizing immediate expensing. They urged the Ways and Means Committee to commit to incorporating liberalization of the depreciation system, and acknowledged that tax incentives were needed to encourage investors to assume risks, to develop new businesses, and to expand existing businesses. Although some regarded the investment credit as nothing more than a temporary transitional measure, they recognized that, once enacted, tax preferences are hard to discontinue.

The investment credit was widely considered a big business tax break because it was made available not only to individuals and ordinary corporations, but also to large mutual savings banks, regulated investment companies, real estate investment trusts, etc. Accordingly, representatives from large firms, such as Honeywell Co., admitted that, although their companies would probably benefit from the new investment credit, it would not be used by companies that most needed it to make possible the expansion and rehabilitation of their equipment.

The president of General Electric summarized the birth of the investment credit, noting, “With respect to the specifics of the investment credit plan, however, I do not think it can go unnoticed that most

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121 Id. (“…if tax incentives are made more and more attractive, investors will put more and more money into new plants and equipment.”).


123 Revenue Act of 1962. Part 7, 87th Cong. 2905-12 (1962) (statement of Walter A. Slowinski of the U.S. Chamber of Commerce, S. Comm. on Fin.) (“When you start a subsidy, it is hard to stop it. We don’t stop subsidies.”).

business executives have shown a distinct lack of enthusiasm.”125 In a similar manner to many other businessmen, he saw a sign of climate change in Washington, and hoped for a deeper change that would replace the present tax provisions that had governed the Code since the 1930s, and which enforced superficial and obsolete capital recovery rules, with rules that placed a high priority on capital formation and modernization.126

The next section explains how a credit differs from a deduction to shed light on the distinct history of both investment incentives. Arguably, taxpayers prefer credits to deductions because they provide greater and faster tax benefits. Yet, the investment credit was considered an expensive subsidy designed for businesses with positive tax liability, namely bigger or more established businesses. This made it more difficult to justify politically compared to small business expensing.

E. The Effect of Tax Credit vs. Tax Deduction

Depreciation is a charge against income, and its purpose is to spread the cost of acquiring an asset or investment expenditure that is expected to generate income beyond the taxable year in which the purchase or the expenditure is made.127 Both the immediate expensing rule and the investment credit work to accelerate the recovery of that expenditure over a shorter period of time, or via a one-time tax credit.

Scholars, such as economist E. Cary Brown, have demonstrated that if we allow taxpayers to immediately expense their capital investments, their effective tax rates on income from those investments will be zero if they have sufficient income from other sources to absorb the deduction.128 The Cary Brown theorem demonstrates that the theoretical equivalence of these incentives, under certain assumptions, is exempting investments from tax altogether.129 Professor Seto further argued that expensing has the effect of making the government a partner in taxpayers’ investment at the percentage of tax rate of taxpayers’ investment. Described by Professor Johnson as “soft money”, investment incentives allow for the cost of the capital investment, so that

126 Id. (“The basic problem is that the present provisions, developed during the Thirties and not basically changed since then...”).
the portion of income that is invested is not taxed. This ability to make or continue investments with pretax "soft money" is an extraordinary privilege.\footnote{Calvin H. Johnson, \textit{Soft Money Investing under the Income Tax}, 1989 U. ILL. L. REV. 1019, 1020 (1989).}

However, the effect of the two investment incentives on taxpayers’ tax liability is very different. The value to the taxpayer of the right to recover the cost of an asset depends upon the time and manner of the recovery, the tax rate, and the appropriate interest or discount factor if the recovery is postponed. The tax credit worked very similarly to the immediate expensing rule with one big difference: it was a credit and not a deduction, which had various implications for its effectiveness in different types of businesses. The value of the immediate deduction was equal to the deduction multiplied by the tax rate, whereas the value of the credit was equal to the full credit portion of the cost, providing that there was a positive tax liability for that year.\footnote{J. Henry Wilkinson, Jr., \textit{The Investment credit Under the Revenue Act of 1962}, 42 Tex. L. REV. 498, 498 (1964).}

Figure II in the Appendix demonstrates the difference between the operation of the tax credit, as opposed to the immediate deduction. Because the tax credit was not refundable and offset only positive tax liability, it was beneficial only to those businesses with positive tax liability that were already capable of purchasing new equipment and machinery. It was less beneficial to firms with scarce profits that were dependent on an existing stream of income and net after-tax earnings in order to make new purchases. In the case of such businesses without positive tax liability, immediate expensing was more beneficial than a credit, because it allowed for self-financing of expansion through deferred income taxes.\footnote{Id.} Figure III in the Appendix further illustrates this effect.

Accordingly, among those small businesses that were dependent on having profits in order to expand, and which often did not have positive taxable income, the investment credit was considered to be inferior to immediate deduction because it was viewed as an expensive tax subsidy to a large and profitable corporation. The deduction was viewed merely as a timing rule.\footnote{Revenue Act of 1962. Part 7, 87th Cong. 3088-89 (1962) (statement of Dan Throop Smith, Professor of Finance, Harvard Graduate School of Business Administration, S. Comm. on Fin.).} Furthermore, as enacted, the benefit of immediate expensing was minor and very limited in its scope, because of the restriction placed on the maximum allowed deduction.\footnote{The investment credit was limited to the taxpayer’s tax liability and could be carried over to following years.} The historical
amounts and maximum limits of the immediate expensing rule are provided in Figure I of the Appendix.

From 1958 until 1981, immediate expensing provided was capped at $2,000 of the allowed deduction. As opposed to the common rationale, the primary reason for setting this limit was not to target small businesses; rather, it was for budgetary reasons, in view of anticipated defense expenditures during the Cold War.\(^{135}\) The predicted loss from the investment credit was $1.3 billion every year, and this was deemed a permanent loss, because the unreduced cost basis of the property would be lost forever.\(^{136}\) In contrast, immediate expensing provided an accelerated reduction in the cost basis, followed by the depreciation of the remainder of the cost basis, and provided a less expensive alternative.\(^{137}\) Finally, the next section points out to the last notable reason for the persistence of expensing to the investment credit, namely the complexity of the latter.

**F. Complex Administration and Bookkeeping**

Members of business groups repeatedly rejected the investment credit for being too complex.\(^{138}\) In expressing its opposition to the new credit, the Chamber of Commerce viewed it as an unpredictable, complex subsidy that would be difficult to administer. It had carrying-over provisions that would create more loopholes; then further legislation would be required to close those loopholes.\(^{139}\)

Small business institutions, such as the House and Senate Select Committees on Small Business, also proceeded to persuade Congress to enact tax measures geared more toward small business, rather than continue with the investment credit.\(^{140}\) Accordingly, the committees advocated for depreciation reform and the expansion of immediate expensing limits to enable small businesses to retain and utilize pre-tax


\(^{136}\) See, e.g., *64 Investment Credit Claim Was $1.3 Billion*, WASH. POST, Aug 30, 1967 at A1 (“a total investment credit of $1.3 billion was claimed in 1964 by half of the 649,000 corporations reporting income tax, the Internal Revenue Service revealed today.”).


\(^{140}\) *Id.* (“Such a minimum credit … would not encourage small businessmen to improve their plant and equipment… to assist small business must provide a realistic means of enabling smaller enterprises to retain a larger proportion of before-tax earnings.”).
earnings. The committee mentioned that investment credit added various complexities when it was applied to S corporations and partnerships. It concluded that in order to appease small-business groups the tax credit should be revised such that it applied to used property.

Indeed, many business leaders argued that instead of initiating a broad reconstruction of all depreciation, the administration introduced a complex device for particular kinds of investments. The Aerospace Industries Association pointed out that the present obsolete depreciation policy was unrealistic and not compatible with technological and scientific advances. They argued that a new tax credit should be replaced with a more permanent, overall reform in depreciation policy. Unions and labor organizations also opposed the introduction of a complex investment credit with varying percentages instead of a broad depreciation reform.

Business executives from large companies, such as the Edison Electric Institute, warned of the tax credit’s overly complex administration. In his article on the 1962 tax reform, the President of General Electric commented that the new device is overloaded with special features and dispensations. Professionals opined that the new investment credit was terribly complex and, in many respects, represented a departure from the conventional income tax system.

\[\text{Id.}\]


\[\text{President’s 1961 Tax Recommendations. Volume 2, 87th Cong. 1537 (1961)}\]

\[\text{Id.}\]


\[\text{Id. (“In this connection we feel strongly that if any credit is granted it should be made to apply to all business taxpayers….the incentive tax credit is too complex, discriminatory, and difficult to administer.”).}\]

\[\text{Id.}\]

\[\text{Gerald L. Phillippe, Taxes and Economic Growth, 14 Tax Executive 302, 305 (1962). See also “[T]he present steepness of personal income tax rates-up to 91 percent, and reaching 50 percent on as low as $16,000 of taxable income-has very little merit in a revenue-raising way. Such rates discourage more economic activity than they confiscate.” Id.}\]

\[\text{Daniel Candee Knickerbocker, Jr., The New Investment credit, 8 PRAC. LAW. 43, 78 (1962).}\]
by the credit.\footnote{26 U.S.C. §§ 38, 46, 47, 48 (1954) as added by 76 Stat. 962, 963, 966, 967 (1962). In return for the credit, the taxpayer reduced his basis for the property whose acquisition produced the credit. S. Rep. No. 1881, 87th Cong., 2d Sess. 19 (1962).} In addition, corresponding sections were added to reduce the amount of the credit, according to the useful life of such property.

