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EFFECTIVE TAX RATES AND ECONOMIC STIMULATION--
A CASE STUDY USING AT&T

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AUTHOR'S NOTE

In reading this article it is very important to realize that Congress and not AT&T passed the laws which produce the tax effects as shown herein. No company should ever be criticized for paying the legal minimum tax. In fact, AT&T is criticized in the article for choosing not to minimize its income tax for years 1954 through 1969. Even here perhaps the state regulatory commissions should receive much of the blame for higher than necessary rates for telephone service.

CONTENTS

Effective Federal Income Tax Rates of AT&T	1
Affected Federal Income Tax Rates as Reported to the SEC by AT&T	5
Factors in the Numerator of the Effective Tax Rate Computation	9
Cause of Change in Effective Tax Rates from 1969 to 1975	11
Tax changes impacting on the job development tax credit	11
Tax changes impacting on the depreciation deduction	12
Changes resulting from changed depreciation methods and lives	13
Effect of AT&T's Tax Savings on Employment	15
Impacts of Large Tax Savings on the Impending Capital Shortage	16
Impacts of Job Development Tax Credit on Federal Tax Revenues	17
Other Tax Factors Affecting Employment	18
Additional Observations	18
Conclusions	19

TABLE OF TABLES

1 - AT&T's Effective Federal Income Tax Rates	2
2 - AT&T Consolidated, Net Incomes before Federal Income Taxes and Current Federal Income Tax and Dividend Payments	3
3 - Effective Tax Rate for AT&T	4

TABLE OF FIGURES

Fig. 1 - FIT Liability	9
Fig. 2 - FIT Expense as Reported in the Income Statement	10

EFFECTIVE TAX RATES AND ECONOMIC STIMULATION--

A CASE STUDY USING AT&T

It is a basic tenet of microeconomics that there exists a balance between capital investment and labor. In other words, if the cost of equipment decreases and/or if the cost of labor increases, there is potential for economically justified substitution of equipment for labor. This idea is contained in the hypothesis that recent tax incentives such as the job development investment tax credit (frequently called the investment tax credit) and accelerated depreciation, when coupled with increasing labor costs such as FICA taxes, have resulted in increased unemployment through the substitution of capital equipment for labor.

The remainder of this article will, among other things, explore the effective federal income tax rates of AT&T and relate the findings to the above hypothesis.

Effective Federal Income Tax Rates of AT&T

The following is a year-by-year reflection of the change in AT&T's effective tax rates. These amounts were computed using 10-K and 12-K data as filed with the Securities Exchange Commission (SEC). The numerator in the computation is the current federal income tax provision and the denominator is the before-federal-income-tax net income as reported to shareholders. Both the numerator and the denominator were calculated excluding the income and federal income taxes of the 100 percent-owned Western Electric Company, Incorporated, because this company is not consolidated in the AT&T 10-K.

Table 1

AT&T'S EFFECTIVE FEDERAL INCOME TAX RATES
(In Thousands of Dollars)

Year (1)	Total Federal Income Tax Provision (excluding Western Electric) (2)	Current Portion of the Tax Provision (excluding Western Electric) (3)	Net Income before Federal Income Tax (excluding Western Electric) (4)	Effective Tax Rate (3 ÷ 4) (5)
1969	\$1,978,579	\$1,887,721	\$3,952,796	47.76%
1970	1,573,396	1,482,187	3,512,191	42.20
1971	1,433,130	989,364	3,376,749	29.30
1972	1,669,913	837,416	3,919,030	21.37
1973	1,962,985	931,617	4,640,936	20.07
1974	2,123,404	678,407	4,982,717	13.62
1975	2,174,088	129,102	5,214,502	2.48

A cursory analysis of this data shows a \$1,261,706,000 (\$5,214,502,000 - 3,952,796,000) increase in the before-tax net income figure for the year 1975 as compared to 1969 or a 32 percent increase over the 1969 income figure, while the current tax provision fell \$1,758,619,000 (\$1,887,721,000 - 129,102,000) or a 93 percent decrease from the 1969 current tax provision. In other words, as earnings before federal income taxes increased, the amount of federal income to be paid decreased by a larger amount than the increase in income. AT&T paid its lowest effective federal income tax rate in the years of

its record earnings. The following bar chart is just another way of showing this effect. Following the bar chart, the computation of the before-tax net income figure excluding Western Electric Company, Inc., is shown.

