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Federal tax policy: Targeted incentives for manufacturing in the post-World War II era

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INTRODUCTION

In the post-World War II period, the federal government occasionally sought to use tax policy to support civilian domestic manufacturing.^a The three main tools it deployed for this purpose were the investment tax credit (ITC), the domestic production activities deduction, and accelerated and bonus depreciation. Eligibility was not necessarily restricted to manufacturing, but these incentives disproportionately benefited the manufacturing sector. Of the three, only the last survives today, and it is scheduled to be phased out in 2027.

The demise of tax incentives for domestic manufacturing fits into a larger pattern. Congress has paid for periodic reductions in the statutory corporate tax rate by eliminating targeted incentives, most recently in

a This review excludes targeted support for specific industries (such as the semiconductor industry under the CHIPS Act), locations (such as Puerto Rico), or non-production activities (such as research and development).

2017. Between big tax bills, narrower bills have been used to introduce (or reintroduce) manufacturing incentives into the tax code — usually in response to recessions, trade imbalances, and other trends and events, as well as pressure from organized interests.

As the United States enters a phase of more active industrial strategy, new opportunities to advance tax policies that support civilian domestic manufacturing seem likely to arise. But any such policies are likely to remain vulnerable to large-scale tax reforms in the future.

INVESTMENT TAX CREDIT

The United States dominated global manufacturing before World War II, and its dominance grew afterward.¹ With past and future industrial rivals like Great Britain, Japan, and Germany flattened, and domestic producers not merely unscathed but supercharged by the war, peace made American mass production ubiquitous around the world.

The recovery of America's competitors, aided by new Cold War alliances, inevitably brought this golden age to a close. The first sign appeared in 1961, when President John F. Kennedy called for an investment tax credit as a means to counter an economic slowdown. The ITC was instituted in 1962, judged favorably, and expanded in 1964. As inflation picked up in the late 1960s, the ITC was removed, then reinstituted in the recessionary 1970s. The ITC was finally made permanent under President Jimmy Carter in 1978; its expansion by Congress as part of President Ronald Reagan's landmark 1981 tax bill marked a historic peak.²

A key basis for making the ITC generous and permanent was the assertion that investment in manufacturing plants and equipment was less than optimal even when the economy was not in recession. Some of the benefits of such investments, in this view, "spill over" to competitors of the investing firm or its customers. For instance, competitors may learn about new technologies, while customers may benefit from lower prices. In such cases, the firm that makes the investment would not be compensated and might even be deterred from investing at all, depriving the economy of benefits. An ITC addresses this market failure and permanently raises the economy's growth rate.³

Skepticism among economists about such claims, and thus about the ITC's effectiveness, grew even as the ITC peaked in popularity. More sophisticated analytical techniques applied during the late 1970s and early 1980s cast doubt on past empirical findings. Rational expectations theorists argued that businesses didn't change their behavior in response to government policy. The notion that policy should be neutral across all asset types, based on the assumption that the market allocated capital efficiently, took

hold. Following the principle of "lower the rate, broaden the base," the 1986 Tax Reform Act eliminated the ITC along with many other targeted tax provisions, while reducing the corporate tax rate.⁴

DOMESTIC PRODUCTION ACTIVITIES DEDUCTION

International trade provides an alternative motivation to favor manufacturing through tax policy. Goods comprise the bulk of trade, and many governments around the world use public policy to seek a competitive advantage for domestic producers.

The United States adopted a series of policies in this vein, beginning in 1971. These policies encouraged manufacturing in the United States by excluding (or deferring) some export income from taxation. Ironically, the first three attempts were held by the World Trade Organization (and its predecessor, the General Agreement on Tariffs and Trade) to be violations of international treaties championed by the United States to prevent efforts to tilt the playing field.⁵

The Domestic Production Activities Deduction (also known as section 199) was the most recent effort to support U.S. exports of manufactured goods while complying with the WTO. Enacted in 2004 and phased in through 2010, section 199 allowed a deduction of 9% of taxable income derived from qualified activities. While firms in non-manufacturing industries, such as film production and oil-and-gas, gained some benefit from the deduction, the Congressional Research Service found that 66% of claims in 2013 were made by manufacturers. The fully-phased-in annual cost of the provision was estimated to be about \$20 billion.⁶

In a rare study of the section 199 deduction, economist Eric Ohrn of Grinnell College found it had a "large effect on corporate behavior." The effect was particularly strong for smaller, cash-strapped producers, while larger firms with easier access to capital were more responsive to lower rates in general. Nonetheless, the deduction was eliminated in the 2017 Tax Cuts and Jobs Act, as arguments in favor of "lower the rate, broaden the base," prevailed again.⁷

ACCELERATED AND BONUS DEPRECIATION

Depreciation refers to the decrease in value over time of a long-lived asset. In tax policy, a depreciation schedule governs the rate at which the value of long-lived assets can be deducted from revenue to determine net income, which in turn impacts tax liability. The longer the period and slower the pace over which tax depreciation occurs, the more expensive it is to make investments. This is because of the time value of money, which means that a dollar saved in the future is worth less than a dollar saved today (how much less depends on interest rates and inflation). In other words, each passing year makes the depreciation deduction that year less valuable than if it had occurred in a prior year. As an incentive, depreciation has maximum value if all expenses can be deducted in the year they are incurred (a practice known as "full expensing").⁸