However, the most notable and perplexing problems were those raised by the basis adjustment provision, also known as the “Long Amendment.”\footnote{Under §48(g) the basis of property subject to the credit was reduced by the amount of the investment credit regardless of whether the credit was used immediately, via the carryback or carryover. These provisions are referred to as the Long amendment, after Senator Russell B. Long of LA who proposed them before the Senate Finance Committee. See 108 Cong. Rec. 16683-85 (daily ed. Aug. 27, 1962) and 108 Cong. Rec. 20580-83 (daily ed. Oct. 2, 1962).} Any unused amount of credit could lower the tax payable in earlier or later years by means of carrybacks and carryovers, but contained many limitations and complex rules.\footnote{26 U.S.C. §46(b) (1954). See also H. R. Rep. No. 1447, 87th Cong., 2d Sess. A17 (1962); Hearings Before the Senate Committee on Finance on H. R. 10650, 87th Cong., 2d Sess. 2360, 3018 (1962).} Other problems related to determining the estimated useful life and time that the property was placed in service.\footnote{Proposed Treas. Reg. §1.46-3(d) (1963). There was also lack of uniformity in the treatment of investment credit by the various states. See Report of Committee on State and Local Taxes, Bulletin of Section of Taxation, American Bar Association, p. 241 (July, 1963).} Scholars noted that there was little doubt that it would generate tax-planning activity among lawyers and accountants, and would stimulate litigation.\footnote{John J. Raymond, Comments on the Revenue Act of 1962, 41 MICH. ST. B.J. 10, 16 (1962).}

Political figures, such as the Chairman of the tax-writing Finance Committee, Senator Byrd (D-VA), professed that the tax credit was “wrong in principle and unnecessary,” and “one of the largest loopholes that has ever been written into the tax law.”\footnote{108 Cong. Rec. 16676 (daily ed. Aug. 27, 1962)(statement of Senator Harry F. Byrd).} Furthermore, Senator Williams (R-DE), declared that this credit was “too complicated for a Harvard professor to understand.”\footnote{108 Cong. Rec. 16818 (daily ed. Aug. 28, 1962)(statement of John J. Williams).}

Although the tax credit had limitations on income tax liability, numerous exclusions, complex carrybacks, carryover and recapture rules, made it very difficult to manage. The immediate expensing rule was considered a better alternative, as it was simpler and easier to administer.\footnote{President's 1961 Tax Recommendations. Volume 2, 87th Cong. 1537 (1961) (statements of Clyde McFarlin, U.S. Indep. Tel., Ass'ns. and John Clark, President, Int'l Union of Mine, Mill & Smelter Workers, H. Comm. on Ways and Means).} Instead of keeping a record of depreciation deductions over years, immediate expensing allowed a write-off of the investment in the first year it was placed in service.

However, the vast opposition to the investment credit by the business community, professionals, and politicians did not stem solely from the...
reasons stated above. Indeed, the credit was thought a complex, big business tax subsidy that discriminated against certain industries and resulted in high budgetary outlays. But these debates did not occur in a political vacuum. Another major reason for the instability and eventual demise of the investment credit was shifting winds in governmental views on the role of fiscal policy. The next part describes the emergence of the New Economic philosophy, during the 1960s, which led to the birth, and later the death, of the investment credit.

II. NEW ECONOMICS IN THE SERVICE OF FISCAL ACTIVISM

The first 50 years of the modern tax system saw tax policy applied in a traditional manner, focusing on revenue-raising goals to assist in the country’s war efforts. Until the Great Depression of the 1930s, orthodox fiscal policy called for annual budget-balancing except in a time of war. During wartime, tax policy was utilized to provide revenues to support the war efforts. When that conflicts was over, wartime taxes were scaled back, but still left at a high level. After World War II, this policy was replaced by the concept of the “stabilizing budget”, a policy that maintained a tax structure that would periodically be recalibrated to maintain a moderate surplus at high employment, with reliance on certain “built-in stabilizers” and monetary policy to combat ordinary recessions. Changes in the money supply were used moderately to influence interest rates and yields on corporate stocks.

During the post-World War II period, we witnessed a shift in tax policy toward utilizing the tax system to direct taxpayers’ behavior and achieving social goals. At the end of the 1950s, the American economy was hampered by recessions and shortage of working capital, compounded by high interest rates and spiraling inflation. The Kennedy administration assumed office in January 1961, in the midst of a recession and sought ways to stimulate the economy.

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159 GEORGE TERBORGH, infra note 158 at 11-13.
160 Carolyn C. Jones, Class Tax to Mass Tax: The Role of Propaganda in the Expansion of the Income Tax during World War II, 37 BUFF. L. REV. 685 (1989)(holding that during the second world war the tax system underwent a shift in tax burden from a few top individuals to an overall revenue machine); JOHN F. WITTE, THE POLITICS AND THE DEVELOPMENT OF THE FEDERAL INCOME TAX 154, 117-118 (1985); W. Elliot Brownlee, Tax Regimes, National Crisis, and State-Building, in FUNDING THE MODERN AMERICAN STATE, 1941–1995, at 93 (W. Elliot Brownlee ed., 1996); See also, Susan B. Hansen, The Politics of Taxation: Revenue Without Representation 104 (1983)(the author asserted that this shift in tax policy was a result of the will of “elected officials to maintain sufficient control over revenue and fiscal policy so as to be able to manipulate the economy and government spending for their own electoral benefit.”).
In addition, the administration’s tax reform activity was not limited to revenue-raising and the elimination of tax preferences, but began to focus on other considerations, such as eliminating unfairness.\textsuperscript{162} Congress initiated a wide-ranging examination of the ways by which the income tax structure increased inequities and the narrowing of the tax base.\textsuperscript{163} These concerns developed into hearings held by the House Ways and Means Committee in 1959. Subsequently, the Kennedy administration initiated an intention to improve the tax structure along the lines of equity and efficiency, in the President’s Tax Message in 1961.\textsuperscript{164}

Accordingly, the 1960s marked a high level of tax activity, by which Congress considered a wide scope of major tax legislation, revenue measures, and important policy implications each year. No longer was fiscal policy aimed at budgetary balancing, but a new era of furthering social and economic goals was underway. Paramount among tax measures was the Revenue Act of 1962, which added the investment credit and made important changes based on the new tax policy.\textsuperscript{165} The next sections focus on the role the investment credit played in the transformation of tax policy from revenue-raising to society’s window and economic stimulus. Eventually, this ambitious vocation turned out to be yet another nail in the investment credit’s coffin.

\textbf{A. New Managed Compensatory Budget Policy}

The economic decline of the early 1960s was still under way and was expected to go further.\textsuperscript{166} The administration’s response was almost entirely to focus on the spending side of the budget, using presidential orders to speed up federal disbursements, such as accelerating procurement placements, highway fund allocations, tax refunds etc. During 1962-1963, the situation escalated when the projected economic mark of 4\% unemployed was not attained.

President Kennedy decided to take things to the next level with a new stimulus theory. Backed by the Council of Economic Advisors he proposed a new approach to put an end to the period of slow growth.\textsuperscript{167} The President’s Economic Report emphasized the need for the development of tax policies that would supplement monetary policy in

\begin{thebibliography}{9}
\bibitem{164} Id.
\bibitem{165} Id at 16 ("Each year has found the Congress engaged in the consideration of major tax legislation, and revenue measures of wide scope and important policy import have resulted.").
\bibitem{166} \textit{George Terborgh, infra note \_\_\_\_\_\_ at 12.}
\end{thebibliography}
assuring investment surplus. The report mentioned that this was intended to be a step further in the art of fine-tuning.\textsuperscript{168} The administration acknowledged that a tax provision might be an efficient tool to achieve a particular objective in certain circumstances, such as expanded outlays on machinery and equipment, which, in turn, promotes economic growth as a positive economic approach. For the first time, the government began to apply affirmative fiscal actions to achieve economic growth.\textsuperscript{169} The administration’s economic policy viewed it appropriate to respond to recurring cycles of recession and recovery with expenditure increases as the weapon to end downslides.\textsuperscript{170}

However, the basic idea of the New Economics philosophy utilized by the Kennedy administration was not new. The idea of controlling economic activity through manipulation of the federal budget position was developed in the 1930s by British economist J. M. Keynes.\textsuperscript{171} Unlike neoclassical economics that promoted the idea of free markets adjusted by an “invisible hand”, Keynesian economic theory called for government intervention in the market to moderate cycles of economic activity.\textsuperscript{172} What the New Economics theory added was the belief in the feasibility of such control and the ability to spur economic growth by increasing federal spending and reducing taxes, or to restrict economic activity by doing the opposite.\textsuperscript{173}

The “New Economics” doctrine called for utilizing fiscal, monetary,\textsuperscript{174} and expenditure policies\textsuperscript{175} in a flexible manner.\textsuperscript{176} The objective of New Economics was to make appropriate changes on either or both sides of the federal budget using four primary characteristics: 1) federal activism, 2) growth orientation, 3) accurate forecasting, and 4) functional calibration.

