IRET Byline

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Clinton's ITC: Too Brief, Too Small, and Too Strange

President Clinton has proposed two types of investment tax credit (ITC) which he hopes will jump-start the economy near-term and improve long-term capital formation without costing much revenue. The credits are severely reduced in value by punitive offsets and other restrictions. For the large businesses that account for 85 percent or more of the nation's investment, the credit is temporary and would do nothing long term to counter Clinton's proposed permanent two percentage point increase in the corporate tax rate for large firms. The credits are likewise inadequate to counter the proposed permanent increases in personal tax rates affecting upper-income savers and investors who own and finance a significant portion of large and small corporations and unincorporated businesses. All businesses would also suffer from energy tax increases. The total Clinton tax package would raise the cost of capital. The credits in no way transform the Clinton package from anti-capital to pro-growth.

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Small businesses (those with less than $5 million in average annual gross receipts in the preceding three tax years) would be allowed a permanent investment tax credit that would apply to all of a firm's investment in eligible types of property. Eligible property would be the same types of assets, principally machinery and equipment, eligible under past credits ("section 38 property", consisting of property with 3-, 5-, 7-, and 10-year recovery periods and 15-year public utility property). Used property, purchased principally by small businesses, would not be eligible. The basic credit would be 7% on assets bought between December 3, 1992, and December 31, 1994, and 5% thereafter. However, 3-year assets would receive only one-third of the credit, 5-year assets two-thirds, and 7-year assets four-fifths, with the full credit reserved for 10- and 15-year assets. (See Table.) The small business credit would be subject to an annual cap to prevent "abuse" of the $5 million gross receipts rule.

The value of the small business credit would be sharply limited by a "basis adjustment". Small businesses would have to reduce the depreciable basis of their assets by the amount of the credit received. That is, if the business received a $7 investment tax credit on a $100 machine, the business could only write off $93 under the normal capital cost recovery provisions. The higher taxes resulting from the reduced write-offs would offset roughly 30 percent of the value of the credit. On 7-year property of small corporations, for example, the effective credit in 1993 after basis adjustment would be 3.81 percent, instead of 5.6 percent. (See Table.) This 100% basis adjustment is the harshest in the history of the ITC. The expanded ITC introduced in the Economic Recovery Tax Act of 1981 had no such basis adjustment. Even the viciously anti-investment Tax Equity and Fiscal Responsibility Act of 1982 required that only half of the ITC be subtracted from the tax basis of the equipment.

For unincorporated businesses, over 92 percent of the permanent 5 percent credit would be wiped out by the basis adjustment and the increase in the owners' marginal income tax rates. The rate hikes include the explicit hike in the statutory rates plus the effect on marginal rates from elimination of the Medicare tax

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base cap. The rate hikes also reflect the impact of Clinton's proposal to permanently extend the phase-outs of itemized deductions and personal exemptions, which would otherwise expire in 1995 and 1996 under current law.

The credit for large businesses would be temporary, incremental, and significantly offset by a punitive recapture provision. Large businesses would receive a basic 7% credit for assets purchased between December 3, 1992 and December 31, 1994. For 3-year property, the credit would be one-third of the regular rate; two-thirds the regular rate for 5-year property; four-fifths for 7-year property; and 7% for longer-lived assets. Through 1993, only investment in excess of 70 percent of the taxpayer's average investment in new and used property in 1989-1991 would be eligible. In 1994, investment would have to exceed 80 percent of the base period average to receive the credit. (The taxpayer may opt to use 1987-1991 as the base period.) The averages would be adjusted for growth of GDP since the base period. Taxpayers could claim the credit on no more than 50 percent of qualified investment in a tax year.

Large businesses using this credit would be required to add the amount of the credit to taxable income over 5 years (1993-1997) for assets placed in service through 1993, and over 4 years (1994-1997) for assets placed in service in 1994. This "recapture" provision would reduce the value of the credit by about 30 percent. For example, in the case of the 10-year asset, recapture would reduce the effective credit rate by 2.16 percentage points. The rise in the corporate tax rate from 34 percent to 36 percent would be equivalent to a "negative credit" of about .2 percent to 1 percent, lasting indefinitely. (See Table.)

The incremental credit for large businesses would provide only a modest incentive for investment, and only in the two years in which it would apply. Thereafter, higher corporate tax rates would have an adverse effect on capital outlays. The small business credit is permanent, but it covers a sector of the economy that accounts for less than 15 percent of capital investment, and much of that in structures not eligible for the credit. Long term, most of the effect of the credit would be offset by the proposed energy tax and other tax increases.

Table: Proposed Investment Tax Credits Rates, Before and After Offsets

Asset life:	3year	5year	7year	10year	15year
Gross credit: large and small businesses, 12/3/92 - 12/31/94.	2.33	4.67	5.60	7.00	7.00
Gross credit: small businesses only, after 12/31/94.	1.67	3.33	4.00	5.00	5.00
Effective rate: large business credit through 12/31/94, accounting for corporate tax rate hike and taxation of credit.*	1.34	2.74	3.23	3.98	3.61
(Credit reduction due to taxation of credit).	-.72	-1.44	-1.73	-2.16	-2.16
(Reduction due to credit equivalent of rate hike. Continues post-12/31/94).	-.20	-.34	-.47	-.64	-1.01
Effective rate: small corporation credit, through 12/31/94.*	1.52	3.11	3.81	4.90	5.19
Effective rate: small corporation credit, after 12/31/94.*	1.08	2.22	2.72	3.50	3.71
Effective rate: small unincorporated business credit, through 12/31/94.*	.73	1.74	1.96	2.40	1.42
Effective rate: small unincorporated business credit, long term.*	.10	.51	.41	.37	-1.04

* Effective rates reflect present values of offsets assuming 3% inflation and a 3.5% real interest rate, and assume credit is reflected in taxpayer's quarterly estimated tax payments. Large business credit valued at 1993 recapture rule. Small business credits reflect basis adjustment. Large and small corporate credits not adjusted for effect of higher personal tax rates on their owners. Unincorporated business credits reflect increases in marginal income tax rates, phase-out extensions, and payroll tax rates on owners.

In view of the strong pace of economic activity, a "jump-start" or stimulus focus is completely inappropriate. Needed, instead, is an effort to make the federal tax system less of an impediment to long-term economic progress. Ideally, business should be allowed an immediate write-off (expensing) of each dollar spent on plant, equipment, and structures (or a capital recovery schedule that permitted a write-off with the same present value as expensing). In the absence of such a system, a properly-designed investment tax credit could offset the short-comings of the current depreciation schedules. Clinton's proposed ITCs, with their offsets and limited applications, fall far short of what is needed to eliminate the tax penalties on capital formation.

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Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.