Table 2

AT&T CONSOLIDATED, NET INCOMES BEFORE
FEDERAL INCOME TAXES AND CURRENT FEDERAL
INCOME TAX AND DIVIDEND PAYMENTS

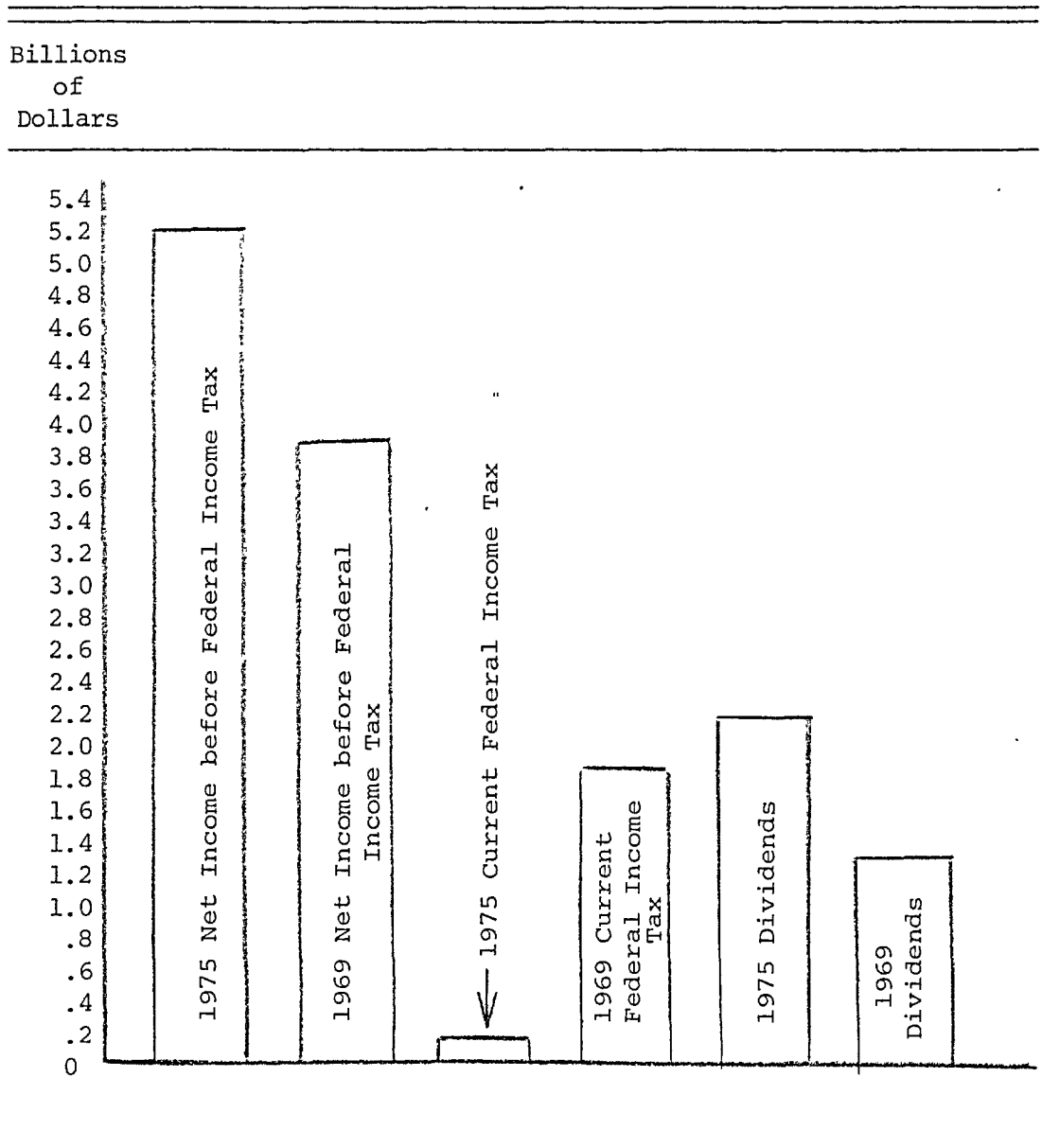


Table 3

EFFECTIVE TAX RATES FOR AT&T
(In Thousands of Dollars)