\textsuperscript{168}Tax Changes for Shortrun Stabilization, Hearings Before the Subcommittee on Fiscal Policy of the Joint Economic Committee, 89\textsuperscript{th} Cong., 2nd Sess., at 64 (statement of Carl S. Shoup).
\textsuperscript{170}Id.
\textsuperscript{171}JOHN CUNNINGHAM WOOD, JOHN MAYNARD KEYNES, CRITICAL ASSESSMENTS 101–120 (1994).
\textsuperscript{172}Id.
\textsuperscript{173}Id. \textit{See also} Economic Report of 1962, \textit{supra} note \_\_ at 70-71 (“Federal expenditures and taxes affect total employment and production by influencing the total volume of spending for goods and services.”)
\textsuperscript{174}Monetary policy can be used in a counter-cyclical manner by allowing greater credit in a lagged economy and restricting borrowing during inflation. \textit{Id.}
\textsuperscript{175}Increase in governmental expenditures can be useful to stimulate the economy and decreased to stop inflation. \textit{Id.}
\textsuperscript{176}Under this doctrine, in order to stimulate an economy, taxes can be reduced so as to spur consumer spending. During inflation, an increase in taxes reduces spending. For a general overview of the “New Economics” doctrine, see Hearings on the President’s 1967 Tax Proposals Before the House Comm.on Ways and Means, 90th Cong., 2st Sess., pt. 2, (1967-1968) at 518-25 (statement of Joseph A. Pechman, Director of Economic Studies, the Brookings Institute).
New Economics called for an active and flexible fiscal policy with a variable budget position adjusted as often as necessary.\textsuperscript{177} The theory portrayed the tax system as in need of occasional “functional calibration”, and assumed the correct position is the one that is correct for the given conditions, and cannot be standardized over time.\textsuperscript{178} It focused on gap-closing and growth, as well as development of statistical measures for the application of growth-oriented policy.\textsuperscript{179} Walter Heller, Chairman of the Committee for Economic Development compared New Economics to previously existing economic models. He argued New Economics is centered on the ever-rising potential of the economy, on gap-closing and growth.\textsuperscript{180}

For that purpose, the theory relied heavily on forecasting. The annual budget submitted in January, for the fiscal year beginning the following July, began to incorporate an average forecasting lead of 12 months.\textsuperscript{181} The incorporation of statistics and scientific calculations into their predictions allowed economists of the Council of Economic Advisors to feel confident of their ability to foresee market changes and react accordingly.\textsuperscript{182} Indeed, new economists were optimistic about their art of forecasting.\textsuperscript{183}

However, critics of the New Economics theory dismissed its effectiveness as counteractive, or contracyclical, fiscal theory, as they believed it had several fundamental problems.\textsuperscript{184} First, economic forecasts were said to be speculative, inaccurate, and lengthy.\textsuperscript{185} There

\textsuperscript{177} \textit{George Terborgh, The New Economics} 8 (1968) (In this book, George Terborgh, an economist at the Machinery and Allied Products Institute and Council for Technological Advancement, describes the essence of the New Economics theory from a critical point of view).

\textsuperscript{178} Id. at 23.

\textsuperscript{179} For example, since New Economics set as its goal the maintenance of economic activity at the “full employment” level, it compiled a series of estimates of potential gross national product (GNP) that would be created at a 4% unemployment rate from which it subtracted the actual GNP to derive the “GNP gap”. It then utilized fiscal policy to eliminate that gap. \textit{Id.} at 20.


\textsuperscript{181} \textit{George Terborgh, supra} note ___ at 22 (arguing that because of the time lag between the initiation of such adjustments and the realization of their economic effects, the adjustments must also be based on forecasts for shorter periods than the regular budget.).


\textsuperscript{183} Walter W. Heller, Op. Cit., p. 69, cited in \textit{George Terborgh, supra} note ____ at 2 ("Our statistical net is now spread wider and brings in its catch faster. Forecasting has the benefit of not only more refined, computer-assisted methods, but of improved surveys of consumer and investment intentions.").

\textsuperscript{184} \textit{George Terborgh, supra} note at 105 ("What we are concerned with, however, is the timing aspects of this form of fiscal action. If it is accomplished, it is subject to all of the lags and affecting tax action- the recognition lag, the legislative lag, and the response lag.").

\textsuperscript{185} \textit{Id.} at 97 (arguing that the average forecasting lead time is 12 months, far beyond the
were three time lags involved in taking tax action: the time it takes to interpret statistical and economic data and officially recognize and acknowledge the need for action (recognition lag), which can further lag for political reasons;\textsuperscript{186} the time required to obtain Congressional approval after such recognition (legislative lag);\textsuperscript{187} and once a tax measure is enacted, there is a further lag in response of the economy to that action.\textsuperscript{188}

According to the Treasury, these time lags can take up to 9-12 months.\textsuperscript{189} The Department of Commerce and National Industrial Conference Board estimated an even longer lag.\textsuperscript{190} Economist E. Carry Brown stated that the response of consumption expenditure to changes in personal income tax estimated is evidenced in two quarters, until tax action gives rise to changes in consumption.\textsuperscript{191} Treasury Assistant Stanley Surrey was more pessimistic, professing that it takes two to four quarters for any significant impact to take place,\textsuperscript{192} while Professor Joseph Peachman anticipated a 6-12 months lag before changes in consumer spending are witnessed.\textsuperscript{193}

Finally, critics contended that once a desired fiscal action is chosen, determining the magnitude of such action was purely speculative. It entailed assessing what would be the course of the economy in the absence of fiscal action, by how much should the action attempt to deflect it from its course and what dosage is needed to accomplish the change.\textsuperscript{194} Rather than being self-evident, the determination of dosage was said to be cloudy and uncertain.\textsuperscript{195} It was not clear whether the credit indeed created new purchases or simply accelerated their timing. The effective range of the CEA and even if the budget were enacted as substantially as proposed, this long lead time would itself preclude any semblance of precise fiscal action.)

\textsuperscript{186} Id. For example, the Administration will be reluctant to admit a recession until forced by a period of consistent data.

\textsuperscript{187} Id. at 105-106. One way to alleviate this lag is through Presidential Executive spending action.

\textsuperscript{188} Id. at 98 ("The lag of demand is likely to be particularly marked in the case of business taxpayers operating against long-term plans ")

\textsuperscript{189} Cong. Rec. 19421 (Aug. 23, 1966) (Statement of Senator Proxmire)(stating that Treasury estimated the average order-to-completion period for investment-credit-eligible equipment as 9-12 months, excluding buildings and structures, for which the period is much longer.)

\textsuperscript{190} See Department of Commerce, OBE Release, 67-9, March 9, 1967; National Industrial conference Board, Capital Appropriations, 3\textsuperscript{rd} Quarter 1967, Table 2.

\textsuperscript{191} E. Cary Brown, Hearings, Subcommittee on Fiscal Policy, Joint Economic Committee, Mar. 1966, at 10.

\textsuperscript{192} Stanley S. Surrey, supra note ___ at 238 (claiming that the impact on the annual rate of GNP ranged between $1 billion and $2 billion per $1 billion of change in individual tax liability.).


\textsuperscript{194} GEORGE TERBORGH, supra note ___ at 108.

\textsuperscript{195} Id. at 184.
next section mirrors these difficulties while describing the use of the investment credit in the 1960s-1980s by New Economics theorists.

B. Investment Credit as an Apparatus to Withstand Foreign Competition and Spur Economic Growth

During the 1960s, economic growth had become the primary objective of the government for political and strategic reasons, arising from balance of payments considerations and an “economic race” with the Soviet Bloc. The U.S. government became concerned with its economic growth rate, which had fallen behind the Soviet Union, Japan, and Western Europe. Many foreign nations were subsidizing investment and allowing a more rapid cost recovery of new plants and equipment, in order to compete with foreign industries.196 There was a growing consensus in politics, industry, and academia on the necessity to provide the equivalent of these foreign investment incentives to spur large-scale capital investments. The Chamber of Commerce emphasized that price and wage scales were not economically efficient compared to those offered abroad.197 Scholars called for the lowering of the corporate tax rate, claiming that higher tax burden put U.S. firms at a disadvantage for expansion and domestic production compared to their competitors.198

There was a general belief that the U.S. had been unable to do a great deal with provisional and restricted incentives, such as the immediate expensing rule, in insuring the modernization and replacement of productive facilities that were so sorely needed.199 Business leaders, such as the President of General Electric, warned that capital formation and economic growth in the U.S. during the 1950s was lower than that of other countries:200

Adding urgency to this task of modernizing our manufacturing plants is the newly-intensified challenge of world competition… But, Cold War aside, the realities of competition in today's world markets demand that we modernize those main aspects of public

196 Richard N. Cooper, National Economic Policy in an Interdependent World Economy, 76 YALE L.J. 1273, 1288 (1967)(Surveying the investment incentives granted by leading nations at that time, including the U.K., Germany, Belgium, Japan, etc.).
198 Revenue Act of 1962. Part 7, 87th Cong. 3088-89 (1962) (statement of Dan Throop Smith, Professor of Finance, Harvard Graduate School of Business Administration, S. Comm. on Fin.) (“If our country is to get its rightful competitive share in the expanding income of the world, our business firms must be free to compete where production is taking place.”).
policy which affect economic growth. In such a re-examination, tax reform must come near the top of the agenda.\textsuperscript{201}

Professionals emphasized that, compared to other nations, U.S. industry suffered from inefficiency and a lack of modernized production methods.\textsuperscript{202} Many foreign plants were newer and more modern than their U.S. counterparts, which put U.S. industry in an inferior competitive position and intensified the nation’s balance of payments problem.\textsuperscript{203}