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"Accelerated" and "bonus" depreciation are conceptually similar. Both policies allow firms to depreciate assets more quickly than under normal accounting principles, which link the pace of depreciation to the useful life of the asset. While the two terms are sometimes used interchangeably, in most of the literature, accelerated depreciation refers to section 179 of the tax code, which is in place permanently, and bonus depreciation refers to a temporary policy with different criteria and eligibility, such as section 168(k) as modified by the 2017 Tax Cuts and Jobs Act.⁹

Any firm that buys durable assets is affected by depreciation policy. Because manufacturing firms tend to buy longer-lived assets more than other types of firms, they are typically more affected by accelerated and bonus depreciation policies. However, the degree to which any particular policy change disproportionately impacts manufacturing depends on the specific rules being applied.

Section 179, which dates to 1958, is the oldest tax provision considered here. In the year it took effect, the law allowed taxpayers to deduct \$2,000 of capital expenses from their income without depreciation (in other words, to expense that amount.) This limit favored small businesses, a feature that has stayed in the code continuously. However, the limit rose to \$10,000 in 1987, \$100,000 in 2003, and \$1 million in 2017, aiding increasingly larger businesses; about two-thirds of all corporations have no tax liability after all credits have been taken. As these dates suggest, the limit for accelerated depreciation has been ratcheted up by major tax legislation, with additional smaller increases in response to economic downturns. While section 179 applies to manufacturing, mining, electricity, and other heavy equipment, it is also available for off-the-shelf software and interior building improvements.¹⁰

As noted above, the 1981 Economic Recovery Tax Act expanded the ITC, and it also made depreciation considerably more generous. As with the ITC, these rules were pulled back substantially in 1982, 1984, and 1986.¹¹ While both Presidents George H.W. Bush and Bill Clinton called for the return of investment incentives, it took the economic downturn precipitated by the popping of the dot-com bubble and the 9/11 terrorist attacks to bring them back in the form of bonus depreciation. In 2002, Congress allowed firms to expense 30% of eligible capital costs in the year they were incurred. The bonus was raised to 50% the following year, and the provision was renewed almost continuously at various levels after that, hitting 100% (i.e., full expensing) during the Great Recession in 2010. In 2017, the Tax Cuts and Jobs Act reinstated the 100% level from late 2017 through 2022. Unless the law is revised, the bonus begins phasing down, in 20% steps, in 2023 and will reach zero in 2027.¹²

Estimates of the cost of these policies to the Treasury vary. "One of the most difficult issues in defining tax expenditures for business income," according to the Congressional Joint Committee on Taxation, "relates to the tax treatment of capital costs." The JCT estimates bonus and accelerated depreciation cost about \$40 billion per year in fiscal years 2022 and 2023. The Treasury Department uses a different method; its estimate is only about \$10 billion for FY2022. While either figure is large relative to most other provisions of the tax code, it is relatively small compared to business expenditures on structures and equipment, which total well over \$1 trillion per year, and even small compared to manufacturing expenditures, which total about \$250 billion annually.¹³

Economists generally agree that accelerated and bonus depreciation stimulate investment, but they disagree about how much and how permanently. A review of the empirical literature by Martin Jacob, for instance, concludes that "bonus depreciation...consistently increases investment." Eric Zwick and James Mahon (2017) find that bonus depreciation had a "substantial effect on investment" in the 2000s. The effect was particularly pronounced for small firms that had been omitted from studies by prior researchers whose estimates were lower. The authors allow that they may be observing planned investment being pulled forward, rather than genuinely new investment, since bonus depreciation is a temporary policy.¹⁴

TAX INCENTIVES FOR CLEAN MANUFACTURING

The debate among economists over accelerated and bonus depreciation is part of a long-running discussion about the effectiveness of any targeted tax incentive. The mainstream of the discipline holds that special treatment for manufacturing is not justified by theory and rarely works in practice. From this perspective, lowering the rate for all businesses is preferable to targeted policies favoring some.

Dissent from this conventional wisdom, however, is rising at the moment. Among economists, accelerating innovation and reducing pollution are widely accepted as justifications for public policy intervention.¹⁵ These outcomes may be enabled by tax incentives that prompt manufacturers to respond by investing more quickly or more fully in making cleaner products or using cleaner processes. Shifting expert views on the utility of tax incentives may provide ballast for arguments made by industry associations, manufacturing-intensive states, and other direct beneficiaries of these policies.

History also suggests, however, that clean manufacturing tax incentives will ultimately be subject to the broader tides of tax policy. Reformers who want to simplify the tax code may gain the upper hand at some point in the next decade or two, as they did in 1986 and 2017. Only the most well-entrenched and well-justified provisions are likely to survive this "clearing of the underbrush." Evidence showing that tax incentives for clean manufacturing work, and an expert community willing to verify that interpretation, would be helpful in this eventuality.

Endnotes

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