10-K and 12-K Data	10-K	10-K	From 12-K 1973		1969	
	1975	1974	1973	1972		
Net income	\$3,147,722	\$3,169,946	\$2,993,256	\$2,532,058	\$2,192,242	\$2,201,242
Plus back federal income tax provisions						
Current FIT provision	129,102	678,407	931,617	837,416	989,364	1,482,187
Deferred FIT provision	1,303,340	1,186,734	806,159	604,317	390,624	71,407
Job development credit increase in FIT provision	741,646	258,263	225,209	228,180	53,142	19,802
Subtotal, federal tax provisions	+2,174,088	+2,123,404	+1,962,985	+1,669,913	+1,433,130	+1,573,396
Total before-tax net income but including Western Electric on an after-tax basis	5,321,810	5,293,350	4,956,241	4,201,971	3,635,161	3,765,638
Less Western Electric net income after tax (included in the above net income figures under the equity method of accounting)	-107,308	-310,633	-315,305	-282,941	-258,412	-253,447
Total before-tax net income excluding Western Electric	5,214,502	4,982,717	4,640,936	3,919,030	3,376,479	3,512,191
Effective Tax Rate Computation (Current FIT provision ÷ Total before-tax net income excluding Western Electric)						
129,102 ÷ 5,214,502 =		2.48%				
678,407 ÷ 4,982,717 =		13.62%				
931,617 ÷ 4,640,936 =		20.07%				
837,416 ÷ 3,919,030 =		21.37%				
989,364 ÷ 3,376,749 =		29.30%				
1,482,187 ÷ 3,512,191 =		42.20%				
1,887,721 ÷ 3,952,796 =		47.76%				

Affected Federal Income Tax Rates as Reported to the SEC by AT&T

The use of the before-tax book income as the denominator causes all timing and permanent differences (differences between the before-tax book income and the taxable income) to impact on the effective tax rate. When companies such as AT&T report to the SEC on form 10-K, they generally reduce the statutory rate only for the tax effect of permanent differences and call the result the "effective tax rate." This is a true distortion of the English language whenever there are significant deferred taxes because of timing differences or amortization of tax credits. The word effective should not be permitted in such cases; the proper term would be affected tax rate. The following example displays the affected or so-called "effective tax rates" as computed by AT&T and contained in their 1975 10-K report in Note (a).

The effective Federal income["] tax rate as determined from the statements of income for the American Company [American Telephone & Telegraph] and its consolidated subsidiaries (Federal Income Taxes divided by the sum of Federal Income Taxes, Net Income and minority ownership interest in net income) was less than the Federal income tax statutory rate for each of the years shown, and the differences are attributable to the following factors: [Emphasis added.]

10-K 1975 Note (a) (continued)

	<u>1975</u>	<u>1974</u>	<u>1973</u>	<u>1972</u>	<u>1971</u>
Federal income tax statutory rate.....	48.0 %	48.0 %	48.0 %	48.0 %	48.0 %
1. Earnings applicable to investments in companies accounted for on an equity basis which are reflected net of income tax.....	(1.0)%	(2.9)%	(3.2)%	(3.3)%	(3.5)%
2. Certain taxes and payroll-related construction costs capitalized for financial statement purposes but deducted for income tax purposes, net of related depreciation adjustments for current and prior years...	(3.1)%	(2.7)%	(2.9)%	(2.9)%	(2.6)%
3. Interest charged construction which is excluded from taxable income, net of related depreciation adjustments for current and prior years.....	(1.6)%	(1.7)%	(1.7)%	(1.9)%	(2.3)%
4. Profits on telephone plant items purchased from Western Electric, a wholly-owned subsidiary, which are capitalized for financial statement purposes but not for tax purposes, and which reduce depreciation expense for tax purposes.....	.7 %	.7 %	.7 %	.8 %	.8 %
5. Amortization of investment tax credits over the life of the plant which gave rise to the credits.....	(2.1)%	(1.6)%	(1.2)%	(1.2)%	(1.1)%
6. Other miscellaneous differences between the calculations of taxable income and book income before taxes.....	<u>(.6)%</u>	<u>(.2)%</u>	<u>(.7)%</u>	<u>(.4)%</u>	<u>(.5)%</u>
Effective Federal income tax rate.....	<u>40.3 %</u>	<u>39.6 %</u>	<u>39.0 %</u>	<u>39.1 %</u>	<u>38.8 %</u>