These concerns played an important role in the government decision to inaugurate the investment credit.\textsuperscript{204} In 1962, U.S. Secretary of the Treasury, C. Douglas Dillon, testifying on behalf of U.S. investment credit, stated:

If U.S. business firms are to be placed on substantially equal footing with their foreign competitors in this respect. It is essential…to our competitive position in markets both here at home and abroad, that American industry be put on the same basis as foreign industry. Unless this is done, increased imports and decreased exports will unnecessarily add to the burden of our balance of payments deficit.\textsuperscript{205}

Under the leadership of its talented Chairman, Walter Heller, the Council of Economic Advisors (CEA) launched one of its most effective public campaigns ever witnessed. In the following years, New Economics became a dominant government philosophy of fiscal planning and action. With the CEA’s blessing, Congress enacted the investment credit in the hope of encouraging equipment and machinery purchase through an increase in the rate of return on investment in these items, and also in cash flow.\textsuperscript{206} Although the declared policy of the Administration was not to use the new investment credit as a countercyclical device, but to make it permanent,\textsuperscript{207} businessmen were skeptical of President Kennedy’s aversion to an on-again-off-again investment credit, and did

\textsuperscript{201} Id.
\textsuperscript{203} Id.
\textsuperscript{204} Richard N. Cooper, National Economic Policy in an Interdependent World Economy, 76 YALE L.J. 1273 (1967).
\textsuperscript{205} Hearings on H.R. 10650 before the Senate Comm. on Finance, 87th Cong., 2nd Sess., pt. 1, at 83 (1962).
\textsuperscript{207} John w. Cook, The Investment Credit: Investment Incentive and Countercyclical Tool, 45 TAXES 227 (1967)(holding both the accelerated depreciation and the investment credit as instituted as permanent parts of the tax code). See also Revenue Act of 1962. Part 7, 87th Cong. 2905-12 (1962) (statement of Walter A. Slowinski of the U.S. Chamber of Commerce, S. Comm. on Fin.) (“The Chairman: Well, it is intended to be permanent, I am confident of that.”).
not believe that he would not restore the credit when capital spending fell again.  

Business executives remained apprehensive regarding the abundant uncertainty in allowing the government such flexibility when “it may prove desirable for the Congress to modify the credit from time to time, so as to adapt it.” They sought certainty. Accordingly, the National Association of Manufacturers described the new credit as a device intended for the manipulation and control of the U.S. economy. The temporary character of the new tax credit, and its declared purpose of countering economic cycles, was a pill the business community found difficult to swallow.

In 1962, McGraw-Hill conducted a survey to predict future capital expenditures as a result of utilizing the investment credit. Businessmen replied that it would only raise their capital expenditure by 1%. Nine out of every 10 companies that participated in the survey replied that they did not anticipate using the tax credit in 1962. That same year, the National Industrial Conference Board conducted a similar survey of the largest manufacturing corporations to determine the effect of the tax credit upon capital investment trends. Here too, the survey reported a rather small expected increase in capital outlay; in the majority of the industries, the anticipated increase was under 1%. A separate survey provided an even gloomier picture. The majority of firms indicated that they did not expect the new tax credit to have any influence on their capital investment decisions, which were more focused on the need for additional capacity or replacement, or the expected economic return.

Nevertheless, as the next part demonstrates, over time, the skeptical business community gradually realized the potential of the investment credit in providing a solid support for investment in machinery and equipment, and in increasing productivity and growth. Soon after its debut, an unprecedented demand for machinery and equipment occurred that exceeded the nation’s capacity to produce such goods. As a result, the government used the investment credit in various ways to react to the changing economic conditions.

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214 Stanley S. Surrey, supra note ___ at 478.
III. Fiscal Activism in Force: Suspension, Restatement, and Repeal

A. The First Years

Indeed, as Figure IV in the Appendix demonstrates, in the years that followed the enactment of the investment credit, the nation witnessed an increase in capital formation rates, a rise in Gross National Product (GNP) and a decrease in the unemployment rate. Business investment expenditures rose to record levels and surpassed the GNP at that time. Although it was not clear whether these changes resulted from the adoption of the tax credit or other political and economic conditions, new economists celebrated this upward trend as proof of the validity of their new fiscal policy.215

The media expressed some concerns that this surge in capital spending and increased demand for new plants and equipment would result in an upsurge in prices, inflationary effects, and eventually a recession similar to the one that had occurred in the preceding decade.216 What the Administration or Congress did not realize at the time was that the capital-goods boom was already underway, but was not yet visible, because of the long lead times involved. Following his election in 1964, President Johnson’s administration continued to practice greater government expensing, characterized by its modern liberalistic approach, which was manifested in a series of ‘Great Society’ legislations that upheld civil rights, Medicare, Medicaid, environmental protection, etc.217

The investment credit was recognized as a powerful cyclical device, and a prevailing method to spur changes in the market by stimulating investments in machinery and equipment.218 However, while the Kennedy administration had intended the investment credit to be

215 Id. at 479.
permanent, the Johnson administration believed it to be a temporary, transitional measure that had been created to resolve economic deficiencies in previous years. It was reluctant to extend the investment credit because of its contracyclical use and its ambivalence toward New Economics.

Once the justification for providing investment incentives no longer existed, with businesses overspending on capital investments, the Johnson administration sought to minimize their scope. In 1965, the economy was powerful, and the new fiscal policy appeared to achieve the right balance of tax reduction and government expenditures, sufficient to provide the fiscal support for Johnson’s far-ranging Great Society programs. During those years, fiscal policy still maintained control of expenditures, but was, to some extent, less restricted by the need to balance the budget.

Increased involvement in the Vietnam War intensified this picture. Sharper defense costs further accelerated the rate of economic activity. The tax credit added unsuitable emphasis to that boom in capital outlays, which created inflationary demand pressures. The record pace of investment in plants and equipment was creating excessive investment demands and considerable inflationary pressures. Accordingly, the rationales for providing investment incentives disappeared in the face of over-production in excess of the economy’s long-term needs. Efforts to curb increasing inflationary pressures necessitated restraining this capital-spending boom.

1. 1966—Suspension

Realizing that there was a need to restrain the over-performance of the economy, New Economists quickly assumed a flexible approach, utilizing tax policy as a temporary stabilizing device. They sought

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219 John w. Cook, The Investment Credit: Investment Incentive and Countercyclical Tool, 45 TAXES 227 (1967)(holding both the accelerated depreciation and the investment credit as instituted as permanent parts of the tax code.).


223 Id. (arguing that the Excise Tax Reduction Act of 1965 was in accordance with the New Economics of tax reduction.).


226 The role of the government in maintaining and balancing stable market growth was
procedural devices, such as the investment credit, to achieve these goals. Accordingly, the CEA acted to suspend the investment credit in 1966. Hearing of the Subcommittee on Fiscal Policy on tax flexibility demonstrated a growing emphasis on the concept of using the federal tax system to achieve economic objectives, which won increasingly wide congressional acceptance from 1962 to 1966. The committee focused on goals such as reduced unemployment, economic growth, and price stability. Tax policy had been playing a growing role in the nation’s overall economic policy.

Proponents of the suspension of the investment credit explained that a temporary suspension would be useful in encouraging businesses to delay capital investments in the current economic state, until a later time that might be more suited to the economic conditions of the market. Those who supported the retention of the investment credit warned against introducing more uncertainty to the market, either by creating a stampede to quickly deliver equipment before the effective date of the suspension, or by postponing expansion plans until the suspension period ended.

Only a few years after its enactment, the investment credit’s biggest adversary, the Chamber of Commerce, began to advocate for making the tax credit a permanent part of the tax structure. Once its constituents realized the new credit’s tax benefits, concerns for certainty and neutrality were pushed aside. These different viewpoints demonstrated the insufficient knowledge and inadequate analysis of the effects of the


Id. at 480.

Id. at 27.

investment credit as a countercyclical tool and an economic stabilizer.\textsuperscript{233} The few surveys that were conducted were limited and displayed little effect on the business decisions of modernizing facilities and providing incentives for capital investments.\textsuperscript{234}

In addition, the convoluted features of the investment credit contributed to its short lifecycle during a time when the administration aimed for greater simplicity. The investment credit was deemed a far too complex device with its various limitations and exclusions, exclusions within these exclusions, different rates under different conditions, the recapture of the credit in the case of certain dispositions, and many other provisions, which made it impossible to comprehend and administer.\textsuperscript{235} Moreover, the Treasury did not provide clear guidance for many of these intricacies.\textsuperscript{236}

Accordingly, Congress temporarily suspended the investment credit from 10 October 1966 through 31 December 1967.\textsuperscript{237} The Tax Adjustment Act of 1966 utilized fiscal restraint for anti-inflationary purposes. This use of tax policy as a short-range economic stabilizer was different from the use of tax policy in previous decades.\textsuperscript{238} In a press conference, President Johnson stated “We won’t give you a bonus to do what we don’t want you to do”.\textsuperscript{239}

2. 1967—Restoration

However, even when suspending the investment credit, the government was already contemplating the early termination of the suspension, and therefore left open the prospect of its restoration.\textsuperscript{240} The brief congressional experience with New Economics was sustained through the suspension of the investment credit. Some congressional representatives objected to submitting to a theory that required them to change the laws and direct the market so frequently.\textsuperscript{241} Since the key

\textsuperscript{234} See infra Part III.B.3.
\textsuperscript{235} J. W. Baldwin, Investment Credit Problems of the Oil and Gas Industry, 13 PROC. ANN. TUL. TAX INST. 429, 430 (1964).
\textsuperscript{236} To illustrate just one complexity, the carryovers and carrybacks rule of the unused portion of the credit were so convoluted that professionals testified that any 1962 unused credit could affect tax returns all the way through to 1973. \textit{Id.}
\textsuperscript{237} Summary of the Act Temporarily Suspending The Investment Credit and Limiting The Use of Accelerated Depreciation (H.R. 17607, 89th Congress, Pub. Law No. 89-800).
\textsuperscript{239} Statement, Press Conference of the President, September 8, 1966. In his 1966 Economic Report President Johnson added, “...improvement of our tax system is a continuing need which will concern this Administration and which deserves the support of all Americans.” See 112 Cong. Rec. 1266, 1270 (daily ed. Jan. 27, 1966).
\textsuperscript{240} Report of the Senate Finance Committee on H.R. 17607.
\textsuperscript{241} See, \textit{e.g.} Address by Representative John W. Byrnes, Ranking Republican Member of
reason for suspending the tax credit was to slow down all equipment purchase activity, the suspension period covered not only property actually built or acquired, but also property ordered during the moratorium period.\footnote{242}

The suspension of the investment credit appeared to achieve this goal. Capital investments were frozen in anticipation of its restoration.\footnote{243} Massive cancellation of orders of equipment and machinery followed the period of the credit holdup. The growth rate of investment in plants and equipment dropped to 4\% in 1967, as opposed to 14-17\% in previous years.\footnote{244} The suspension impacted several industries, which saw a fall of over 80\% in the number of orders of tools and machinery since it went into effect.\footnote{245}

The reinstatement of the tax credit in 1967 came in a year of legislative drought after many years of frequent legislative action in the federal income tax area.\footnote{246} The Johnson administration pushed for tax increases\footnote{247} relying on the CEA and leading economists, such as Joseph Peachman, to support its fiscal policy.\footnote{248} In March 1967, the administration was back in Congress with a restoration bill.\footnote{249} Although the bill was swiftly passed in the House, the Senate Finance Committee disagreed with the changes made in the House version, which retroactively expanded the types of cases in which the tax incentives were to be made available.\footnote{250}

\begin{footnotes}
\footnote{242}{That would have been unlikely had companies been able to continue to place orders for manufacture and merely defer the delivery dates.}
\footnote{243}{See testimony of Secretary Fowler, in Hearings on H.R. 6950 Before the House Comm. on Ways and Means, 90th Cong., 1st Sess. 6-7 (1967).}
\footnote{244}{\textsc{Cong. Rec.} S. 3415-3416 (Mar. 9, 1967).}
\footnote{245}{\textsc{Cong. Rev. S.} 3251 (Mar. 9, 1967) (reporting that industries, such as railroad equipment manufacturers, experienced a drop in orders of 78\%-84\%).}
\footnote{249}{President’s Message Relative to Restoration of Investment Credit, H.R. 81, 90th Cong., 1st Sess. (1967).}
\footnote{250}{The committee reported that the House version of the bill was discriminatory against taxpayers who postponed investments compared to taxpayers who ordered equipment or began construction during the suspension period, S. Rep. 79, p. 2.}
\end{footnotes}
Eventually, the suspension lasted only 5 months and on 31 May, 1967, only 3 months after the President’s message, Congress passed, and sent to the President, a bill to restore the investment credit. In addition to ending the credit’s suspension period ahead of the scheduled date, the restoration bill introduced changes to the limitations of the amounts of the tax credit, and for the effect of the suspension provisions to be applied retroactively to March 9, 1967. Albert Karust summarized this period stating, “While the adoption of the bill mercilessly ended a fiasco, it did not terminate the headaches of the episodes.”

3. 1969—Repeal

Prior to the suspension of the investment credit, studies on the future effect of such temporary abrogation on capital investments had cast considerable doubt on the effectiveness of the tax credit in spurring capital investments. These studies showed only a modest anticipated reduction, if any, among the largest manufacturing companies at that time. It was argued that the effect of the tax credit was noticeable, to some degree, in marginal industries and on small businesses. This was not sufficient for the administration to sustain such a mechanism, which was largely portrayed as a business subsidy.

Northwestern University economist Kanyon Poole emphasized that it is not clear that special investment tax incentives are truly needed, and that investments and savings are created independently and as an outcome of tax inducements. Tax Professional questioned the effectiveness of utilizing the investment credit as a countercyclical tool. In his role as Assistant Secretary of the Treasury for Tax Policy

251 H.R. 6950. The President signed the bill into law as P. L. 90-26, 81 Stat. 57, on 13 June, 1967. The Senate agreed in conference to reach a middle ground on the definition of the “suspension period property” between the House version and the more restrictive Senate amendments.

252 Gerald J. Holtz and Harold R. Jenkins, Restoration of Investment Credit and Accelerated Depreciation, 45 Taxes 660 (1967) reporting that the suspension period was shortened to 9 March 1967, instead of 31 December 1966, and eventually took place from 10 October 1966 to 9 March 1967. The limitation on the amount of investment credit, which may be claimed in any 1 year was increased from 25% to 50%, as of 9 March, 1967.

253 Albert L. Kraus, Investment credit—Possible Suspension Sparks Advance In Spending on Plant and Equipment, N.Y. Times, Mar. 26, 1969, at 61.

254 Investment Statistics, Special Survey: The Suspension of Tax Incentives-Impact on Capital Investment, Sept. 1966 (The National Industrial Conference Board surveyed 1,000 of the largest manufacturers on future effects of the temporary suspension of the tax credit and found an anticipated 1.3%-2.8% reduction.).


256 Id. at 232.


at that time, Stanley S. Surrey promoted the enactment of the new tax credit. However, after stepping down from his position, Surrey criticized the use of the tax credit as a countercyclical device. Drawing on foreign experience with countercyclical tax incentives, scholars believed it desirable to utilize, withdraw, and reinstate tax concessions as an integral plan for regulating fiscal policy.

Although the investment credit was kept under the radar in other countries, the legislative process in the U.S. made it impossible to avoid signaling to the market when the tax benefit was scheduled to be suspended or restored. This inherently lost the countercyclical nature and effectiveness of the tax measure.

The growing U.S. involvement in the Vietnam conflict, with peak involvement in 1968, continued to create a build-up in capital spending and deployment of war-related industries. In 1969, investments in new plants and equipment were at a high point. Investment incentives augmented these inflationary pressures by stimulating demand even further. As a result, the Treasury sought to place a higher national priority on the need for general taxpayer relief. It proposed to repeal the 7% investment credit, claiming that the tax subsidy to business investment that had been needed in the early 1960s to modernize the productive capacity of the U.S. was no longer a priority over other pressing national needs.

In his tax reform message on April 21, 1969, President Nixon supported the repeal of the investment credit. He described it as “a Democratic measure” and an “unwarranted and unneeded” subsidy to

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259 Tax Changes for Shortrun Stabilization, Hearings Before the Subcommittee on Fiscal Policy of the Joint Economic Committee, 89th Cong., 2nd Sess., at 243 (statement of Stanley S. Surrey)(“These effects would cover a wider range of investment-including inventories and accounts receivable-than would a change in the investment credit.”). Later on, Surrey argued against utilizing the credit as a countercyclical device since the effect of the investment credit is also directly influenced by corporate tax changes and indirectly by individual income tax rates.


261 Tax Changes for Shortrun Stabilization, Hearings Before the Subcommittee on Fiscal Policy of the Joint Economic Committee, 89th Cong., 2nd Sess., at 60 (statement of Robert A. Gordon)(“In a different form, the Swedish government has been using tax incentives to investment for a number of years as an integral part of its stabilizing fiscal policy.”)

262 Id (“By the time whatever measures may have been needed gets past Congress, the opposite probably is needed. This is what happened the last time the investment credit was suspended. The suspension was proposed on Sept. 1, 1966, and enacted in November, retroactive to Oct. 10.”).