It is interesting to note that the AT&T computation of "effective" tax rate shows an almost steadily increasing "effective" tax rate from 1971 through 1975. The method of reporting "effective" tax rates to the SEC allows a company to treat as currently paid the tax effect of all timing differences. Thus, in 1975 AT&T reported their "effective" tax rate using the total tax provision as the amount in the numerator of their computation as if this sum were the amount paid. The total tax provision is the sum of the current tax provision (\$129,102,000), the deferred tax provision (\$1,303,340,000), and the increase in the tax provision caused by deferral of the investment tax credit (\$741,646,000). The sum of these numbers is \$2,174,088,000 and, when divided by the before-tax net income (excluding Western Electric Co.) of \$5,214,502,000, produces a rate of 41.7 percent. This approximates the 40.3 percent "effective" tax rate computed by AT&T.

The difference between the 2.48 percent actual effective tax rate and the company's 40.3 percent affected rate can be explained another way. The excessive tax amounts in the company's calculations result from the use of the so-called comprehensive method of accounting for interperiod timing differences (primarily the tax effect of the excess of tax depreciation over book depreciation). If the flow-through method were used, the current tax provision would probably be the only figure shown as the federal tax provision. As a result, net income (after-tax) would be increased from \$3,147,722,000 to \$5,192,708,000. This \$2,044,986,000 difference is the result of recording the deferred

provision of \$1,303,340,000 attributable to depreciation differences and the increase in the ITC provision of \$741,646,000 as tax expenses. These amounts will never be paid to the U.S. government under the current tax law.

The decrease in the current portion of the total tax provision of AT&T is show below:

Table 4

CURRENT FEDERAL INCOME TAX PROVISION AS A PERCENTAGE
OF THE TOTAL FEDERAL INCOME TAX PROVISION
(excluding Western Electric)
(In Thousands of Dollars)

<u>Year</u>	<u>Current Federal Income Tax Provision</u>	<u>Total Federal Income Tax Provision</u>	<u>Current Provision as a Percentage of the Total Provision</u>
1969	\$1,887,721	\$1,978,579	95.4%
1970	1,482,187	1,573,396	94.2
1971	989,364	1,433,130	69.0
1972	837,416	1,669,913	50.1
1973	931,617	1,962,985	47.5
1974	678,407	2,123,404	31.9
1975	129,102	2,174,088	5.9

Factors in the Numerator of the Effective Tax Rate Computation

The current tax provision of many, if not most, U.S. corporations contains a paid or accrual for anticipated tax deficiencies in case of an audit by the Internal Revenue Service. The change in the amount of this accrual, if it is a net increase, would result in a larger current tax provision than is actually paid or payable per tax return. Thus, any significant increase in this "reserve" can produce an effective tax rate greater than that reflected using actual before-audit tax return data.

In addition, whenever subsidiaries such as Western Electric are consolidated for tax return purposes but are accounted for in financial reporting under the equity method (which reflects only the net income of the subsidiary company), distortion in the current tax provision as compared to the tax return can result. The following is an example of the possible effects on a parent company's financial statements. Assume the parent has one subsidiary which it accounts for under the equity method but includes the subsidiary in a consolidated tax return and that the tax rate is a flat 50 percent.

	<u>Before-tax Book Income</u>	<u>Taxable Income</u>	<u>Current Tax at the Assumed 50% Rate</u>
Parent (without any income from the subsidiary)	\$300	\$130	\$ 65
Subsidiary	<u>100</u>	<u>(150)</u>	<u>(75)</u>
Totals	<u>\$400</u>	<u>\$(20)</u>	<u>\$(10)</u>

Figure 1. FIT Liability

While the consolidated tax return would reflect a \$10 tax refund, the parent company's current tax provision would be \$65 in the annual report to shareholders and, if there were no permanent differences between book and tax, the deferred provision would be \$85 [(\$300 - 130) x 50%]--a total provision of \$150 (50% x \$300). Assuming there are no permanent differences between the pretax book net income and taxable income figures and assuming the AT&T approach is used, the parent company would show the following:

Book income before tax and subsidiary earnings	\$300
Current FIT (50% x \$130)	\$65
Deferred FIT (50% [\$300 - \$130])	<u>85</u>
Total FIT expense	<u>-150</u>
	\$150
Equity method income from subsidiary after tax (\$100 - 50% x \$100)	<u>50</u>
	<u>\$200</u>

Figure 2. FIT Expense as Reported in the Income Statement

An analysis of the parent company's effective tax rate would represent a division of \$65 by \$300 yielding a 21.7 percent effective tax rate when, in effect, the consolidated companies had a tax refund of \$10.

This example is similar to the AT&T and Western Electric problem except that the tax refund allocated to Western Electric was less than the tax provision allocated to AT&T. Nevertheless, it does reduce the AT&T effective tax rate from 2.48 percent to 2.31 percent when Western

Electric data is combined with AT&T data for 1975. Western Electric was allocated a refund of federal income tax of \$4,291,000 for 1975 which reduced AT&T's total current tax to \$124,811,000 (\$129,102,000 - \$4,291,000). When this is divided by the before-tax net income including Western Electric of \$5,400,112,000 (\$5,214,502,000 + \$185,610,000 before-tax net income of Western Electric), the result is an effective tax rate of 2.31 percent for 1975.

Cause of Change in Effective Tax Rates from 1969 to 1975

This change from 47.76 percent (1969) to 2.48 percent (1975) is due in large part to two basic factors. First, the tax laws affecting both the job development tax credit and accelerated depreciation have been greatly liberalized especially for public utilities (which includes AT&T). Secondly, beginning in 1970 the company had changed methods and useful lives in computing depreciation for tax purposes while retaining the straight line depreciation method and full useful lives for financial reporting. This is the cause of the deferred tax as shown in prior tables.

Tax changes impacting on the job development tax credit

The Tax Reform Act of 1969 terminated the investment tax credit; which for public utilities had been set in 1962 at 3 percent of qualified investment. This termination was not retroactive on orders for equipment; thus, it reduced the growth in unamortized investment credits for AT&T from \$90,858,000 in 1969 to \$19,802,000 in 1970 (per AT&T 12-K data for 1973). The Revenue Act of 1971 brought back the investment tax

credit but renamed it the job development investment credit. Economist Robert Eisner, in a newspaper article entitled "A Way to Create Jobs: Cut Payroll Taxes," stated,

The equipment tax credit has even, strangely, been labeled a "job development credit," although among its effects must certainly be some inducement to substitute machinery for labor.¹

In the process of resurrecting the credit, the rate for public utilities was increased from 3 to 4 percent. Perhaps more important than the increase in the rate was the addition of tax provisions which preclude a state regulatory commission from passing on to customers of the public utility this decrease in tax expense.

The Tax Reduction Act of 1975 brought a 250 percent increase in the rate of the job development credit for public utilities from 4 to 10 percent of qualified investment. With the prior hamstringing of state regulatory commissions in 1971, this was a very significant increase. This is reflected in AT&T's increase in amounts of tax provision associated with the job development credit which were \$741,646,000 for 1975 and only \$258,263,000 in 1974.

Tax changes impacting on the depreciation deduction

Accelerated depreciation methods were first permitted in 1954. In 1962, useful lives for most property were greatly reduced. In addition,

¹Robert Eisner, "A Way to Create Jobs: Cut Payroll Taxes." New York Times, August 17, 1975. Reprinted in Encouraging Capital Formation Through the Tax Code, testimony before the Task Force on Tax Policy and Tax Expenditures and the Task Force on Capital Needs and Monetary Policy of the Committee on The Budget, U.S. Senate, Committee Print, 94th Congress, 1st Session, p. 117.

a flaw in the 1962 guideline depreciation rules permitted, in effect, the redepreciation of fully depreciated assets with the allocation of these amounts to other assets not yet fully depreciated. This error, the use of open-ended group depreciation accounts, was gradually corrected beginning in 1965.