263 Id.


265 Accompanied it with an extension of the 10% surcharge to 1970 in order to make funds available for other high-priority programs. Id.
business. As a policy matter, President Nixon opposed the use of the investment credit as a countercyclical measure, viewing the justification for its use only as an emergency and transitional measure to correct deficiencies in the tax structure on a temporary wartime basis.\footnote{President's Proposal to Repeal Investment credit and To Extend Tax Surcharge and Certain Excise Tax Rates, 91st Cong. 187-90 (1969) (statement of Rep. Edward Garmatz, Member, H. Comm. on Ways and Means).}

Business leaders expressed concerns that repeal of the investment credit without reforming the capital recovery system would impose a substantial and unwarranted tax increase.\footnote{Tax Reform Act of 1969. Part 5, 91st Cong. 3962-66 (1969) (statement of Carl M. Halvorson, President of the Associated General Contractors of America, S. Comm. on Finance).} Therefore, during hearings at the Senate Finance Committee, they requested that Congress generate more realistic depreciation rules to accommodate the unusual circumstances of the economy and inherent features of certain industries.\footnote{Id.} Instead, business executives suggested granting immediate expensing allowance, irrespective of the size of the investment or the useful life of depreciable property, as an equitable step toward expanding the application across all industries and all businesses.\footnote{Staff of S. Comm. on Fin., 91st Cong., Tax Reform Act of 1969, H.R. 13270. Part A: Testimony to be Received Friday, Oct. 3, 1969. Part B: Additional Statements. (Topics: Real Estate, Depreciation Deductions and Recapture; Public Utilities Depreciation, Earnings and Profits, etc.) 215-21 (Comm. Print 1969).}

The Machinery Dealers National Association—a trade association of small businessmen in the used-machine tool industry—also appeared before the Senate Finance Committee hearings on the Tax Reform Act of 1969. They protested that the Act did not include tax revisions to assist small businesses that have difficulty in securing loans or adequate equity.\footnote{Statement of Saul Pearl president of the Machinery Dealers National Association, Staff of S. Comm. on Fin., 91st Cong., Tax Reform Act of 1969, H.R. 13270. Part A: Testimony to be Received Friday, Sept. 26, 1969. Part B: Additional Statements. (Topics: Real Estate, Depreciation Deductions and Recapture; Public Utilities Depreciation, Earnings and Profits, etc.) 5 (Comm. Print 1969).} They advocated for the reinstatement of the investment credit for small businesses only, stating that the impact of the repeal would be devastating to the sales of their machine tools and proposed the increase of immediate expensing to a more realistic level.\footnote{Id. (“In our judgment the limited reinstatement of the investment credit would be the simplest and most effective means of preserving many of our nation’s small businesses.”).} The small business administration echoed these concerns, and suggested a limited credit be permitted only for businesses with certain maximum net taxable or gross sales, or by limiting the credit to a specific dollar amount of machinery and equipment purchases per year.\footnote{Review of Small Business Administration’s Programs and Policies - 1969, 91st Cong. 242-44 (1969) (Recommendation of The Smaller Business Association of New England to Increase First Year Depreciation Allowance; S. Comm. on Small Bus). See also Staff of J.
In view of the repeal of the tax credit, the joint committee suggested revision of immediate expensing to eliminate the dollar limitation of the additional first-year depreciation to increase its effect.\textsuperscript{273} Effective April 18, 1969, Congress repealed the investment credit with both President Nixon and the Committee on Ways and Means declaring that the investment credit “has fulfilled its purpose of increasing investments during a period of slack demands and has outlived its usefulness as a stimulant to the economy.”\textsuperscript{274} The next section reveals that this repeal did not last long.

\textbf{B. The Era of Trial and Error}

1. 1971-1975 Reinstatement and Increase

During 1970, inflationary pressures grew stronger than at any time since the Korean War, and inflation was not restricted to domestic monetary and fiscal policies; there had been an ongoing worldwide forceful spike in consumer product.\textsuperscript{275} With the move away from the gold standard, the dollar decreased in value, and food, agricultural products, and basic industrial materials became in short supply.\textsuperscript{276} Credit demands were unusually heavy, and interest rates were at extremely high levels, at over 8\%.\textsuperscript{277} Calls to restore the investment credit were accompanied by pleas for fiscal restraint and a compulsory savings plan.\textsuperscript{278}

The Federal Reserve declared, “violent price increases that stem from such sources cannot readily be handled with customary weapons of economic stabilization policy.”\textsuperscript{279} President Nixon adopted a pragmatic approach, refusing to become dogmatically attached to the idea of fiscal

\textsuperscript{273} Staff of J. Comm. on Internal Revenue Taxation, J. Comm. on Ways and Means, 91st Cong., Summary of Problems Presented in Statements Submitted to Committee on Ways and Means with Respect to Treasury Proposal to Repeal the Investment Credit 1-6 (Comm. Print 1969).


\textsuperscript{276} On August 15, 1971 President Richard Nixon ended the international convertibility of the dollar to gold, which resulted in the so called “Nixon Shock”. There was no correspondent plan put in place to revalue currencies until more than a year later. \textit{Id.}


\textsuperscript{278} \textit{Id.} (“Additional fiscal restraint is also needed at this time… investment credit or a compulsory savings plan-that could be quickly reversed”).

\textsuperscript{279} \textit{Id.} at 569.
activism. However, he recognized the theory’s political appeal and its use in attaining certain economic objectives. Following the CEA recommendation, he announced a series of fiscal policy actions in line with the New Economics policy. As a first step, President Nixon put in place a price control program that put a temporary freeze on prices on certain foods, wages, and domestic goods in order to moderate inflationary pressures. Second, he instructed the Federal Reserve to restrain monetary policy and limit Federal expenditures. Finally, he reinstituted the investment credit, and while the administration recommended reinstating a 10% credit, Congress restored the investment credit at its historical 7% level. In his message to the nation, President Nixon justified these actions in the hope of attaining job development and improving international competitiveness and the nation’s balance of payments. Scholars commented that a bloc of pro-business votes made the legislative process, including the restoration of the investment credit, politically effortless.

Economic recovery began to occur in early 1971 and gained considerable momentum during 1972. Employment and incomes rose strongly; sales and new orders gradually improved, creating an environment of moderate price increases. The rate of expansion in aggregate economic activity rose further in the closing months of 1972, and rapid expansion continued into 1973. Production of goods and services increased by more than 6%, and the rate of product exports rose by 44%. Spending on new plants and equipment started an upward trend in 1972, rising by around 4% after declining by approximately 6% in 1971. A survey held by Department of Commerce indicated an anticipated 13% increase in business capital investments in 1973. The Federal Reserve acknowledged a number of factors that assisted this economic recovery and gain in business capital spending, amongst them the restoration of the investment credit in late 1971.

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282 T.D. 7128, 36 Fed. Reg. 11,924
284 Gerard M. Brannon, The Revenue Act of 1971- Do Tax incentives Have New Life?, 14 B.C. Indus. & Com. L. Rev. 891, 897 (1973)(arguing Congress contained a bloc of pro-business votes as well as a bloc of liberal votes that enabled the quick enactment of the investment credit.).
Chairman of the Federal Reserve Board, proposed the permanent alteration of investment credit, in accordance with countercyclical considerations, but his proposal was stymied by the Nixon administration, which refused to fully commit to New Economics activism.

From January 1973 until December 1974, the world experienced one of its major stock markets downturns in modern history. This market recession was exacerbated in November 1973, when a spike in oil prices was the result of an oil embargo issued by the Organization of Arab Petroleum Exporting Countries against the U.S. for its involvement in the Middle East conflict. The sharp increase in oil prices, coupled with high government spending due to the Vietnam War, led the nation to a period of 3 years of stagnation. The U.S. economy’s GDP growth dropped to 2.1%, and inflation rates soared from 3.4% in 1972 to 12.3% in 1974.

In 1974, in order to curb inflation and augment the effect of the investment credit on spurring capital investments, President Ford recommended that investment credit be made refundable, but he was unsuccessful.

Figure IV demonstrates that stagnation, as reflected in new capital equipment investments. By 1975, the prices of industrial raw materials had begun to decline and employment and production had decreased rapidly.

383, 395 (1973)("the reinstitution of the investment credit in December 1971 was a contributing factor to the fast economic growth that was experienced in 1972.").


291 See Davis, E. Philip, Comparing Bear Markets – 1973 and 2000, 183 NAT’L INST. ECON. REV. 78–89 (2003); Companies Take Over the Takeover Game from Flashy Raiders, WALL ST. J., Jan. 25, 1988, at 1, col. 6 (describing how low prices resulting from the market crash were followed by hostile corporate takeovers).


Unemployment had risen sharply to over 7% of the labor force. Many businesses postponed or canceled plans for construction of new facilities, or for installing new machinery and equipment. The government’s New Economics policy and fiscal program continued in force, curbing the long recession, but acknowledging past lessons of the need to avoid increasing inflation. Accordingly, the administration acted to increase the extent of the investment credit to temporarily boost capital demand. The Board and the Open Market Committee adopted policies to encourage greater expansion in monetary and credit. The administration proposed a major tax cut in the Tax Reduction Act of 1975, containing a temporary increase of the investment credit from 7% to 10% of the cost of qualified property. The administration justified these tax changes in helping to provide more jobs and moderating inflation by improving the capacity and efficiency of industrial plants.

By mid-1975, the economy had recovered and returned to its normal capacity. Nevertheless, businessmen and professionals continued to call for permanent extension of the investment credit. They argued that while this credit provided a substantial incentive for business to make investment in plants and equipment, its on again-off again character made it an unreliable factor in facility planning. Congress responded by enacting the Tax Reduction and Simplification Act of 1977, declaring it aims to provide economic stimulus, to increase consumer spending, to expand production of goods and services, and to reduce unemployment. The act kept the investment credit at its 10% level, justifying its expansion and the introduction of a new jobs tax credit to help boost GNP growth.

1970 and 1976 see Figure V. in the Appendix.

297 Id. at 62.
298 Id.
299 Id.
301 Statement by Arthur F. Burns, Chairman, Board of Governors of the Federal Reserve System, before the Joint Economic Committee, February 7, 1975, 61 Fed. Res. Bull. 60, 63 (1975)(“But, while the Federal Reserve recognizes all this, we are also mindful of the lesson of history that rapid growth of the money supply will lay the base for a new wave.”).
302 W. Bruce Thomas, How to Increase Capital Formation, 29 TAX EXECUTIVE 222 (1976) (in this short article Mr. Thomas, who is the Executive Vice President-Accounting Service, United States Steel Corporation, calls for increasing measures to create capital, including increasing the investment credit to 12% and making it permanent.).
304 Id.
2. The Reagan Years and the Tax Reform Act of 1986

The election of Ronald Reagan in 1980 marked a record in tax legislation activity.\textsuperscript{305} In 1979, an increase in Iranian oil prices created a worldwide energy crisis. Spiking oil prices led the government to tighten its monetary policy to control inflation, and a short recession followed during 1981-1982. Proponents of major tax reform plans recognized that depreciation schemes favored industries that invest heavily in depreciable assets over others, such as high technology industries, service industries, and the trade sector, which invest more heavily in inventories.\textsuperscript{306} In addition, high rates of inflation eroded the real value of depreciation deductions over the years, diminishing the profitability of investment and discouraging businesses from replacing old, with more modern, equipment. Therefore, the Committee recommended a substantial restructuring of depreciation deductions and maintaining or increasing the investment credit to stimulate capital formation, increase productivity and improve the nation’s competitiveness in international trade. The Senate Finance Committee declared that “present rules for determining depreciation allowances and the investment credit need to be replaced because they do not provide the investment stimulus that is essential for economic expansion.”\textsuperscript{307}

The most sweeping tax legislation in the history of the Internal Revenue Code to this day was manifested in the Tax Reform 1986 Act. This act reflected a major shift in tax policy, which at that time focused on simplicity, fairness, equity, and economic neutrality.\textsuperscript{308} Support for a “fairer” tax code and tax neutrality received growing bipartisan support. The shift in tax policy followed the philosophy that investment decisions should be based on economic, rather than tax, incentives.\textsuperscript{309} The main advocates of this policy were Treasury Secretary James A. Baker III, and Speaker of the House of Representatives Congressman Thomas P. O’Neill, Jr., the latter noting:


\textsuperscript{306} Department of Treasury, Tax Reform for Fairness, Simplicity, and Economic Growth: The Treasury Department Report to the President xiii (1984).


\textsuperscript{309} Gleckman & Berger, \textit{Tax Reform-Long Term, A streamlined Code Will Bolster the Economy, but Short Term?} BUS. WEEK 55 (Sept. 1, 1986)(citing Secretary Baker remarking “This Is a very significant change. We're going to have a far more efficient system than we have now.”).
I would like to think of the economy at all times, but I have to think of the national interest. We have to think of fairness. We have to think of what the people really want. Is it right? It is right that corporations of America should pay no taxes, that the wealthy of America should find loopholes? The answer is no...It is a voluntary tax code that we have seen erode.\textsuperscript{310}

The 1986 tax reform focused on lowering rates and expanding the base by eliminating many tax preferences.\textsuperscript{311} To compensate for the losses in revenue caused by individual income tax reduction and corporate rate reduction, the 1986 Act repealed a host of exclusions, deductions, and credits primarily used by corporate taxpayers.\textsuperscript{312} It aimed to move the income tax base toward a cost recovery system that improved the measure of income in terms of receipts less the cost of income production.\textsuperscript{313} Prior to the enactment of the 1986 Act, the revenue loss estimates from the investment credit for 1986 were projected at $30.9 billion,\textsuperscript{314} which made it an obvious target for repeal. The credibility problem of the investment credit and skepticism regarding its effect on the economy reinforced the notion that this measure should be put to rest.\textsuperscript{315}

Some tax practitioners and business owners predicted that the 1986 tax reform would increase compliance costs on small businesses. They believed that the elimination of the investment credit and other depreciation preferences would have an unfavorable economic impact on many small businesses.\textsuperscript{316} The immediate expensing rule was left intact.

\begin{itemize}
\item \textsuperscript{310} 65 Cong. Digest 44 (Feb. 1986).
\item \textsuperscript{313} Daniel L. Simmons, \textit{The Tax Reform Act of 1986: An Overview}, 1987 BYU L. REV. 151, 226 (1987). Opponents of the repeal of business incentives, such as Congressman Marjorie S. Holt, opposed the effect such action would have on the economy. See 65 Cong. Digest 58 (Feb. 1986) ("My concern is the economic consequences of the legislation, and I have concluded that it will retard capital formation and investment, restrict economic growth, and cause higher unemployment.").
\item \textsuperscript{315} Statement of James S. Fralick, Assistant Professor of Economics at Fordham University, Regarding The President’s Proposed investment Credit, in Bernard D. Reams, Jr., \textit{Tax Reform - 1971: A Legislative History of the Revenue Act of 1971} (Public Law No. 92-178 1180 (1996), Tax Proposals Contained in the President’s New Economic Policy, Part 4; Hearings before the House Committee on Ways and Means; September 17, 1971 (detailing the various credibility problems that investment credit has presented in history.).
\end{itemize}
for its small business affiliation and relatively minor revenue impact. Even before President Reagan had signed the 1986 Act into law, lobbyists and other interest groups acted to reinstate the investment credit without much success. In proposing to repeal the investment incentives, the Ways and Means Committee reasoned that it did not accomplish its intended purpose, and did not stimulate capital investment to a degree sufficiently significant to produce economic growth. For the long term, the investment credit merely shifted the timing of equipment purchases that would have taken place regardless of the credit. On October 22, 1986, the Tax Reform Act put an end to the controversial history of the investment credit.

IV. CONCLUSION

History teaches us many important lessons. Here the message is loud and clear. Fiscal activism is a pill difficult to swallow, unless titled with the proverbial “small business”. The language of the immediate expensing rule has made it available to businesses of all sizes. Nevertheless, its history demonstrates this tax benefit perpetuated as a result of being repeatedly endorsed as a small business measure. It has

AKRON TAX J. 69, 80 (1987) (“the elimination of the investment credit (ITC) results in an asymmetric treatment of investment in physical capital and investment in research and development.”).

317 Szabo, Welcome to Tax Reform, 74 NATION’S BUS. 22 (Nov. 1986). See also Gleckman, This Is Not the Last Chapter in Tax Reform, BUS. WEEK at 64 (Sept. 1, 1986).


319 Id.

320 26 U.S.C. §§ 46-48 (amended 1986) (technically, these sections were "amended" in 1986, but they were repealed de facto).

321 In 1978, the house reported on depreciation for small business that, under present law, there are no special provisions exclusively applicable to the depreciation of assets by small businesses. It admitted that, although not limited to small businesses, immediate expensing was enacted to provide a special incentive for small businesses. See P.L. 95-600, Revenue Act of 1978, H. Rep. No. 95-1445. The Senate report on Economic Recovery Act of 1981 reiterated the fact that under present law there are no special provisions specifically applicable to depreciation of assets by small business. See Pub. L. No. 97-34, Economic Recovery Act of 1981, S. Rep. No. 97-144.

322 For example, in 1993, the house committee recommended increasing the amount allowed to be expensed under immediate expensing from $10,000 to $25,000. The house committee explained, “increasing the amount allowed to be expensed will provide an incentive for small businesses to increase their investment in capital assets, thus promoting economic growth and increasing demand for productive assets.” See P.L. 103-66, Omnibus Budget Reconciliation Act of 1993. In 1995, the house proposed increasing the $17,500 amount allowed to be expensed under Code immediate expensing to $35,000. The House Committee believed it is necessary to increase this small business benefit. It reported that that “immediate expensing provides important benefits for small businesses by lowering the cost of capital and eliminating depreciation recordkeeping.
enjoyed wide bipartisan support for its expansion as part of the continued support of small business institutions and lobby groups.\footnote{See, e.g. Hearings before the Subcommittee on Entrepreneurship and Special Problems Facing Small Business of the Committee on Small Business, United States Senate, 5. Hrg. 99-677, U.S. Government Printing Office, Washington, D.C., 1986; See also Summary of Activities, H. Rep. No. 109-740 (where the SBA Office of Advocacy's strongly supported to increase expensing limits arguing many small businessmen have taken advantage of it to increase their working capital); On January 18, 1995, during hearing in the Committee on Small Business representatives from the National Federation of Independent Business (NFIB), the Small Business Legislative Council (SBLC), and the Small Business Survival Committee advocated for the extension of the immediate expensing rule. See Summary of Activities, H. Rep. 104-873. In April of 2003, the Subcommittee on Tax, Finance, and Exports conducted hearings on the effects of immediate expensing on small business community. See Summary of Activities, H. Rep. 108-800.} The investment credit had no such providence.

It is a well-known axiom taxpayers often prefer the use of credits to deductions. The scope of credits is usually larger and they work faster to offset positive tax liability. Yet, the investment credit had a far more onerous calling than the typical tax credit. The investment credit was part of a series of far reaching measures taken to balance the economic market. In times of mounting foreign competition and inflationary pressures, it functioned as a countercyclical mechanism. The investment credit was part of the administration’s experiments in New Economics theory and regulating capital investments. It illustrated the transformation of the tax system from a revenue-raising device to social and economic stimulus instrument. The decreasing confidence in government fiscal activism led Congress to revoke the investment credit. Conversely, Congress perpetually extended and expanded the immediate expensing rule though it remains unclear it has been fulfilling its purpose.