Starting in 1969, the period we are currently analyzing, there were several significant changes which affected AT&T. First, the Tax Reform Act of 1969 prevented the state regulatory commissions from forcing a public utility to pass the tax savings resulting from accelerated depreciation methods on to its customers. In the Revenue Act of 1971, the so-called Asset Depreciation Range (ADR) provisions were legislatively enacted. This further decreased useful lives of most assets. The ADR regulations permit the expensing of the cost of removing certain assets even when the income on the sale of these assets is not recognized as income. AT&T, through a private letter ruling, was able to extend this treatment to assets placed into service prior to ADR. But perhaps the most significant ADR change of all eliminated the reserve ratio test, a test for determining whether useful lives for depreciation purposes were realistic.

Changes resulting from changed depreciation methods and lives

AT&T's decision to change its depreciation methods and lives for federal income tax purposes was not made until 1970 when they received, in the Tax Reform Act of 1969, the legislative provisions which prevented state regulatory commissions from passing the tax savings on to their

customers. The resulting growth in AT&T's deferred tax account because of depreciation differences is shown below:

Table 5

AT&T TAX SAVINGS BECAUSE OF DEPRECIATION DIFFERENCES

Year	Depreciation Difference	Unpaid Tax Expense Due to Depreciation Differences
	(In Thousands of Dollars)	
1969	-0-	-0-
1970	\$ 71,407	\$ 71,407
1971	390,624	462,031
1972	604,317	1,066,348
1973	806,159	1,872,507
1974	1,186,734	3,059,241
1975	1,303,340	4,362,581

At this growth rate, the cumulative amount will exceed \$10 billion by 1980.

It is interesting to attempt to compare these figures to the taxes that AT&T might have saved from 1954 through 1969, had they chosen to do so. Had the potential tax savings for this 16-year period (1954 through 1969) equalled \$10 billion, then residential and commercial customers of AT&T would have in effect been overcharged for the cost of service by at least \$10 billion. In fact, the amount could be almost double, or \$20 billion, because of the additional tax savings achieved

by reducing revenues in order to pass on the initial tax savings due to depreciation deductions. The fact that AT&T chose to charge its customers billions of dollars in federal income taxes which could have been legally avoided shows gross disregard for the well-being of its customers. AT&T acted as a conduit through which higher than necessary costs for telephone service were passed from customers on to the federal government in the form of taxes which could have been avoided. In the meantime, AT&T was lobbying for control of state regulatory bodies such that a choice to minimize taxes could be made without the state regulatory commissions having the power to pass on the savings to AT&T customers. This was achieved in the Tax Reform Act of 1969 and was based largely on the idea that if the entire tax savings were passed on to the customers there would be, as noted before, a doubling up of the federal revenue loss and the direct stimulation of a tax reduction would be lost to regulated companies.

"

Effect of AT&T's Tax Savings on Employment

With tax savings of \$4,362,581,000 due to increased tax depreciation and tax savings of more than \$1,526,242,000 in job development and investment tax credits from 1970 through 1975, should increased employment result? In other words, AT&T received over \$5,888,823,000 in six years from the federal government in tax savings. During this six-year period AT&T's before-tax earnings, excluding Western Electric, rose from \$3,512,191,000 for 1970 to \$5,214,502,000 for 1975, an increase of 48.5 percent.

AT&T's September 15, 1976, third quarter letter to shareholders stated that:

Evidence of the Bell companies' improved productivity is the fact that today--with no more employees than a half-dozen years ago--we are handling 53 per cent more business, serving 16 million more telephones and completing 60 per cent more long distance messages. In 1970, the Bell companies employed 83 people for each 10,000 telephones they serve. Today that number is 63.

It certainly appears that the foregoing of about \$6 billion of tax dollars has not resulted in one net job increase at AT&T. Perhaps this example of substitution of capital equipment for labor could account for some of the growth in unemployment during periods of inflation and business expansion.

Impacts of Large Tax Savings on the Impending Capital Shortage

Not long ago many people were predicting massive capital shortages-- a \$650 billion figure was mentioned for the U.S. alone. Where are these shortages? Today there is, if anything, just the opposite--an abundance of investment capital. This is reflected in the September 1976 Economic Report from Manufacturers Hanover Trust:

A matter of discussion for the past many years has been the possibility of an impending worldwide capital shortage. The very high levels of interest rates in recent years would tend to support the validity of this concern. However, the actual facts suggest that the record high interest rate levels were due more to inflation and the effect that inflation has upon interest rates than to an absolute shortfall of capital supply against the demand for capital. In fact, presently there is an ample supply of financial capital in the world capital markets. Interest rates have been trending lower, particularly in those parts of the world where inflation has become less of a concern, and there is nothing in view at present that would suggest that the downtrend in long-term money rates will be reversed. [Emphasis added.]

But the fact that financial capital is readily available to finance necessary construction apparently is not a sufficient reason to generate potentially needed real investment outlays. It is quite an anomalous picture both in the U.S. and abroad. As noted, capital investment has been lagging around the world, while at the same time the ample supply of financial capital has been instrumental in bringing long-term interest rates down but such rates still remain unusually high by any historic precedent. Side-by-side with this is the fact that labor force unemployment rates in most developed countries are holding at unusually high levels and the standard forecast is that employment will remain high for an indefinite period ahead.

With the combination of tax savings from depreciation and the job development tax credit--approximately \$6 billion to AT&T alone since 1970--there should be little wonder that AT&T's need for additional capital has greatly decreased as has that of many other U.S. corporations.

Impacts of Job Development Tax Credit on Federal Tax Revenues

This law, a part of the Tax Reform Act of 1976, made the temporary increases in the job development tax credit of the Tax Reduction Act of 1975 effective for years through December 31, 1980. It also changed the order of applying past credits to the pre-credit tax liability and increased from 50 to 100 percent of the amounts of tax liability which railroads and airlines can offset with these credits. Before these changes, the Committee on the Budget of the United States Senate received data (published as a committee print in March 1976) indicating revenue loss in excess of \$5.8 billion for 1975 for the job development investment credit and a projected loss in excess of \$9.1 billion for 1977. These 1977 estimates may have to be revised upward for the 1976 changes.

Of the estimated \$5.8 billion revenue loss, \$4,860,000,000 was attributed to corporations. Of this, \$854,189,000 (\$741,646,000 + \$112,543,000 amortized credit) went to AT&T. Thus, AT&T received 17.6 percent of the total corporate tax revenue loss from the investment (job development) tax credit in 1975, and AT&T did not provide any increases in jobs.

Other Tax Factors Affecting Employment

While corporations have been given huge incentives to buy capital equipment, Congress has increased the cost of labor significantly. Social security sector tax receipts in the federal budget have increased over 600 percent since 1962. In fact, in the federal budget for fiscal year 1977 these taxes are about 2-1/4 times the corporate income tax collections when, as late as 1966, corporate income tax collections exceeded the social security sector taxes.

Through tax changes Congress and the Executive branch of government have thus greatly reduced the after-tax cost of equipment and significantly increased the cost of labor. With these changes working in the same direction, some substitution of automated equipment for labor must be taking place which would not otherwise have been made.

Additional Observations

With some corporations paying real effective tax rates of over 30 percent, there is almost as much inequity in the corporate tax as in the individual tax. The fact that AT&T was virtually free of federal income tax in the year it reported its highest before-tax net income is an example

of the results of lobbying and the lack of concern for tax equity in Congress and especially in the Senate Finance Committee. It is exasperating to note that AT&T's effective income rate was even lower than the federal excise tax rate added to everyone's telephone bills. The fact that a \$6 billion federal tax revenue loss to AT&T took place without causing AT&T to employ a single additional employee may also be a reflection of what is wrong in Congressional planning and the trickle-down theory.

Perhaps the Revenue Act of 1962 contains the total story of corporate lobbying efforts and results. This act now permits corporations to deduct the cost of lobbying to achieve favorable tax provisions. Thus, lobbying for more central planning is partially paid for through saving of tax dollars because its cost is now deductible.

Conclusions

Obviously, a one-company case study, even if it is AT&T, is not conclusive evidence. The question of substitution of capital for labor and the tremendous shifts in the tax burden through changes in the social security tax need in-depth analysis. It is perhaps too early to rename the investment tax credit the job elimination credit, but the early returns appear to be in that direction. It certainly appears that for the \$6 billion of tax expenditures to AT&T the country received little, if any, benefit.