In 1992, the George H.W. Bush administration proposed a new form of expensing. In order to expedite economic recovery the administration sought to accelerate purchases of new equipment.\footnote{See Economic Growth Acceleration Act of 1992, H. Rep. No. 102-432 H.R. Rep. 102-432.} The proposed tax preference allowed a temporary additional first-year depreciation deduction of 10% of the adjusted basis of certain qualified property. This “bonus depreciation” was in addition to the benefit already available under immediate expensing rule.\footnote{See Tax Fairness and Economic Growth, H.R. Con. Rep. No. 102–461.} Yet, the proposal did not receive congressional approval.\footnote{A key difference between 100% bonus depreciation and immediate expensing property is that bonus depreciation only applies to new property, while immediate expensing applies to both new and used purchased property.}

A decade later, President George W. Bush continued his father’s legacy to enact various business tax incentives. In 2002, as a response to the economic contraction caused by the terrorist attacks of September 11,
2001, President Bush revived his father’s proposal. That year, Congress added section 168(k) that provided additional first-year deduction of 30% of the cost of equipment. 327 This added deduction essentially nullified the phase-out effect of the immediate expensing rule. A year later, Congress extended the bonus depreciation and increased its scope to 50% of the cost of equipment. 328 Professors Karen Burke and Grayson McCouch suggested these generous business investments had a political motive. They meant to appease the business community for the failure to eliminate the double taxation of corporate dividends. 329

Over the past few years, Congress continuously extended the time and scope of the “temporary” immediate expensing rule and bonus depreciation. 330 Lately, Congress increased the immediate expensing allowance limits to $500,000 and the phase-out threshold to $2 million, the highest levels in the history of this tax benefit. 331 It also temporarily increased the bonus depreciation to allow deductibility of 100% of the cost of certain property. 332 Last year, President Obama even proposed to make the expensing rule permanent and to allow the entire cost of any qualified investments immediately deductible. 333

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330 For example, in 1991, the House proposed to temporarily increase the $10,000 amount allowed to be expensed under immediate expensing to $25,000 for 2 years. In conference, the amount was increased to $20,000, rather than $25,000. See Tax Fairness and Economic Growth, H.R. Con. Rep. No. 102–461. In the Small Business Job Protection Act of 1996, Congress increased the value of these benefits over a phase-in period ending in 2003. In 1998, the house recommended gradually increasing the $18,500 amount allowed to be immediately deducted under immediate expensing to $25,000 for taxable years beginning in 2003 and thereafter. See Taxpayer Relief Act of 1998, H. Rep. No. 105-739. In 1999, the house report recommended gradually increasing the $19,000 amount allowed to be immediately deducted under immediate expensing to $30,000 for taxable years beginning in 2000 and thereafter. See Wage and Employment Growth Act of 1999, H. Rep. No. 106–467(I).
333 Id. See also Gary Guenther, Congressional Research Services, Small Business Expensing Allowance: Current Status, Legislative Proposals, and Economic Effects (Sep. 29, 2010), available at http://economic-legislation.blogspot.com/2010/09/small-business-expensing-allowance.html Obama proposed to allow businesses of all sizes to expense all qualifying capital expenditure with 100% bonus depreciation.
On the other hand, over the years there has been little empirical analysis of the effects of investment tax incentives. Although it appears that their future is secure for the time being, studies on the effectiveness of investment tax incentives in spurring investments, whether through deductions or credits, remain inconclusive. In fact, one study revealed only 10% of the firms that claimed accelerated depreciation recently admitted that these preferences played a decisive role in their investment decisions. The efficiency of the immediate expensing rule and the bonus depreciation should be reevaluated to ascertain if it actually advances its stimulative objectives, if it does not, it should face the same fate as the investment tax credit.

This Article is to point out the purpose certain investment tax incentives meant to serve. It hopes to instigate further discussions on the effectiveness of such measures in actually stimulating the economic market. Wilbur Mills forcefully argued against the use of the tax system to affect investment behavior without proper accountability. As time passes, he argued it is essential that tax incentives be tested against their intended goals. It is time we reexamined the equitability and desirability of investment tax incentives, whether deductions or credits. Future studies should evaluate their effectiveness as economic catalyst, compared to other direct alternatives.

334 Gary Guenther, Congressional Research Service, Immediate expensing and Bonus Depreciation Expensing Allowances: Current Law, Legislative Proposals in the 113th Congress, and Economic Effects, available at http://economic-legislation.blogspot.com/2013/02/section-179-and-bonus-depreciation.html (concluding that available evidence indicates that the expensing allowances probably have had no more than a minor effect on business investment.).


APPENDIX

Figure I:
Historical Maximum Allowance and Investment Limitations of Immediate expensing from 1958 to 2014

<table>
<thead>
<tr>
<th>Year</th>
<th>Maximum Expensing Allowance</th>
<th>Maximum Cost of New Equipment</th>
</tr>
</thead>
<tbody>
<tr>
<td>1958-1981</td>
<td>20%</td>
<td>$10,000</td>
</tr>
<tr>
<td>1982</td>
<td>$5,000</td>
<td>---</td>
</tr>
<tr>
<td>1983</td>
<td>$5,000</td>
<td>---</td>
</tr>
<tr>
<td>1984</td>
<td>$7,500</td>
<td>---</td>
</tr>
<tr>
<td>1985</td>
<td>$5,000</td>
<td>---</td>
</tr>
<tr>
<td>1986</td>
<td>$5,000</td>
<td>---</td>
</tr>
<tr>
<td>1987-1992</td>
<td>$10,000</td>
<td>$200,000</td>
</tr>
<tr>
<td>1993-1996</td>
<td>$17,500</td>
<td>$200,000</td>
</tr>
<tr>
<td>1997</td>
<td>$18,000</td>
<td>$200,000</td>
</tr>
<tr>
<td>1998</td>
<td>$18,500</td>
<td>$200,000</td>
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<tr>
<td>1999</td>
<td>$19,000</td>
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</tr>
<tr>
<td>2000</td>
<td>$20,000</td>
<td>$200,000</td>
</tr>
<tr>
<td>2001-2002</td>
<td>$24,000</td>
<td>$200,000</td>
</tr>
<tr>
<td>2003</td>
<td>$100,000</td>
<td>$400,000</td>
</tr>
<tr>
<td>2004</td>
<td>$102,000</td>
<td>$410,000</td>
</tr>
<tr>
<td>2005</td>
<td>$105,000</td>
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</tr>
<tr>
<td>2006</td>
<td>$108,000</td>
<td>$430,000</td>
</tr>
<tr>
<td>2007</td>
<td>$125,000</td>
<td>$500,000</td>
</tr>
<tr>
<td>2008-2009</td>
<td>$250,000</td>
<td>$800,000</td>
</tr>
<tr>
<td>2010-2013</td>
<td>$500,000</td>
<td>$2,000,000</td>
</tr>
</tbody>
</table>

Figure II:
Immediate Expensing v. Tax Credit

<table>
<thead>
<tr>
<th></th>
<th>Immediate Expensing</th>
<th>Tax Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profits</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Cost of New Equipment</td>
<td>($50,000)</td>
<td>($50,000)</td>
</tr>
<tr>
<td>Immediate Expending</td>
<td>($2,000)</td>
<td>---</td>
</tr>
<tr>
<td>Taxable Income</td>
<td>$48,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>Tentative Tax (50% flat tax rate)</td>
<td>$24,000</td>
<td>$25,000</td>
</tr>
</tbody>
</table>
The value of a tax credit to a corporation facing a 50% tax rate was greater than the value of utilizing immediate expensing. The corporation is allowed to immediately expense 20% of the cost of the property maximum capped at $2,000. This brings the corporation effective tax rate down from 50% to 24%. Alternatively, the corporation can enjoy 7% of the cost of the property as a tax credit, which brings its effective tax rate down from 50% to 22%. Although the immediate expensing rule only changed the timing of the depreciation deduction and not the amount of such deductions, the tax credit provided dollar-for-dollar reduction and had a larger effect on positive tax liability.

**Figure III:**
Immediate Expensing v. Tax Credit with Low Net After-Tax Earnings

<table>
<thead>
<tr>
<th></th>
<th>Immediate Expensing</th>
<th>Tax Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profits</td>
<td>$52,000</td>
<td>$52,000</td>
</tr>
<tr>
<td>Cost of New Equipment</td>
<td>($50,000)</td>
<td>($50,000)</td>
</tr>
<tr>
<td>Immediate Expending</td>
<td>($2,000)</td>
<td>---</td>
</tr>
<tr>
<td>Taxable Income</td>
<td>$0</td>
<td>$2,000</td>
</tr>
<tr>
<td>Tentative Tax</td>
<td>$0</td>
<td>$1,000</td>
</tr>
<tr>
<td>(50% flat tax rate)</td>
<td>---</td>
<td>($3,500)</td>
</tr>
<tr>
<td>Tax Credit</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>(7% of cost of new equipment)</td>
<td>0.0%</td>
<td>0%</td>
</tr>
</tbody>
</table>

Figure III shows that a corporation with scarce profits that invests almost all of them in purchasing new equipment is indifferent to utilizing the tax credit or immediate expensing. In both cases, the corporation ends up with no tax liability. Both effective tax rates decline from 50% to 0%. Although both investment incentives can be carried forward, their postponed value is reduced because of the concept of time value of money and the desirability to recover cost for income tax purposes at the earliest possible moment.

**Figure IV**
[In billions of dollars]


Figure V: